EXECUTIVE RISKS: A BOARDROOM GUIDE 2010/11

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Foreword

We are delighted to be publishing the second edition of Executive Risks – A Boardroom Guide in association with WIllis Limited.

Bringing together contributions from leading legal practitioners in 20 jurisdictions worldwide, as well as special focus chapters dealing with specific issues that are important to executives as they consider the risks they face, this publication has been designed to provide readers with a guide to developments affecting executive risk .

The focus is on recent developments. Our country correspondents have set out to identify significant changes in local regulation and case law which impact – or look likely to impact – the risk exposures of directors. Based on first-hand practical experience, their analysis addresses the key trends in this fast-evolving field.

We would like to thank them for the considerable time and effort which they have invested in this publication. Their contribution has been invaluable. We would also like to express our gratitude to Willis Limited for its support throughout this project.

The following editorial does not purport to provide exhaustive coverage of the subject – instead, its intention is to direct readers towards the principal areas of practical concern. The views expressed are those of the authors and the reader's attention is drawn to the disclaimer on the inside front cover of the publication which explains the scope of the guide and liability.

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INTRODUCTION

Mark Wakefield, Executive Director,
FINEX Global, Willis Limited

Willis Limited, Registered number: 181116 England and Wales. Registered address: 51 Lime Street, London, EC3M 7DQ.
A Lloyd's Broker. Authorised and regulated by the Financial Services Authority.

Willis is delighted to present the second edition of *Executive Risks – A Boardroom Guide 2010/11,* which we hope that the reader will continue to find an informative and invaluable reference tool for exploring directors' duties and the risks they may incur should breaches of those duties take place.

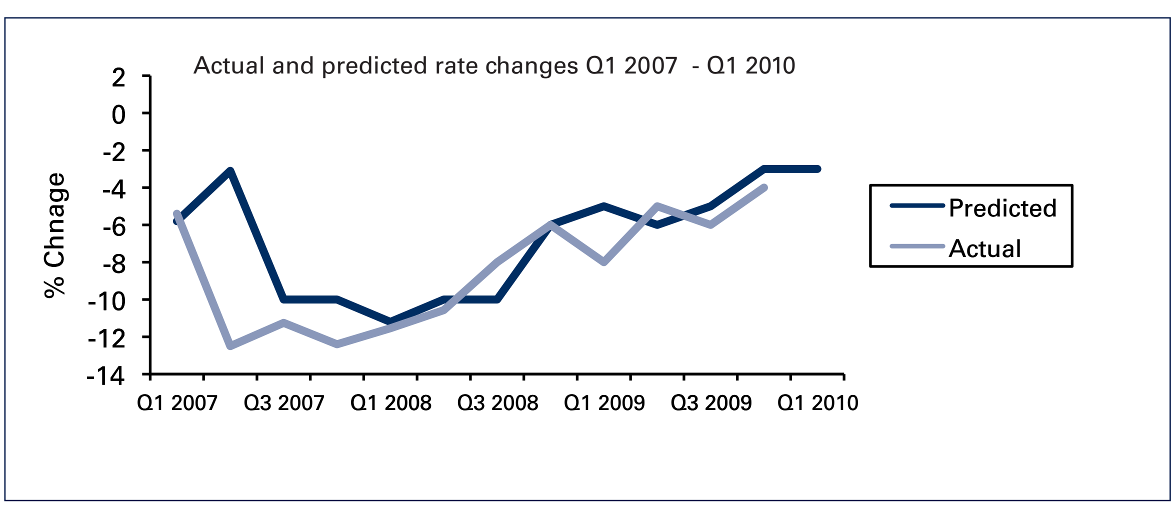
Since publication of the first edition in 2007, the global economy has witnessed volatility and upheaval unprecedented since the middle of the last century. As a consequence, the regulatory landscape continues to change rapidly, and we are seeing regulators with increased powers and increasingly willing to use them. The stress on accountability in all jurisdictions places new and additional duties and responsibilities on directors and executive officers. There are increasingly onerous fines, penalties and in some cases even custodial sentences for those that neglect to ensure that they understand and comply with those duties. The global nature of the financial crisis brought home the fact that no director can afford to view the world from a single jurisdiction. Today more than ever, they are vulnerable to claims that may be brought in any jurisdiction in which their business operates.

The aim of this guide is to set out the topics that should be uppermost in the minds of directors operating in 20 countries around the world. Each chapter is written by a legal expert in that particular country and examines key features of corporate governance, relevant developments in legislation, the role of regulators and the developments in the nature of claims and claimants with a particular bearing on directors and officers.

We have asked each contributor to highlight the issues that they believe to be the most pertinent and explore the future developments that could create problems for company directors and for which they therefore need to make sure that they plan and prepare accordingly. It's clear that it is not possible to take a fixed view of the legislation relating to directors' liabilities. Change is the name of the game. The debate about how to marry the need for strong governance and protecting investors' interests with the need to promote a healthy competitive marketplace that is as free as possible continues unabated.

In this edition we have also included some special focus chapters that deal with broader topics that all directors need to be aware of. These include coverage of risk management, the impact of government investigations, cross-border risks, regulatory cooperation and powers and recent cases of note. Many of these issues apply universally, regardless of jurisdiction and further reinforce the view that operating successfully in a global economy requires company directors to understand the risks they face as well as the undoubted benefits that globalisation creates.

Overall, the D&O insurance market remains challenging for financial institutions since they have been primarily the focus of the subprime crisis, while in the commercial arena things are more stable. Nevertheless, as we have seen from events following the collapsed dotcom bubble, declining markets and weakened balance sheets create an environment where the potential for claims against directors of companies across the industry spectrum is heightened. A company's ability to manage risk effectively continues to grow in importance and those businesses that are able to differentiate the risks they face and communicate them effectively to their investors, as well as to their insurers, will be rewarded with enhanced pricing and coverage.

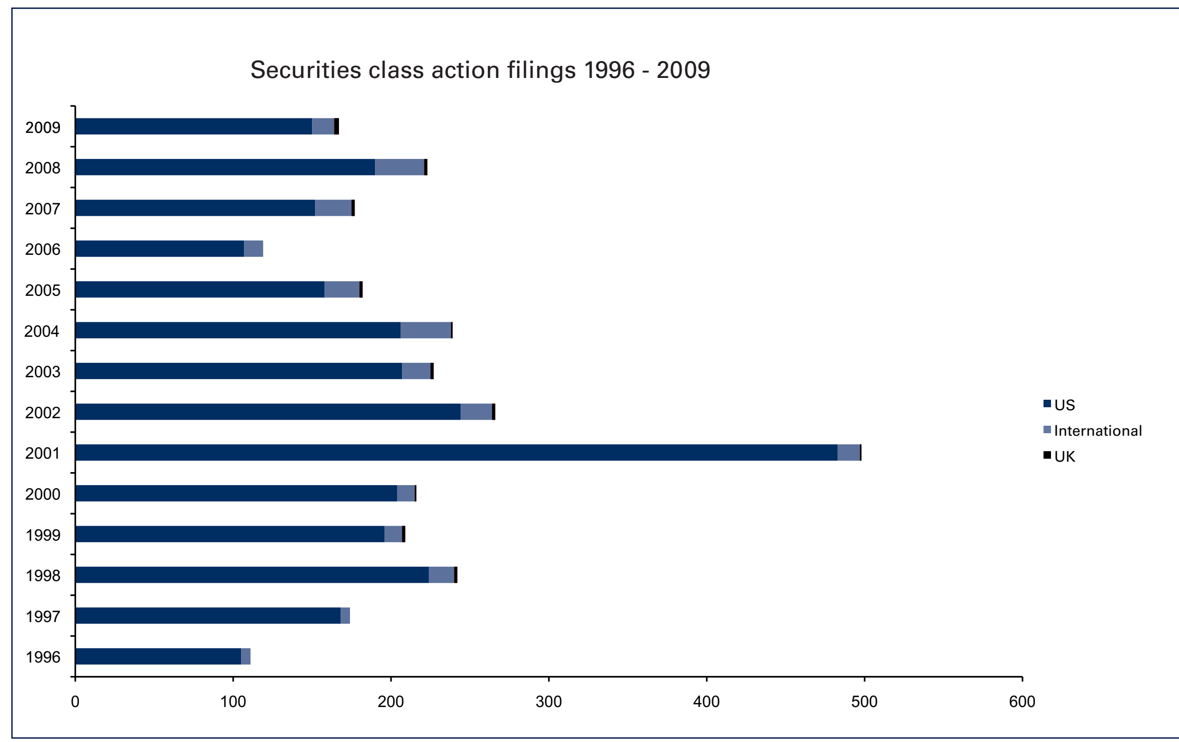


The broker's perspective

From the broker's perspective there have been a number of significant developments in the three years since the first edition of this guide was published. While it is beyond the scope of this introduction to provide a detailed and exhaustive of all these changes, below are outlined some of the most significant developments that have a direct bearing on the roles and duties of directors and officers of all companies and the consideration of the protections available to them.

Claims overview

Directors and officers around the globe increasingly risk being sued for accounting irregularities; issues arising from mergers

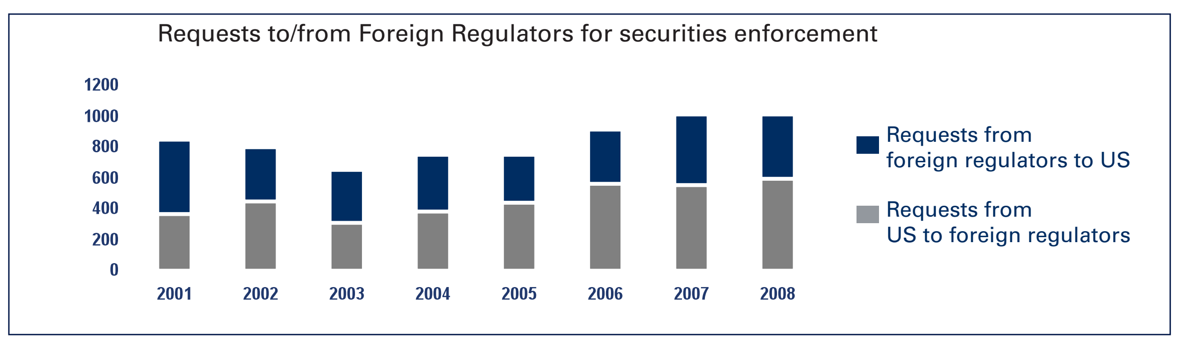


and acquisitions (M&A) and insolvency proceedings; employment-related claims; and breaches of health and safety legislation, environmental laws, and competition regulations.

As always, we must look to the USA as the most litigious global environment, where companies face significant exposure if their securities are traded there. The last couple of years have seen a significant spike in the number of class actions with the average number of actions filed during the period 2007-2009 being some 60% higher than in 2006. Many of the claims filed during this period are currently pending, however, given the size of some of the financial institutions and other companies which have been targeted, there is good reason to assume that the average settlement amounts of these claims is also set to be higher than in previous years.

From the international perspective for the same period, the average number of non-US companies which were the subject of class action filings was 14% of the overall total – continuing a trend since 2004 that has seen a significant increase in filings against international companies. During this period there were two mega-settlements against European companies, with Royal Dutch Shell settling for $123m and Parmalat for $90m.

Another emerging trend in recent years has been the greater appetite of regulators globally in identifying and prosecuting companies and their directors for breaches of competition and securities regulation. Overall, there is a growing appetite for increased and improved enforcement, and this can be seen at a local level in just about any jurisdiction. What is interesting is the increased cooperation between regulators on an international basis. For example, the SEC has published data on inward and outward requests for securities enforcement assistance, and during 2008 there were over 1000 such requests made (about 60% outward, and 40% inward). We expect to see this trend continue and companies should be clear about the scope and clarity of the cover they have under their policies for investigations and enforcement proceedings.



Sub-prime

The subprime crisis has had a major impact on the claims environment for financial institutions' directors and officers. They are in many ways operating in a world that is changed irrevocably from the pre-crisis environment and will unquestionably be subject to greater regulation and supervision as a result of governments' resolve to try and ensure that a similar crisis does not unfold again. High-profile claims against directors and officers of those institutions have driven a significant increase in rates across the financial sector. For businesses in other sectors the impact of sub-prime has not manifested itself so clearly in higher rates, although the length and depth of weakened financial environment over the coming years is certain to add pressure to companies which are struggling to deliver returns to their shareholders. The insurance market therefore remains sceptical, if not downbeat, on the future claims environment, since historically there has always been a strong connection between periods of financial instability and increased focus on the actions of company directors.

The emergence of collective redress mechanism in Europe

Perhaps the most important legal development for businesses operating outside the US is the move towards collective redress mechanisms in some European jurisdictions. The development of an equivalent to US class actions has long been discussed. The imbalance between the actions available in the US and those to which EU security-holders have access raises some challenging questions about respective access to justice for investors on either side of the Atlantic. While critics of US class actions point to the perceived excesses of the US system – including vast awards made by juries, frivolous claims and a system that encourages an aggressive plaintiffs bar – concerns about the imbalance are driving more urgent calls for similar mechanisms to find their way into the European legal landscape.

The development of specific legislation in a number of EU countries has now made that a reality. While these are presently largely limited to consumer claims, it seems inevitable that they will provide a framework for extending mechanisms for collective redress to investor actions. Directors and executive officers should monitor these developments carefully.

Germany, the Netherlands and Sweden have all developed some legal mechanisms for taking what are *de facto* class actions, though the provisions and conditions for the type and scope of action in each country vary significantly. The European Commission has been debating the use of mechanisms for collective redress and has issued a white paper and commissioned research. The main area of concern for the Commission is antitrust, but principles that underpin any legislation that arises from those deliberations are likely at some point to translate into the investor litigation arena.

Representations and severability of D&O insurance contracts

The insurance market has made important strides forward on this issue in recent years, ensuring that D&O policies are appropriately drafted to the cover provided. Historically, it has not been uncommon for policies to stipulate that the application for cover, as well as any financial statements submitted therewith, are the basis of the contract. In some jurisdictions, this has the effect of creating warranties as to the accuracy of the information in the application, as well as the financial statements. Clearly this is not a favourable situation given that one of the main sources of D&O claims is for misrepresentations in a company's financial statements and other public communications. Today, it is more common for policies be non-rescindable for anything other than fraudulent misrepresentation by an individual, and to have very limited imputation of knowledge between the persons insured under the policy and the company itself.

Scope of the conduct exclusion

The conduct exclusion is another area which has developed meaningfully in recent years and is one that companies should discuss with their broker to ensure that it is appropriately drafted to their needs. It is usually possible to limit the application of this exclusion to 'intentionally fraudulent' conduct rather than conduct which, although wrongful, has arisen from negligence rather than an intention to deceive. Recently, many insurers have clarified that the exclusion will only apply if there is a finding of fraud in the underlying claim, as opposed to in a separate or parallel proceeding such as a declaratory proceeding brought by the insurer, and that it will only apply after a final, non-appealable finding against the insured person. In reality, this will create considerations for companies about how far they wish the policy to stand behind a director who they feel has acted inappropriately, since policy limits could be eroded by a lengthy appeal process, and some companies may prefer an earlier limitation to cover such as an admission by an insured person that they have acted in a fraudulent way, even if they subsequently wish to continue their defence of a claim.

Scope of investigations cover

As discussed above, international cooperation and information sharing between regulators in different jurisdictions is becoming increasingly common. Investigations are becoming an increasingly common source of claims under D&O policies, and it is essential to ensure that the policy contains an appropriate level of cover for these types of claims. In the first instance, companies should be clear whether their policy provides cover only for investigations of directors personally, or whether cover will also be available for situations where a director is asked to attend an investigation into the affairs of the company, since it is likely that a director will want to have the benefit of legal representation in such situations. Additionally, it is important to

review the triggers for cover under the policy – for example, will the policy only respond once a director has been subpoenaed or will cover be available following a 'request' to attend an investigation – including a request to interview or supply information? The answer to these questions can ultimately play an important role in securing cover and making sure that a director has the appropriate representation at an early stage of an investigation, which may help mitigate their ultimate exposure to claims. ■

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ARRANGING EFFECTIVE D&O COVER

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Davies Arnold Cooper

The rapid growth of international trade experienced in the last 60 years has been both a primary cause and effect of globalisation. According to World Trade Organisation figures, the volume of international trade since 1950 has increased twenty-fold. For directors and officers involved in international businesses, the risk of claims from unfamiliar jurisdictions has become almost immeasurable. Equally, arranging effective D&O cover to protect against this risk on a consistent basis worldwide has become ever more difficult. This chapter considers some of the problems that insureds encounter.

The buying process: the difficulty of making a fair presentation

Any application for D&O insurance asks for all pertinent information about the company applying for insurance, including financial information about a company and any subsidiaries, claims history, and knowledge of problems which may lead to claims. Underwriters see the questions dealing with potential claims or circumstances as one of the most significant features of the application form. The signatory will usually be required to warrant that no such potential claims or circumstances exist. If the answers are not complete and accurate, underwriters may have grounds for avoiding the policy. For any large global company, the collection of accurate information for this purpose is obviously problematic. For instance, consider a risk manager or director of a Europe-based company responsible for buying insurance which has subsidiaries in the US. Will the warranty be complied with if it is not disclosed that a senior office holder in the US has read in the *Wall Street Journal* that investors are considering filing an SEC action? Possibly not. The potential SEC action could amount to or indicate a problem that could lead to a claim such that it should be included in the application form. Such knowledge may be deemed known to the company even if the Europe-based risk manager is completely unaware of the problem: it may be no defence to say that no-one in the European operation was actually aware of the US problem.

For smaller businesses it may remain a satisfactory solution to require each individual to consider the application form or be asked specific questions designed to elicit the relevant information. For larger and more complex businesses, this may not be a satisfactory solution. Although, through case law that has developed it is not every employee's knowledge that will be relevant, the presence of policy language designed to specifically address this problem is becoming more common.

One way that this is increasingly being dealt with in the market is to include a clause in the policy which specifically identifies who will be responsible for collating information for inclusion in the application form and whose knowledge will be attributed to the company – sometimes referred to as a 'responsible person' clause. Insureds should be aware of whose knowledge is relevant for the purposes of making presentation to insurers.

Warranties

It is frequently the case that an application form and subsequently the policy itself will seek assurances of the accuracy of particular facts. For D&O cover this is often related to particular financial statements.

When completing the application form, it should be remembered that, for instance in the US, securities fraud lawsuits are frequently based upon a contention that publicly filed financial statements were intentionally or recklessly misleading. Policyholders should therefore apply caution when making representations or warranties in the application or the policy which incorporate by reference previous publicly filed financial statements.

Circumstances: before a claim arises

D&O policies issued in the London market are written on a claims made basis. The trigger for coverage is therefore the making of a claim against the insured within the period of insurance irrespective of when the incident giving rise to the claim happened. This is however subject to the requirement to notify insurers of 'circumstances'. Most policies will include an obligation on the insured to notify its awareness of a 'circumstance' that could give rise to a claim, within a stipulated time period.

With the onset of the recession and near collapse of well-established banking systems, combined with the revelation of frauds, business failure, and poor business judgement reaching unprecedented levels, we have seen nervous insureds in finance and banking sectors increasingly notifying more general and broad circumstances to insurers. A well-advised insured should have in mind the necessity to balance its obligation to give full disclosure both at the time of buying insurance and when making claim notifications under the policy on the one hand, with the desire not to increase unnecessarily the appearance of risk or cause insurers concern. There are a number of factors that an insured should take into account before going down this route.

Recent decisions of the English courts have confirmed that what constitutes a notifiable circumstance is purely a question of fact. If the existence of a circumstance is established, the character of that circumstance must be one that may/could/is likely to (depending on the policy requirement) give rise to a claim. It follows that a notification of a specified event (eg the collapse of Bernard L Madoff Investment Securities LLC), with no details of how this may lead to claims against directors for this particular insured, would not be regarded as a notification but merely as a 'newsflash' of information in the public domain. This does not, however, mean that it should not be notified. The Court of Appeal (in the *Kidsons* case) recently held that where a notification provision imposes a fairly loose and undemanding test, the notification should be 'fair, comprehensive and comprehensible'.

What is actually being notified and whether it is likely to give rise to a claim will, however, be judged objectively (ie what a reasonable recipient of a notification would think was being notified and whether the reasonable person believes that might

lead to claims). Whether or not as the insured you 'genuinely believe' that you will face claims is irrelevant.

If 'awareness' of a circumstance is what is being notified, an insured's state of mind is nevertheless relevant to determine the extent to which it is aware (and hence capable) of notifying. If an insured is unaware of a circumstance it cannot notify it; an insured therefore needs to be able to point to facts which support its conclusion that there is a circumstance.

Where the notification is necessarily vague and ambiguous, the insurer may respond in one of three ways:

- *Communicate a rejection*: the insurer may reject the notification. If this is the insurer's response, an insured may still challenge the rejection
- *Say nothing*: the insurer may remain silent as to the scope of the notification. If a claim later arises, the insurer may then argue that the claim cannot possibly be linked back to the vague notification
- *Challenge the notification and make further enquiries*: the insurer may try to extract further information from the insured to understand the scope of the notification by asking questions (under a reservation of rights as to its validity) . For example, the insured may be asked to identify:
  - i) The nature of the wrongdoing which might be the subject of a claim
  - ii) The potential claimant(s); and
  - iii) The loss which might be claimed. The scope of the notification will be limited to matters of which the insured is aware.

Overall, it is probably safer for insureds to notify their knowledge of the claim, even if it is vague. Although further questions may be asked by insurers to limit the scope of the notification, insureds should provide continuous information in relation to the claims/circumstances notified as soon as it becomes available.

A well-advised insured should have in mind the necessity to balance its obligation to give full disclosure with the desire not to unnecessarily increase the appearance of risk or cause insurers concern.

Notification of a claim: conditions precedent

As stated above, for D&O policies the trigger for coverage is the making of a claim against the insured within the period of insurance irrespective of when the incident giving rise to the claim happened. The third-party claim must also be notified under the policy to insurers. Sometimes this is a requirement that must be strictly complied with in order for cover to be effective. This is the case where the notification provision is properly classified as a condition precedent. Under a claims made cover such as D&O, notification clauses are often drafted as conditions precedent. Under English law, this means that if an insured fails to notify a claim strictly in accordance with the notification provision, insurers will have a complete defence to the claim. However, other jurisdictions do not necessarily treat such clauses in the same way. In some jurisdictions, particularly in civil law countries, the insurers would still have to prove they have suffered prejudice as a consequence of the breach of the notification provision.

As such, an insured should familiarise itself with the notification provisions in the policy and the time frames for notification of a claim and have processes in place to ensure claims are notified in accordance with those obligations.

Defence costs

It is often the case that directors and officers are as interested in defence cost cover as they are an indemnity for a finding of liability against them. Often proceedings that are commenced against directors and officers include allegations amounting to criminal offences. Things can become extremely difficult where a number of directors and officers are implicated in the alleged illegal activities. The dispute that arose out of the actions involving Allen Stanford is illustrative.

Last year James Davis, the CFO of two Stanford entities, pleaded guilty to various charges, submitting statements, with supporting documents, implicating his co-defendants in a wide range of illegal activities. On 26 January 2010, in Houston, Judge Hittner ordered D&O insurers to continue paying the defence costs of Stanford directors in the Securities and Exchange Commission ('SEC') and criminal proceedings under the D&O policy.

In 2009, the SEC initiated an action against Allen Stanford and others. Allegations concerning the alleged Ponzi scheme included falsification of financial statements to investors who purchased $8bn worth of certificates of deposit whose large returns turned out to be fictitious.

Following the guilty plea of the Stanford Group CFO, D&O insurers declined cover for the defence costs being incurred in the SEC and criminal actions. Insurers did not rely upon the fraud exclusion which excludes cover for loss resulting from a claim brought about by any dishonest, fraudulent or criminal act. A fraud exclusion of this type requires some form of adjudication which determines the existence of fraud. That was the case with the Stanford policy and it was inevitable that insurers conceded that, under US law, until there has been an adjudication in the underlying proceedings, this exclusion has no application.

Insurers did, however, rely upon the money laundering exclusion which excludes cover for loss 'arising directly and indirectly as a result of or in connection with any acts (or alleged act or acts) of money laundering…' and states insurers are obliged to pay defence costs until 'such time it is determined the alleged act or alleged acts did in fact occur'. This exclusion has no 'adjudication' requirement and insurers argued they were in a position to determine there had been money laundering.

The judge concluded the directors would suffer 'real, immediate and irreparable harm' if they were not able to pay their defence costs and the insurers' position would require the directors to prove their innocence in the underlying proceedings before obtaining cover for defence costs, which they needed to defend themselves in those actions. This contravened the very purpose of the policy.

The insuring clauses which determines the scope of cover available can be relevant and should be subject to inspection before insurance is purchased. By reference to an example we have seen in Spain, if the insuring clause refers specifically to 'negligent wrongful acts' then D&O insurers can defeat claims even for advancement of defence costs if the crime being alleged can only be committed fraudulently. In emerging markets, where D&O insurance is to some extent new and the first disputes have started to arise, the issue in Stanford is untested. What we can predict is that the result will not be the same in all jurisdictions. Although such specific issues are untested in emerging markets, in civil law countries, such as Brazil for example, the approach in Stanford may be followed to reflect one of the country's main constitutional principles that 'no-one shall be considered guilty prior the issuing of a final penal adjudication'.

Many of the problems that occur when buying and making claims under D&O and other liability insurance arise because of inconsistencies between the laws and regulations in different jurisdictions.

In England, Judge Hittner's sympathetic finding for the directors may not automatically be followed. English courts may be open to arguments over the type of 'adjudication' that is required to satisfy a typical fraud exclusion. Although US law is already clear on the point, it requires an adjudication in the underlying proceedings, under English law, the courts will look at the contractual wording to determine what cover was intended – and, on the face of it, such an exclusion does not preclude insurers seeking an adjudication in the civil courts if the evidence of the insured's criminality is obvious. In England, where evidence of crime is sufficiently strong, whether D&O policies automatically respond is an issue which is currently untested.

Convergence

In the last decade or so, many commercial insureds have taken advantage of the opening of previously closed markets to sell their products overseas. Likewise, insurance companies have broadened their coverage to include these overseas markets in order to accommodate insureds that are developing internationally. Many of the problems that occur as described above when buying and making claims under D&O and other liability insurance arise because of inconsistencies between the laws

and regulations in different jurisdictions. Sometimes it is not the fact that there is an inconsistent approach, more that there is an ignorance that in some jurisdictions things are done differently. This is particularly so in the context of the risks present for directors and officers. There has historically been no common understanding regarding critical questions such as: Who are 'directors' and 'officers'? On what basis can claims be brought against directors and officers? To what extent is it permissible for directors and officers to purchase insurance for those liabilities?

However, we are seeing that global organisations and increased cross-border trade are resulting in greater convergence in the insurance markets, both in terms of regulation of the market and coverage terms. We are far from having a uniform worldwide approach to insurance but as insureds expect to get consistent cover for their directors and officers, wherever they may be operating, so insurers are striving to deliver products to achieve that end. ■

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your
risk

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CROSS-BORDER RISKS: LOCAL EXPOSURES – LOCAL COVERAGE

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Directors and officers (D&O) liability insurance policy terms vary depending upon the insurer and risk. However, the basic D&O insurance contract is fundamentally based on US and English law. Despite the differences in legal concepts around the world, the basic D&O insurance contract has been exported out of the US and England and sold in non-US and non-English jurisdictions. The result is an imperfect fit between the basic D&O insurance contract and local law.

Directors and officers are looking more closely at the language and enforceability of their D&O policies and questioning whether the traditional 'one global policy' approach to insuring D&O liabilities leaves them exposed. The evolving area of international risks is putting corporate governance firmly on the table at the board meetings of companies with foreign operations. The growing menu of permitted litigation is extending far beyond the borders of North America and England. A number of countries, including South Korea, Israel, and the Netherlands, have enacted legislation permitting shareholder class actions. There is also an increasingly aggressive approach around the globe by regulators seeking to enforce laws within their own borders and extending those enforcement actions into neighbouring foreign jurisdictions.

This chapter highlights some of the issues facing directors and officers in a global setting and examines some of the factors to consider when evaluating the effectiveness of global D&O insurance.

Indemnification

Coverage under a D&O policy is based on the availability of corporate indemnification. Traditional 'Side A' insuring agreements provide coverage for non-indemnifiable loss and 'Side B' insuring agreements provide coverage for indemnifiable loss. D&O policies have provisions expressly presuming that the insured entity will indemnify and advance expenses to a director to the maximum extent 'permitted by law' (eg presumed Delaware law standard). While bifurcating coverage between Side A and Side B works perfectly well in jurisdictions such as the US and England where the law on indemnification is well established, difficulties arise in other jurisdictions where the legality and enforceability of indemnification is not well defined.

Unfortunately, the law on indemnification is not clear in many jurisdictions outside of the US or England. When the standard US D&O policy is used in a jurisdiction where the legality and enforceability of indemnification is unclear then coverage, in turn, becomes unclear. One argument is that all loss should be covered under Side A because indemnification is uncertain and, therefore, unavailable. Another argument is that all loss should be covered under Side B because indemnification is uncertain and, therefore, unlimited. Side A coverage tends to be broader with no retention (deductible) applying. Side B coverage usually has a significant retention often amounting to millions of dollars. When the policy language has not been adapted to reflect the legal framework of a particular jurisdiction, the director could be left arguing with the insurer as to whether Side A or Side B coverage, ie the retention, applies.

Even in the US, indemnification agreements and by-laws often fall short of providing the maximum protection 'permitted by law'. For example, an insured entity's indemnification agreements or by-laws often do not provide for the mandatory advancement of expenses. In such instances, the basic D&O insurance policy (and/or the relevant indemnification agreements and by-laws) must be revised and rewritten appropriately to match the legal reality of each other and the relevant jurisdiction.

The bottom line is that it is important to understand what indemnification is available to a director and how to revise the D&O policy and/or corporate documents to reflect the appropriate legal framework. This often requires a combination of corporate law expertise and sophisticated knowledge of relevant insurance law issues.

Admitted insurance policies

Historically, companies have purchased one global policy expecting to protect all of their directors and officers worldwide. Unfortunately, complications may arise when local directors and officers end up in court and find that their company's global D&O policy does not protect them because their global policy does not meet the requirements of a 'local' or 'admitted' ('admitted') insurance policy in their particular jurisdiction. A global insurance policy will only cover directors and officers in countries where admitted insurance is not required.

An admitted insurance policy is one purchased from an insurance company licensed in the state or country where the policy is purchased. An admitted insurance policy is purchased through a locally licensed agent or broker and the policy form and marketing are regulated by local authorities. Many countries have stringent laws and regulations dictating that any risk in their country must be insured through an admitted insurance policy. In other words, the risk must be insured by an insurance company that is licensed in the country where the policy is purchased.

In a growing number of countries, such as Russia and many countries in Asia, admitted insurance is mandatory. In some countries it could be illegal for a foreign subsidiary's directors and officers to be covered by the global D&O insurance programme of the parent company. In some jurisdictions companies may face potential fines, excise taxes or other legal impediments to a global policy responding to local D&O lawsuits.

Brazil is an example of a country where a non-admitted policy will not be allowed to provide payment of a locally incurred loss. The law in Brazil permits the government to freeze the assets of the director or officer when a claim arises until a ruling

is issued in the director's or officer's favour. Therefore, the only source of funds for the director or officer for payment of defence costs may be an admitted insurance policy.

France requires that insurance risks be written by an insurer with its registered office in the EU or by a French-registered branch of a non-EU insurer. Intermediaries who place business with non-admitted carriers could be fined as much as €15,000, or receive prison sentences of up to six months. Similarly, Japan requires insurers to establish a branch office in Japan and obtain a licence from the prime minister to engage in insurance business. Violators can be fined up to 3 million Japanese yen or sentenced to a maximum of two years' imprisonment.

Because the legal requirements and related consequences vary widely from jurisdiction to jurisdiction, answering the following questions should help a company make an informed decision as to the necessity of local coverage:

- What are the laws on indemnification in the foreign jurisdiction? To what extent is indemnification allowed and from what source?
- Is there express law requiring locally admitted insurance?
- Can the global policy respond to a claim in the foreign jurisdiction?

Companies need to answer these questions to understand the potential risk in a particular country. Companies should work with their lawyer and broker to develop a comprehensive network of protection, which includes the appropriate indemnification arrangements, a global D&O policy, and local insurance, as needed. Considering the answers to these questions is key to ensuring that a company has adequately addressed cross-border risks and related insurance issues.

One of the main reasons why many D&O insurance programmes are not truly global in nature is that the D&O policy wording does not reflect the legal and commercial realities of all jurisdictions.

Policy wording

One of the main reasons why many D&O insurance programmes are not truly global in nature is that the D&O policy wording does not reflect the legal and commercial realities of all jurisdictions. While a specific policy term may be adequate in the parent company's jurisdiction, that same term may not be suitable for subsidiaries in other jurisdictions. The same provision can have a different meaning when you consider cross-border risks.

For example, certain non-US D&O policy forms have an exclusion that coverage will not be provided for any 'wilful or reckless' violation of a statute, regulation or other law. This provision is not usually found in a US D&O policy form because an exclusion for reckless conduct could preclude coverage for US securities claims, of which a key element is *scienter*, ie acting either wilfully or recklessly. This subtle wording difference could be fatal to coverage in a US securities class action suit.

Another example is the 'insured versus insured' exclusion. This exclusion prohibits coverage under the policy when one insured brings a lawsuit against another insured. This exclusion is generally standard in US policies but will not be appropriate in several jurisdictions, such as Germany and Russia, where a dual board structure operates. Under these regimes, the law imposes a duty on what is generally known as the supervisory board to bring proceedings against officials if their actions adversely affect the company. A standard US policy wording containing an insured versus insured exclusion would thus preclude coverage for such claims and would therefore eviscerate significant coverage for both the company and its directors.

The definition of 'claim' should be sufficiently broad to cover a wide range of proceedings (for example, civil, criminal, administrative, regulatory, investigations) that could arise in any of the relevant jurisdictions. Many D&O policies impose restrictions regarding the type of investigation that will be covered and the point in the investigation when coverage will be triggered. It is therefore important that the policy language precisely addresses the realities of how investigations are conducted. For example, while some investigations in the US start with the service of a subpoena, some investigations in other countries do not. Subtle differences in wording can have considerable impact on the amount of costs recoverable.

Coverage for extradition costs is not a standard feature of many D&O policies. While the cost of fighting extradition should theoretically already be subsumed under coverage for defence costs relating to criminal proceedings, cautious directors are increasingly requesting express coverage for the costs of fighting extradition. In addition, a D&O policy can be modified to provide coverage for the cost of obtaining a bond that could prove invaluable to directors in jurisdictions where it may take a long time to get to trial.

These are a few examples of the issues that arise when one policy tries to cover global risks. The point to bear in mind is that there is no 'one size fits all' D&O policy that will adequately meet the risks and exposure faced in all jurisdictions. Variances in policy conditions, if not adequately addressed, could lead to significant gaps in coverage at both the director and company level.

Tax and currency issues

Another consideration for purchasers of global D&O coverage is the variation in tax treatment of both the payment of premium on behalf of directors or officers and receipt of coverage in different jurisdictions. In some instances, the policy premium must be allocated among the various individual insureds and then considered a part of a director's or officer's remuneration subject to income tax. Given that premiums for large multinational corporations may run into millions of dollars, such an approach could lead to serious out of pocket consequences for those affected. In addition, if a claim occurs, it may also be the case that any insurance recoveries received by the directors or officers under the D&O policy may again be deemed taxable income within the jurisdiction. Coupled with restrictions on currency flows, payments into the jurisdiction from a foreign insurer may further subject the company or director or officer to income or capital gains tax. Legal advice should be sought on these issues.

Conclusion

As a result of the constant evolution of new laws and corporate governance standards around the world, directors and officers are recognising the growing importance of having properly structured D&O coverage to respond to changing global D&O liabilities. Furthermore, as a consequence of today's increasingly regulated environment and litigious climate, more directors and officers are asking if they are adequately covered for international risks. As discussed above, various factors must be considered when determining how a company should structure it's global D&O programme, and there is no simple or uniform answer when it comes to global protection. Ultimately, in order to ensure sufficient protection for its directors and officers, a company should be aware of the developing global risks and continually assess such risks in relation to its indemnification arrangements and global D&O insurance programme. ■

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THE IMPACT OF EMERGING GLOBAL REGULATORY REQUIREMENTS FOR DIRECTORS AND OFFICERS

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The economic downturn and its widespread effects have underscored the complex and interconnected nature of global business, social, political, and environmental ecosystems. As a consequence, governments and other major entities have recognised the need to collaborate in taking corrective measures and in rebalancing their sovereign interests in the new economy. Existing and new initiatives will most likely be implemented through strengthened and increased law and regulatory measures across a broad spectrum of stakeholder interests, spawning a new era of global regulatory cooperation and power.

These circumstances will have profound consequences for businesses of all sizes as pressures increase for transparency and accountability in meeting the expectations and demands of myriad stakeholders. Specifically, directors and officers will be exposed to increased liability as they become more proactive in attempting to meet these new requirements. Most of the liability impact comes from the US, UK and EU, simply because they are the leading economies in terms of regulatory structure and enforcement. However, emerging economies are rapidly catching up as they integrate into the global business infrastructure.

What are the regulatory exposures?

When economies are in a chaotic state due to extremes of growth or recession, there is usually an increase in wrongdoing as individuals or companies take advantage of unique situations for financial and competitive gain. Usually only in downturns however, is there an increase in the reporting of wrongdoing, as companies and countries seek recovery more aggressively to improve their financial situation. Accordingly, during downturns there is also an increase in company and regulatory investigative actions.

Following are a few examples of regulatory expansion and the corresponding investigatory and compliance issues faced by companies and their directors and officers in the contemporary business environment. Within companies, the impact of corporate matters related to regulatory issues will be experienced into the future as companies and regulators work their way through the lifecycles of the various cases.

According to a report from Wolters Kluwer Financial Services, in the US there are approximately 270,000 items of law and regulation that pertain directly or indirectly to the insurance industry. The report estimated almost 26,000 changes to these state and federal laws and regulations in 2009 alone (*Trends and Developments in Legislative and Regulatory Activity,* September 2009, Wolters Kluwer Financial Services.) Such magnitudes of regulation can be considered representative of other highly regulated industries as well, such as healthcare, telecommunications, pharmaceutical, medical devices, financial services, energy, and utilities.

In the UK, the Regulatory Enforcement and Sanctions Act 2008 (the 'Act') was enacted to increase the effectiveness of risk-based regulation, as applicable to a broad range of regulators. It enables the imposition of regulatory sanctions directly without judicial intervention. Such sanctions can include fines, compliance and restoration requirements, stop notices, and enforcement of various kinds. These regulatory powers are being used increasingly in cases as a way to expedite resolution at reduced cost.

In 2008, UK courts dealt with £1.1bn of fraud, the highest level recorded since 1995 and the second-highest in 21 years. This level is expected to increase for the courts and regulatory agencies as the impact of the economic downturn plays out (*KPMG Forensic Fraud Barometer*. February 2009).

In dealing with fraud, bribery and corruption, the UK Serious Fraud Office ('SFO'), has imposed civil sanctions and used these new powers in conjunction with other legislation on the books, such as the Proceeds of Crime Act 2002, to achieve civil recovery.

In addition, the SFO cooperates closely with the US and other countries to carry out its responsibilities. For example, the SFO and the US Department of Justice ('DOJ') cooperated in an eight-year investigation and in reaching settlements with BAE Systems plc. (The settlement with the DOJ excluded BAE Inc, the North American subsidiary that contracts with the Pentagon.) According to SFO, it was a groundbreaking global agreement that resulted in BAE pleading guilty to two charges and paying US$400m (£255.7m) to the DOJ and £30m to the SFO. The agreement also involves 'substantial ethical and compliance reforms', according to the SFO press release (BAE Systems plc and SFO press releases, 5 February 2010).

In addition, international cooperation in financial matters is reaching beyond the US and the UK. In its 2008-2009 fiscal year, the UK Financial Services Authority ('FSA') received 830 new requests for help from foreign regulators, up 27% from the prior year, highlighting the cross-border nature of the financial crisis. The US Securities and Exchange Commission made 774 requests for help and received 400 requests for help from foreign entities. (*Financial Times*, 'FSA Steps Up Cross-Border Fraud Probes', Brook Masters, 2 February 2010.) It should also be noted that the SEC has strengthened its enforcement abilities, with the enforcement division now having the power to subpoena documents without the consent of the SEC's five commissioners. According to Robert Khuzami, the recently appointed director of the enforcement division, there are plans to form five new specialised units focusing on asset management, structured financial products, municipal bonds and public pensions, market abuse and manipulation, and foreign corrupt practices. (Speech by Robert Khuzami before the Association of the Bar of the City of New York on 6 August 2009 as reported in the *AM Law Daily*).

In another example of cross-border issues, the US Federal Trade Commission recently required that a UK company change its website policy to remove false assertions that the company complied with the US Safe Harbor Program, relating to

information collected in the EU and transferred to the US. The case also involved issues related to domicile of the business, consumer warranties, taxes, and import duties, and, accordingly, highlights regulatory reach as it relates to international e-commerce.

Developing new approaches

In the US, regulators and law enforcement officials are also being innovative in their approach to investigations and enforcement. New York's attorney general, for example, has filed a civil fraud complaint under New York's Martin Act, alleging that Bank of America officials ignored advice from auditors, lied to their top internal lawyer, and intentionally failed to disclose fully the losses by Merrill Lynch prior to a shareholder vote on the merger. The complaint seeks to force the officials to return all gains and pay penalties and restitutions. This is after Bank of America reacted to stakeholder pressure and changed its bonus programme from all cash to a mix of cash and stock, some of which will vest over several years.

Use of the Martin Act is a formidable weapon, as the act imposes criminal penalties under broad provisions of fraud that can be violated without proof of *scienter* (intent or knowledge of wrongdoing), coupled with broad administrative discovery by prosecutors who have pre-existing subpoena power. (Washington Legal Foundation, *Legal Backgrounder*, 'New York's Martin Act: Expanding Enforcement In An Era Of Federal Securities Regulation', Robert A. McTamaney, 28 February 2003.)

The DOJ is also being more innovative, relying more heavily on the 'Responsible Corporate Officer Doctrine', whereby a person can be held responsible for violations of law even if there was no knowledge or intent, as long as the person was in a position of responsibility to do something about it.

At the same time, countries are also cooperating to target 'non-conforming' states that act in their own self interest, for example, by increasing pressure to prevent the use of financial havens for tax evasion. In the US, Congress recently introduced H.R. 3424, a bill designed to eliminate current tax loopholes that permit foreign-controlled insurers to avoid US income tax on profits from policies covering US risks. (The practice of reinsuring US-insured business with a foreign affiliate in a low or no-tax jurisdiction deprives the US Treasury of $billions in tax revenues and provides foreign insurers with a competitive advantage over US insurers in attracting capital to write US business.)

Other international non-regulatory entities are weighing in on regulatory matters as well. The International Monetary Fund and the Financial Stability Board have proposed taxing large companies to create a global insurance fund to aid financial institutions in need of rescuing. In addition, the FSA has published 12 standards as minimum requirements for country governance, representing a 'Code of Good Practices on Transparency in Monetary and Financial Policies [that] have relevance for aspects of payment and settlement as well as financial regulation and supervision'.

Regulators are backing up their mandates with serious tools. Under the UK Data Protection Act, for example, the Information Commissioner is expected to have the power to impose penalties of up to £500,000 for serious data protection breaches.

Not only are regulators writing and enforcing regulations, some are now directly involved in the human resource functions of setting standards and of interviewing directors and officers to determine suitability for their positions. The FSA, for example, will include foreign companies with influence over UK banks and brokers in its effort to strengthen governance initiatives. These initiatives include requirements that banks establish board-level risk officers and risk committees and the interviewing by FSA officials of potential bank board members to validate their market knowledge and their understanding of business risk, strategy and governance.

There is however, some recognition that regulators need to operate under some form of guidance that reflects sensitivity to those being regulated. In the UK, for example, over 17 major regulators are bound by *The Regulator's Compliance Code* which defines six principles designed to guide individual regulators in establishing policies that reduce administrative burdens and achieve effective inspection and enforcement.

On the other side of the coin, specific industries have organised to make sense of the increasing scope and complexity of international regulations. One example is the Inter-Jurisdictional Regulatory Collaboration Committee, a construction industry organisation comprising standards and regulatory bodies from 14 countries. The general purpose and intent of the IRCC is to increase understanding of international construction-related regulations and standards and public policy, and promote a more open environment of inter-jurisdictional commerce in the areas of building design and construction.

Companies are also looking more closely at ordinary business strategies and practices that might expose them to regulatory issues. One area deserving attention is the licensing of intellectual property. Companies that expand into new markets often lack in-country physical resources to leverage cost-effectively their IP, relying instead on licensing arrangements to facilitate their objectives. Such arrangements often place dependence on third parties to conform to in-country legal and regulatory requirements, thus creating potential exposure and liability for the licensor.

Another important area of operations requiring attention is the discovery of electronically stored information, or e-discovery, a process requiring adherence to strict protocols in the US under the rules of civil procedure. Performing e-discovery can be expensive on its own, but sanctions for violating procedure can add significant costs, as demonstrated in

one recent case in which an auto manufacturer was required to pay $8m as a result of discovery sanction (*Magana v. Hyundai Motor America*).

Regulatory harmonisation

Probably nowhere is regulatory cooperation more apparent than with efforts underway to harmonise international accounting and financial reporting standards. In the US, the Financial Accounting Standards Board is working closely with the International Accounting Standards Board ('IASB') to harmonise the US Generally Accepted Accounting Principles ('GAAP') with the International Financial Reporting Standards ('IFRS'). As evidence of progress, the SEC is permitting some large multinational companies to start using IFRS during 2010, with full adoption shortly thereafter. Currently, over 100 countries use IASB standards.

IASB standards are 'principles-based' while GAAP are 'rules-based'. This means that companies using GAAP will not only have to transition on a technical accounting basis, they will also have to adjust their thinking and operational practices. Under the principles-based approach, the judgements applied by senior practitioners such as actuaries, financial specialists and accountants must be thoroughly documented and communicated to others involved in decision-making processes. This will require thorough integration of these processes, along with education of stakeholders about them.

These efforts are on a parallel course for adoption of Solvency II, an EU framework directive conceptually in line with IFRS, designed to strengthen and streamline solvency requirements across the EU with the objective of creating a single market for insurance. The US National Association of Insurance Commissioners is working to help establish an orderly transition to IFRS and to Solvency II.

These initiatives are expected to facilitate global capital flows and lower the cost of raising capital, as well as introduce operational efficiencies for global companies. The principles-based approach does, however, introduce a degree of increased exposure for directors and officers, as practitioners depend less on complex rules for justification of their actions and more on individual judgements.

Impacts and implications for directors and officers

As discussed above, regulatory matters have significant potential impact on the liability exposure to directors and officers. More and more corporate matters are being handled outside the courts, resolved directly through sanctions imposed by regulatory entities and by alternative dispute resolution approaches that depend heavily on the outcomes of investigations (inclusive of inquiries and requests for information) and discovery findings. Interpretations of findings during investigations and discovery in turn rely heavily on the opinions of experts who have specialised experience and expertise in the particular matters under examination. Accordingly, third-party experts, especially investigators, forensic accountants, actuaries, information technologists, and former executives with specialised industry knowledge, may play an increasing role in outcomes.

The lifecycle of these corporate matters flows from the initial trigger events in an iterative and often highly disruptive and costly process involving investigations, discovery, pleadings and negotiations, resolutions through trial or settlement, and finally ending with the impact of the case(s) playing out over time for the various entities involved, including compliance assessments and ongoing monitoring.

The power of regulators in this lifecycle process can expose directors and officers to unforeseen liabilities. According to Dan Hurson, former assistant chief litigation counsel at the SEC and principal at Hurson Law in Washington, DC, the policies at agencies such as the SEC and DOJ favour those companies that cooperate, thus, in effect, creating a situation where companies are inclined to perform aggressive investigations in an attempt to avoid or mitigate severe sanctions. As a result, it is possible, and even probable, for directors and officers, as well as employees who may have been acting in the best interests of the company to be inadvertently swept into a potential legal minefield simply by being there.

As investigations move forward, usually from the bottom up, and additional information is uncovered prior to, or during, formal discovery, directors and officers may find themselves drawn into the process whereby seemingly benign interviews become incriminating evidence leading to a range of negative consequences. Some of the earliest of these negative consequences could be that corporate indemnity is withheld and D&O insurance is found not to apply, leaving the director or officer to seek counsel at his or her own expense and thus potentially placing him or her in an adversarial position with the company. At that point, the director or officer would most likely not have access to the corporate information needed to mount a defence.

Best practice measures for directors and officers

By the very nature of their positions, directors and officers will always be exposed to risk. They can, however, reduce potential liability by considering the following enterprise-wide programmes and practices:

- Ensure that the company has in place governance, risk-management and compliance programmes that continuously demonstrate their effectiveness through rigorous self-assessment and third-party audits; that are operationally integrated downstream; that are built on the integrity of information and bidirectional information flow; and that are based on ethical principles and standards communicated and institutionalised throughout the enterprise.

- Ensure that the company has in place a documented Information Lifecycle Management program that includes, at minimum, a records-management programme component and an e-discovery programme component that attend to the retention of essential corporate information and timely disposition of non-essential information, especially emails.
- Ensure that the company has in place at the board level, a risk-management committee and a compliance committee, each headed by board-level officers. These committees should focus on the overarching conceptual similarities of various regulations and the efficient integration of information, processes and controls in achieving compliance.
- Ensure that there is direct and consistent communication among directors and officers and general counsel regarding roles, responsibilities, agendas and potential issues, with the objective of working collaboratively to harmonise views and achieve mutual objectives.
- Be more open and transparent in communicating internally and externally regarding the positive actions taken to enhance and execute GRC programmes.

In addition to these programmes, directors and officers should seek the help of expert counsel to ensure that the company provides them with adequate protection under all investigatory and civil/criminal process under all appropriate circumstances. Important areas to address in D&O insurance policies include, but are not limited to:

- Adequate definition of terms such as 'wrongful acts', 'allegations' and 'insureds' in order to ensure that terms used in the policy adequately describe and do not preclude appropriate coverage scope and circumstances
- Elaboration of the circumstances for the advancement and the amount of legal and other fees and costs for defending claims
- Scope and specificity of the enumerated exclusions in the policy so as to avoid any ambiguity; to ensure that coverage related to actions by specific entities, such as regulators, are not excluded; and to ensure that coverage applies to the full scope and responsibility of directors and officers.

Taking advantage of such counsel prior to employment, or early in employment, to address D&O insurance, and during other critical circumstances to address potential liability issues, helps ensure that directors and officers and the company are in alignment.

Consistent application of these best practices supporting compliance with stakeholder requirements, as well as protection of directors and officers while fulfilling their responsibilities, provides a more coherent and cohesive operating environment that reduces potential operational risk and liability, thus helping enhance company value.

Summary

As the global economy becomes more integrated, cooperation among governments and regulators across all industry sectors becomes imperative as a means to maintaining stability while sustaining growth. Such cooperation will facilitate the harmonisation of laws and regulations, making compliance easier and more cost-effective. Concurrently, however, cooperation will enable more rigorous enforcement, making non-compliance by individuals and companies a higher-risk proposition.

At the same time, directors and officers must become more proactive in dealing with governance, risk management and compliance, involving themselves deeper into operational issues in order to achieve board objectives.

Because of the increased complexity of global business and the severity of non-compliance sanctions, directors and officers will need to understand better their compliance requirements and seek to protect themselves through a number of measures. Those measures include improved insurance policies, combined with risk avoidance and mitigation efforts through rigorous compliance programmes. In addition, companies should consider including a risk management and compliance committee, headed by a dedicated risk and compliance officer as a component of the board of directors. ■

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RECENT D&O INSURANCE CASES OF NOTE IN THE UNITED STATES

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Claim or notice?

Always give notice?

Admiral Insurance Co. v SONICblue Inc., 2009 WL 1308905 (N.D.Cal. May 11, 2009) primarily addresses the complex and, for the insured, potentially fatal issue of notice in the context of claims-made policies.

In the context of general liability claims, most jurisdictions will only deny coverage because of late notice if the insurer can show it was prejudiced by the late notice. However, under claims-made policies such as D&O and EPLI policies, almost all jurisdictions deny coverage for late notice without any need for a showing of prejudice by the insurer. This creates a particular problem for policyholders because the insured must report 'claims' and the policies offer broad, expansive definitions of claim, such as 'written notice of a demand for monetary or non-monetary relief'.

Policyholders often are unaware that informal notices, such as letters, might constitute 'claims' that they need to notice to their insurer. This case does not provide a convenient bright line test for policyholders but the lesson to be learned is that even informal notices can be claims that the company must report. Practically, the only way for a policyholder fully to protect itself is to provide notice as broadly as possible.

Is it a claim?

Definitions of 'claim' differ markedly among insurance policies and a broker must use his best efforts to confirm that his client has the most favourable definition. One major battleground is whether different types of government subpoenas constitute a 'claim'.

In *Jemmco Partners v. Executive Risk Indemnity, Inc.,* Docket No. L-486-07 (N.J Superior Ct., filed March 22, 2007), Jemmco, a hedge fund, received subpoenas seeking documents from the SEC, the Commodities Futures Trading Commission ('CFTC'), and a grand jury. The subpoenas involved market timing and late trading.

Jemmco was insured under a D&O policy which provided coverage against 'claims'. 'Claims' was defined in pertinent part as: (a) 'any civil proceeding in a court of law or equity including any mediation or alternative dispute resolution ordered or sponsored by such court'; (b) 'any criminal proceeding in a court of law'; and (d) 'any administrative or regulatory proceeding commenced by the filing of a notice of charges, formal investigative order, or similar document'.

Jemmco provided notice of the subpoenas to its insurer and the insurer denied coverage, arguing that the subpoenas related to other parties and mutual funds, and not Jemmco, and therefore were not 'claims' as defined in the policy. Jemmco sued for coverage, taking the position that the grand jury proceedings were criminal proceedings in a court of law, falling within subsection (b) of the definition of a claim.

The court found that the grand jury proceeding was a criminal proceeding and that the SEC and CFTC matters were administrative or regulatory proceedings. Next, the court addressed the subsection (d) requirement that regulatory proceedings be commenced by 'the filing of a notice of charges, formal investigative order or similar document'. The court found sufficient an affidavit from Jemmco's attorney stating that he had seen the formal investigative orders, which were not public, when he met with lawyers for the SEC and CTFC.

The court then noted that the policy's definition of 'claim' required that the claim be against an insured 'for a wrongful act' and found that there were disputed issues of fact as to whether the subpoenas asserted such 'wrongful acts' by the insured. The court noted that a subpoena, unlike a complaint or an indictment, does not 'allege particular conduct or make accusations' (*Jemmco* transcript at 37). The court stated that it was unwilling to find that a document such as a complaint or indictment was necessary for a subpoena to be a claim. It said that a subpoena with a target letter would be sufficient, and that other circumstances or notices may also qualify.

Insured's duty to cooperate

In *Vigilant Insur. Co., et al. v. The Bear Stearns Companies, Inc.*, 2008 WL 65620 (N.Y. Mar. 13 2008), the New York Court of Appeals ruled that Bear Stearns Companies, Inc., was not entitled to insurance for its USUS$80m settlement with the Securities and Exchange Commission ('SEC'), the National Association of Securities Dealers ('NASD'), and the New York Stock Exchange ('NYSE'), because it failed to obtain its insurers' consent to the settlement.

In early 2002, the SEC, NASD and NYSE, along with state attorneys general, initiated a joint investigation into the practices of research analysts at various financial services firms, including Bear Stearns, focusing on the potential conflicts of interest arising from the relationship between the analysts' research functions and investment banking objectives.

On 20 December 2002, Bear Stearns signed a settlement-in-principle with the SEC, NASD and NYSE to settle the claims. On 21 April 2003, Bear Stearns consented to be permanently enjoined from violating a number of NASD and NYSE rules and agreed to pay a total of US$80m to resolve fully the pending regulatory claims. The settlement was allocated US$25m as a penalty, US$25m in disgorgement, US$25m for independent research and US$5m for investor education. Three days after executing the settlement agreement, Bear Stearns sent letters to its insurers requesting their consent to the settlement.

Bear Stearns' primary professional liability insurance policy (the 'Policy'), provided US$10m in coverage for losses resulting from claims against the insured for its 'wrongful acts'. The Policy attached in excess of a US$10m self-insured retention. In addition, Bear Stearns had another US$40m in follow form excess coverage. The Policy required Bear Stearns to obtain the consent of its insurers prior to agreeing to settle any claim in excess of US$5m.

The insurers denied coverage for the settlement and brought a declaratory judgment action in the state supreme court, arguing that the insured had breached the policy provision obligating it to obtain the insurers' consent before entering into the settlement. The insurers moved for summary judgment. The state supreme court found an issue of fact as to when the settlement became final and, therefore, whether Bear Stearns breached the provision obligating it to obtain the consent of the insurers prior to settlement. The Appellate Division agreed that an issue of fact existed as to whether Bear Stearns had breached the policy obligation to obtain consent to settlement. The insurers appealed, raising a number of objections to the Appellate Division order. In particular, the insurers argued that Bear Stearns resolved and finalised the settlement of the case when it executed the settlement-in-principle in December 2002, or, at the latest, when it signed the consent agreement in April 2003, without advising the insurers.

The Court of Appeals noted that in the April 2003 settlement agreement, Bear Stearns agreed to pay US$80m and to be permanently enjoined from violating certain NASD and NYSE rules in order to resolve all the pending regulatory claims against it. The court also noted that in that agreement, Bear Stearns acknowledged that the SEC could present a final judgment to the federal court for signature and entry without further notice to the company, evidencing Bear Stearns' intention to settle the matter fully at that time. Moreover, Bear Stearns did not provide that the settlement was subject to its insurers' approval. Thus, even though the federal court did not approve the settlement until October 2003, the court determined that the parties had fully resolved the claim in April 2003. Since Bear Stearns had failed to obtain insurer approval of the settlement prior to that date, as required by the terms of the Policy, the court held that Bear Stearns was barred from recovering the settlement proceeds from the insurers.

Unfortunately, in the exigency of litigation, insurance can become an afterthought. Lapses most frequently occur in the notice process and late notice of a claim often forecloses coverage. However, all insurance policies require the cooperation of the insured, and many policies require the insurers' consent to settlement, or even to litigation decisions. The adversarial posture that often exists between companies and their insurers can also cause a company to avoid keeping its insurer informed or not seek its approval. Insurance management is an essential component of any litigation strategy.

Unfortunately, in the exigency of litigation, insurance can become an afterthought. Lapses most frequently occur in the notice process and late notice of a claim often forecloses coverage.

Recission

In *Platte River Ins. Co. v. Baptist Health*, 2009 WL 2015102 (E.D. Ark. Apr 17, 2009), the insured Baptist Health ('BH'), a non-profit organisation operating hospitals in Arkansas, sought coverage for claims brought against it after its adoption of an economic conflict of interest policy ('ECOI Policy').

The insurer, Platte River Insurance Company ('Platte River'), disclaimed coverage on the grounds of BH's alleged prior knowledge of circumstances that could give rise to a claim. The ECOI Policy provided that no physician who directly or indirectly acquires or holds an ownership or investment interest in a competing hospital shall be eligible to apply for initial or renewed appointment or clinical privileges in the professional staff of any Baptist Health hospital. This practice is also known as economic credentialing.

Prior to the adoption of the ECOI Policy, BH's CEO commissioned a project to research ECOI policies. The research was in

response to a request by the Office of the Inspector General of Health and Human Services for comments regarding the legality of economic credentialing. The research discovered that several hospitals had been defendants in cases challenging their ECOI policies. BH retained outside counsel to draft its own ECOI policy in order to avoid violation of anti-kickback or anti-trust laws. A month before formally adopting the ECOI policy, BH's CEO testified at a Federal Trade Commission hearing concerning economic credentialing. At the hearing, a doctor for a competing institution voiced his concerns about the potential risk to BH by adopting an ECOI policy. At about the same time, a member of the board of trustees sent a letter to BH's CEO expressing his concerns regarding the legality of adopting an ECOI policy. He believed that the ECOI policy would trigger a suit against BH. BH formally adopted its ECOI policy in May 2003.

Upon the expiration of its policy with Executive Risk Indemnity Insurance ('ERII') in October 2003, BH's broker submitted a renewal application with another insurer. The application stated:

> 'No Entity nor any individual proposed for coverage is aware of any fact, circumstance, situation, transaction, event, act, error or omission which they knew or should reasonably have known may result in a claim that may fall within the scope of the proposed insurance, except as follows. If answer is 'None', so state.'

BH replied, 'None'. BH also included a copy of the ECOI policy in its submission to the underwriter.

The underwriter reviewed the application but would later testify that she did not recall evaluating any of the risks associated with the ECOI policy. After providing a quote to BH, the underwriter provided an additional application which asked:

> 'Does anyone for whom insurance is intended have any knowledge or information of any act, error, omission, fact or circumstance which may give rise to a claim which may fall within the scope of the proposed insurance?'

BH responded, 'No'.

Further, both applications contained prior knowledge exclusions. The latter provided that the statements in the application were material to the acceptance of risk and were relied upon by the underwriter. Coverage was ultimately bound in December 2003.

BH was first sued because of its adoption of the ECOI Policy in February 2004. Two years later, the insurer notified BH that it had become aware of issues regarding prior knowledge. Subsequently, the insurer denied coverage for any suit relating to the ECOI policies and filed an action seeking declaratory judgment. The insurer moved for summary judgment seeking rescission on the basis of the alleged misrepresentations in the applications. The insurer also argued that the prior knowledge exclusions in the applications were incorporated into the policy and barred coverage.

The court granted the insurer's motion for summary judgment. First, the court found that the applications were incorporated into the policy. The opinion found that BH understood that its statements in the applications were material to the acceptance of the risk. The court rejected BH's arguments that the questions on the applications were ambiguous, particularly where both: (1) requested any facts or circumstances which 'may result in a claim', and (2) were followed by clear language providing that any claim resulting from knowledge of such facts and circumstances would be excluded from coverage.

Excess D&O insurance

Many corporations, even the smallest concerns, are aware of the need for substantial directors' and officers' liability insurance to protect their officers and directors from the risk of liability while managing the affairs of the company. However, even when the company buys excess insurance on top of the primary policy to ensure adequate limits to cover both defence expenses and settlements/judgments, an issue may arise as to whether the excess insurer's obligations are triggered if the primary insurer pays less than its full limits in a settlement where the company steps in to pay the gap left by the primary insurer's refusal to cover certain of the claims.

Where a company steps in to fill the 'gap' left by the primary insurer, the excess carrier may assert that its limits are not triggered, thereby blocking a potential settlement of a large claim by making the excess limits unavailable to the company. Two recent cases demonstrate that this is a very real risk for policyholders since courts are willing to take the excess insurer's side on this issue.

In *Comerica Inc. v. Zurich Am. Ins. Co.*, 498 F. Supp. 2d 1019 (E.D. Mich. July 27, 2007), Comerica entered into a settlement of several securities class action lawsuits for a total amount of US$21m. Comerica's primary carrier disputed coverage on some of the claims and ultimately agreed to pay US$14m of its US$20m limit towards the settlement. Comerica sought coverage from its excess insurer for the US$1m excess of the 'gap' it would fill in the settlement amount with its own money, as well as in excess of US$2m in additional legal fees. The excess insurer refused to pay, arguing that the underlying policy hadn't been exhausted, relying upon language in its policy that coverage was not triggered until 'after all such "Underlying Insurance" has been reduced or exhausted by payments for losses'. The court came out in favour of the excess insurer, holding that the

language in the excess policy was unambiguous and coverage was only triggered by the full payment of limits by the underlying insurance, and that the insured stepping in to fill that gap was not what the excess carrier contracted for. See also, *Qualcomm, Inc. v. Certain Underwriters at Lloyd's London*, 73 Cal. Rptr. 3d 770 (Cal. App. Mar. 25, 2008).

Bankruptcy – insured v. insured exclusion

Biltmore Associates v. Twin City Fire Insurance Company, N. CV-05- 04220-FJM (9th Cir. July 10, 2009) concerns the crucial issue of application of the insured v. insured exclusion in the bankruptcy setting.

The debtor in possession asserted that its directors and officers had looted the company. As part of the reorganisation, the debtor in possession assigned its claims against its directors and officers to the Creditors Trust, whose trustee then sued the company's directors and officers.

Where a company steps in to fill the 'gap' left by the primary insurer, the excess carrier may assert that its limits are not triggered, thereby blocking a potential settlement of a large claim by making the excess limits unavailable to the company.

The court denied coverage on the basis of the 'insured v. insured' exclusion, finding that 'a post-bankruptcy debtor in possession acts in the same capacity as the pre-bankruptcy debtor for the purposes of directors' and officers' liability insurance'. The court held that since the debtor and its directors and officers were all insureds under the D&O policy, the 'insured v. insured' exclusion barred coverage. The court found that the assignment of the claim by the debtor in possession to the creditors' committee did not change this result since the creditors' committee was still pursuing the claim of the debtor.

Courts in many states have addressed the application of the 'insured v. insured' exclusion to claims by debtors in possession, creditors' committees and trustees. The resulting case law is wildly inconsistent. Companies should try to endorse their D&O policies to explicitly exempt such claims from the operation of the insured v. insured exclusion.

Inadequate consideration exclusion

In *Delta Financial Corp. v. Westchester Surplus Lines,* 398 B.R. 382 (Bankr. D. Del. 2008), the insured company engaged in a transaction with its noteholders in which the noteholders were to receive cash flow certificates with a value of US$153,000,000. However, the certificates turned out to have a value of only about US$43,000,000, resulting in litigation. When the company turned to its D&O liability policy, the insurer denied coverage on the basis of an 'inadequate consideration' exclusion which stated, in pertinent part, that there was no coverage for claims 'based on . . . actual or proposed payment of the Company of allegedly inadequate or excessive consideration in connection with the purchase of securities issued by any company'. The court upheld the insurer's disclaimer.

The 'inadequate consideration exclusion' is one of numerous new exclusions that the insurance industry is adding that sharply reduce coverage and which often pass unnoticed by insurance brokers and consultants. The policyholder does have two remedies for new exclusions. In most states, the insurer on a renewal must advise the policyholder of any reductions in coverage. The broker has a similar duty to advise its client of any changes to the policy. Both insurers and brokers often fail in these duties.

Bump-up exclusion

Genzyme Corp. v. Federal Ins. Co., 2009 WL 3101025, civ. Action no. 08cv10988-NG (D. Mass. Sept. 28, 2009) demonstrates the prevalence of the insurers' defence that many settlement payments do not constitute 'loss' under the D&O policy but, rather, are restitutionary payments that are not covered.

On 28 September 2009, the United States District Court for the District of Massachusetts dismissed a lawsuit filed by Genzyme Corporation ('Genzyme') seeking insurance coverage from Federal Insurance Company (the 'Insurer') under its D&O insurance policy (the 'Policy') for a settlement of a shareholder class action. In determining that there was no insurance coverage for the settlement, the court relied primarily upon the definition of 'loss' in the Policy and a 'bump-up exclusion' in the Policy, which relieved the insurer of liability for any 'inadequate or excessive consideration in connection with [the] purchase of securities'. (According to the Insurer, this exclusion is apparently referred to in the insurance industry as a 'bump-up' exclusion because it is used to describe litigation seeking to increase or 'bump-up' the consideration paid for security.)

A number of shareholder lawsuits were filed against Genzyme and its officers and directors as a result of a share exchange, and these shareholders were certified as a class on 6 August 2007. The complaint primarily alleged that Genzyme and its officers and directors conspired to depress the market value of outstanding Biosurgery Division stock in order to exchange it for common stock at a rate that would result in a profit for the General Division shareholders – including Genzyme's top officers and directors – at the expense of Biosurgery Division shareholders. Genzyme agreed to settle the class claims by making a one-time payment of US$64m.

Genzyme sued the Insurer for coverage under its D&O Policy. The court determined that Genzyme did not have coverage for the settlement payment as a result of two key terms in the Policy – an exclusion from the definition of a covered 'loss' for 'matters uninsurable under the law' and a 'bump-up' exclusion which provided, in pertinent part, that:

> '[The Insurer] shall not be liable … for that part of Loss … which is based upon, arising from, or in consequence of the actual or proposed payment by any Insured Organization of allegedly inadequate or excessive consideration in connection with its purchase of securities issued by any Insured Organization.'

As an initial matter, the court determined that the settlement payment was uninsurable under Massachusetts law for reasons of public policy. The Insurer cited abundant case law supporting the notion that an insured does not incur an insurable 'loss' when he is merely forced to disgorge money or other property to which he is not entitled (ie an 'ill-gotten gain'; see*, e.g., Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.3d 908 (7th Cir. 2001)). Genzyme argued unsuccessfully that the settlement payment was not restitutionary in nature since the company did not receive any benefit from the share exchange.

The court then turned to the bump-up exclusion in the Policy. Genzyme argued that the share exchange did not involve an actual 'purchase' of securities since it was a share exchange and therefore the exclusion was inapplicable. The court relied upon the dictionary definition of 'purchase' which includes an exchange for something of equivalent value, and found that the share exchange was in fact a 'purchase' as that term was used in the Policy. Accordingly, the court held that the exclusion was an absolute bar to coverage under Insuring Clause 3 – coverage for securities claims brought against the entity.

Genzyme further argued that even if it was barred from recovering for securities claims brought against it as a result of the bump-up exclusion, it was still entitled to reimbursement for the money it paid to indemnify its directors and officers, since the settlement was a global resolution of the claims in the underlying lawsuit. The court disagreed, stating that no court has 'split the baby' in this manner where coverage for claims against the entity were barred, since companies can only act through their directors and officers. Moreover, the court was concerned that permitting this type of distinction with regard to a global settlement would permit companies to structure settlements in a manner to maximise coverage under the indemnification provisions of a D&O policy where the payment was in fact restitutionary in nature.

This decision to deny coverage for settlement payments made to shareholders was largely driven by public policy concerns. The court was very keenly attuned to the risk that providing coverage for these types of shareholder settlements would encourage fraud and chicanery by insured corporations. The decision also has far-reaching impact beyond D&O policies containing a bump-up exclusion since the court relied upon the disgorgement/restitution exclusion as an independent basis for barring coverage. In doing that, the court expanded that exclusion to include a stock redistribution or recalibration. This was a novel analysis of an exclusion found in nearly every D&O policy and may give insurers ammunition to go farther afield in their denials of coverage on the basis of this exclusion, in situations where, as in Genzyme, the company itself did not profit from the underlying transaction. Accordingly, insureds may need to argue that the judge's creative recalibration analysis is restricted to the specific and unusual circumstances of the Genzyme case and should not be broadly applied.

Intentional conduct exclusion

In *Greenwich Ins. Co. v. Media Breakaway, LLC et al.*, 2009 U.S. Dist. LEXIS 63454 (C.D. Cal. July 22, 2009) Greenwich filed a declaratory judgment action regarding its duty to defend and indemnify its insureds, an online marketing company and its CEO and president, for a lawsuit filed by MySpace claiming multiple violations of state and federal law for 'phishing' – sending unlawful, unsolicited commercial advertisements through MySpace user accounts. MySpace was awarded over US$6m in damages as a result of arbitration of the underlying case. The arbitrator found for MySpace on the ground that Media Breakaway 'condoned, encouraged, knew about and benefitted from the unlawful spam attacks on MySpace…'

Accordingly, the insurer argued that the damages were barred by the following exclusions in the policy for any claim made

against an insured 'brought about or contributed to in fact by any: (1) intentionally dishonest, fraudulent or criminal act or omission or any willful violation of any statute, rule or law; or (2) profit or remuneration gained by any Insured to which such Insured is not legally entitled'.

The court agreed with the insurer, concluding that the exclusion for intentional conduct clearly applied to the arbitrator's findings and therefore, the claim was not covered under the policy. The court therefore held that the insurer had no duty to defend or indemnify the insured for the action and ordered that the insured repay the defence expenses received. ■

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D&O LIABILITY COVERAGE FOR US GOVERNMENTAL INVESTIGATIONS

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The problem of coverage for investigatory costs

When independent directors and corporate officers think of directors' and officers' ('D&O') liability insurance, they often express concerns about being protected from shareholder claims alleging violation of federal or state securities laws, imaginative consumer claims, and miscellaneous claims alleging that some corporate decision constituted a breach of fiduciary duty. Shareholder and other breach-of-duty lawsuits are among the most common types of claims that would trigger D&O coverage, but, as explained elsewhere in this publication, the provisions of D&O policies that protect against individual liability for mistaken (allegedly illegal) corporate decisions provide broad coverage for a wide variety of wrongful acts.

In most cases, coverage extends to almost any decision by an officer or board of directors that becomes a basis for a subsequent damages claim. For instance, some D&O policies may include protections against lawsuits naming individuals as defendants on environmental claims and others may include protections for employment-related claims, which also may be insured by standalone employment practices liability insurance ('EPLI') policies.

While the coverage provided for claims asserted in lawsuits or arbitration proceedings may be relatively clear, D&O policies often are vague about coverage for governmental investigations, whether commenced as an adjunct or as a statutory prerequisite to litigation. For instance, the filing of a charge of discrimination with the Equal Employment Opportunity Commission ('EEOC') or equivalent state fair employment agency is a prerequisite to a federal employment discrimination lawsuit. Are the costs of responding to the administrative charge of discrimination covered? Similarly, numerous other government agencies may conduct sometimes lengthy investigations of activities within the scope of their regulatory authority. Are such investigations, sometimes culminating in cease and desist orders or other, administrative actions, covered D&O claims? What about governmental investigations commenced or accompanied by administrative subpoenas? Are grand jury investigative subpoenas that could lead to a criminal indictment or other governmental action covered?

Certainly, one of the more significant investigations that publicly traded companies and their directors and officers may face is an investigation commenced by the Securities and Exchange Commission ('SEC'), which usually is initiated by an informal letter of inquiry. Few companies faced with such a letter will refuse to cooperate with the SEC. Are the costs of producing voluminous documents and making individual witnesses available to testify before the SEC insured? Does the answer differ if the SEC issues a formal order of investigation, followed by subpoenas that might eventually lead to the filing of a securities lawsuit or entry of an administrative consent order? What if the SEC investigation parallels a pending shareholders' lawsuit alleging the same (or similar) violations?

Unfortunately, if asked (and the question certainly should be asked by sending appropriate notice of the investigatory action to the insurance carrier), D&O carriers often will answer 'no' to most, if not all, of the foregoing questions. Invoking the sometimes vague, over-simplified definition of a covered 'claim' or 'securities claim', the carrier will advise that the costs of responding to a governmental investigation – sometimes millions of dollars – are not 'defence costs' or 'losses' insured by the applicable policy.

In this chapter, we will focus on some of the more common D&O policy provisions implicated by governmental investigations, especially SEC investigations that often generate the largest corporate costs. Costs incurred by the corporation in responding to an SEC investigation may be covered if the so-called 'side C' securities coverage for the corporation has been purchased. The corporation also may incur expenses in protecting (through corporate indemnity agreements or as required by law) the interests of insured individuals named in the governmental investigations. Insurance for the corporation's costs of indemnifying its officers and directors against claims for alleged wrongful acts covered by a D&O policy is commonly referred to as 'side B' coverage.

Many, if not most, D&O polices are silent regarding coverage for governmental investigations and, as discussed below, the case authority addressing this issue is rather limited. Before discussing this authority, we will address some of the common policy language implicated when the company and its insured officers and directors are faced with governmental investigations, including the all-important notice of claim and notice of circumstances provisions of D&O policies that must be satisfied to preserve coverage for government investigations.

Policy language regarding coverage for investigatory costs

D&O policies typically cover, for a stated policy period, claims that are made against an insured and reported to the carrier within the policy period or a grace period, usually 30-60 days after the policy expires. As a result, the policy's definition of a claim that must be reported to the carrier is critically important. Service of a lawsuit, an arbitration demand, or a criminal indictment alleging wrongful acts clearly would be a claim that must be reported. The definitional language describing what is a claim must be carefully reviewed when the matter involves some other form of demand, whether from the government or perhaps from a shareholder in a derivative matter, asking the company to take some action or to cease and desist from a current course of allegedly wrongful conduct. Careful review of the policy language is necessary to determine whether or not such a demand is a covered claim.

Some definitions of claim explicitly encompass investigations, whereas others are less clear and refer merely to 'proceedings'. For instance, one sub-part of the definition of 'claim' in a current D&O policy form reads:

> '[A Claim includes] a formal civil administrative or civil regulatory proceeding commenced by the filing of a notice of charges or similar document or by the entry of a formal order of investigation or similar document.'

The terminology 'civil administrative or civil regulatory proceeding' is a common component of the definition of 'claim', but this terminology is not usually defined in the policy. As discussed below, some courts have concluded that this terminology includes a regulatory investigation commenced by the SEC or another governmental agency. Because the foregoing definition references a '*formal* civil administrative or regulatory proceeding' and 'entry of a *formal* order of investigation', the carrier probably would contend that an informal letter of inquiry from the SEC is not a claim that would trigger coverage. However, a formal subpoena or SEC investigatory order must be reported to the carrier to preserve the D&O policy coverage.

The foregoing definition focuses on 'proceedings', but this policy form also specifically covers regulatory investigations of individual insureds ('insured persons') by defining 'claim' to include:

> '[A] civil, *criminal, administrative or regulatory investigation* of an **insured person** for a **wrongful act** where:
>
> such **insured person** is specifically identified in writing by the investigating authority as a person against whom a proceeding described… above may be commenced; or
>
> (ii) *solely with respect to an investigation of an* ***insured person*** *by the Securities and Exchange Commission, such* ***insured person*** *has received a Wells Notice, or has received a subpoena and is otherwise specifically identified in writing by the SEC as a person against whom enforcement proceedings may be commenced*…. (emphasis added).'

This language, unlike the wording of many D&O policies, specifically covers a civil or criminal 'investigation of an insured person', which may include a grand jury subpoena; a subpoena from the SEC; an SEC Wells Notice specifically accusing the insured person of improper conduct; and, perhaps, even an informal letter of investigation, so long as it identifies, by name, the insured person who is exposed to future governmental enforcement action. The various stages of an SEC investigation are discussed below.

But what if the investigatory proceeding does not name or accuse an individual insured person of committing a wrongful act? Is the corporation covered for its investigatory costs? Assuming the company purchased entity (side C) coverage for a securities claim, the absence of a similarly specific definition addressing investigations suggests that the carrier will deny coverage for anything short of issuance or entry of a formal order of investigation that causes the corporation to incur investigatory expenses.

Another D&O policy form contains the following, rather vague definition explaining when a securities claim is a claim that would trigger the policy's side C coverage for the insured organisation:

> 'Securities claim' means a claim, other than an administrative or regulatory proceeding against, or investigation of an organisation, made against any insured…[alleging violation of the securities laws]….
>
> Notwithstanding the foregoing, the term 'securities claim' shall include an administrative or regulatory proceeding against an organisation, but only if and only during the time such proceeding is also commenced and continuously maintained against an insured person.'

This policy, like most, does not define the terminology 'administrative or regulatory proceeding', and it does not specifically address the issue of when such a 'proceeding' is 'commenced' against the insured organisation and also 'continuously maintained' against an insured person. Under such a clause, it is unclear whether and when an SEC investigatory proceeding would be deemed to be a claim that (a) would trigger the entity (side C) coverage and (b) obligate the insured entity to send notice of the claim to the carrier. As discussed below, one solution to uncertain definitions of 'claim' is to send notice of circumstances to the carrier. Sending such notice will avoid the possibility that the carrier will contend that failure to send notice of the investigation forfeits all coverage for the resulting costs (and liability), if a formal enforcement proceeding or litigation ensues.

The notice of circumstances advising of governmental investigations

If a governmental investigation is a 'claim', the proceeding must be timely reported to the carrier to avoid forfeiture of coverage. While the circumstances in which an investigation constitutes a claim vary, depending on the proper interpretation of vague policy wording, the safer approach is to report any such investigation to the carrier, either as a claim, a potential claim, or a notice of circumstances that might give rise to a covered claim. Sending such a notice to the D&O carrier will preserve the policy coverage if the investigation either is a claim or later ripens into a claim that exposes the insured

company or its insured directors and officers to significant future costs and liability.

A notice of circumstances clause in a current D&O policy form reads, in relevant part, as follows:

> 'If during the policy period an insured:
>
> becomes aware of circumstances which could give rise to a claim and gives written notice of such circumstances to the company; or
>
> …
>
> gives written notice to the company of a securityholder derivative demand, then any claim subsequently arising from the circumstances referred to... or from the securityholder derivative demand… shall be deemed to have been first made during the policy period in which the written notice… was first given by an insured to the company, provided any such subsequent claim is reported to the company as soon as practicable.'

If a governmental investigation is a 'claim', the proceeding must be timely reported to the carrier to avoid forfeiture of coverage.

Assuming it is unclear whether an investigatory proceeding is in fact a claim, sending notice to the carrier under such a clause will at least eliminate controversy over whether or not there is coverage if an undisputed claim is later made. However, there may still be controversy regarding whether or not the costs incurred in responding to the initial investigatory demands are a covered loss.

For instance, the foregoing policy form provides expressly that pre-claim costs are not in fact covered:

> 'With respect to any such subsequent claim, no coverage under this coverage section shall apply to loss incurred prior to the date such subsequent claim is actually made.

Moreover, the policy reaffirms that pre-claim investigatory costs are not covered by expressly excluding coverage for

> any amount incurred by an Insured in the defence *or investigation of any action, proceeding or demand that is not then a claim* even if (i) such amount also benefits the defence of a covered claim, or (ii) such action, proceeding or demand subsequently gives rise to a claim….(emphasis added).'

By contrast, another form of D&O policy contains different language, which suggests that once a subsequent claim is made, the date of the claim relates back to the date of the notice of circumstances, thereby covering the investigatory costs incurred after that prior date:

> 'If during the policy period or during the discovery period (if applicable) an organisation or an insured shall become aware of *any circumstances which may reasonably be expected to give rise to a claim* being made against an *insured* and shall give written notice to the insurer of the circumstances [with particulars]… *then a claim which is subsequently made* against such insured and reported to the insurer alleging… any wrongful act which is the same as or related to any wrongful act alleged or contained in such circumstances *shall be considered made at the time such notice of such circumstances was given* (emphasis added).'

While the often controversial issue of what may be a 'related' wrongful act is beyond the scope of this chapter, it is critically important, both for purposes of preserving and perhaps retroactively confirming coverage, to report any governmental investigatory proceeding to the D&O carrier as soon as the investigation is commenced. Toward the end of this chapter, using some of the foregoing clauses as examples, we will focus on the issue of when (and if) an SEC proceeding constitutes an insured claim, and briefly address some of the cases that have considered the issue of coverage for governmental investigations.

SEC investigatory proceedings

The scope of coverage available for the costs of responding to an SEC investigation is a very uncertain issue under many

D&O policies. SEC investigations often involve several stages, including: (1) issuance of a letter of inquiry seeking cooperation from the recipient (usually the organisation) in producing corporate documents and providing testimony from officers, directors or employees; (2) issuance of a formal order of investigation identifying possibly illegal conduct; (3) issuance of subpoenas directed to the corporation or its directors, officers or employees; and (4) issuance of Wells Notices advising individuals of alleged improper conduct. Eventually, absent a settlement, criminal indictments or civil complaints may be served.

As discussed above, the typical D&O policy may not clearly define the scope of coverage available for the various stages of an SEC investigation. Such an investigation may trigger the side B coverage for reimbursement of the corporation's costs of indemnifying insured persons against claims, including, as noted above, administrative or regulatory investigations. The coverage for the costs of indemnifying insured persons may be broader than the side C coverage for the costs of defending the corporation against SEC investigations. The key issue is determining whether or not the SEC investigatory proceedings constitute a covered securities claim. The outcome may depend upon a court's interpretation of the often vague policy language (as discussed below).

There is very little case authority on whether or not and when an SEC or other governmental investigation is a claim that would permit recovery of defence costs.

Case authority addressing D&O coverage for investigations

If a policyholder can convince the insurance carrier that a covered claim has been made, the costs of investigating that claim will be covered defence costs. As commonly defined, defence costs will include 'reasonable and necessary fees, costs and expenses consented to by the insurer . . . resulting solely from the *investigation*, adjustment, defence and/or appeal of a claim [including a securities claim] against an insured ….' (emphasis added).

There is very little case authority on whether or not and when an SEC or other governmental investigation is a claim that would permit recovery of defence costs. Courts that have addressed this question focus on the policy's definitions of claim or securities claim and whether or not the policyholder's interpretation of the policy language, if reasonable, should be accepted.

For example, if the SEC issues a formal order of investigation, absent clear policy language to the contrary, such an order should be a claim. In *National Stock Exchange v Federal Ins Co*, No 06 C 1603, 2007 WL 1030293 (ND Ill March 30, 2007), the D&O policy at issue, like the policy form quoted above, defined a claim as 'a formal administrative or regulatory proceeding commenced by the filing of a notice of charges, formal investigative order, or similar document'. The carrier contested coverage, but the court reasoned that an investigation launched by the SEC through a formal order satisfied the definition, because to hold otherwise would render the phrase 'formal investigative order' meaningless. On the other hand, the court found that the investigation (and thus the 'administrative proceeding') did not begin with the earliest, *informal* SEC investigative communications with the insured. See also *Minuteman Int'l, Inc v Great Am Ins Co*, No 03C6067, 2004 WL 603482, *3 (ND Ill 2004) (an SEC investigation causing the insured to incur substantial costs in responding to subpoenas and document requests qualified as a 'claim… seeking monetary or non-monetary relief and commenced by the… receipt of filing of notice of charges or similar document….').

Where the definition of a claim references 'administrative or regulatory proceedings', seeking 'non-pecuniary' relief, the courts have ruled that other types of investigatory proceedings, such as those commenced by the Department of Justice ('DOJ'), are covered claims'. For example, in *Polychron v Crum & Forster Ins Cos*, 916 F 2d 461, 462 (8th Cir 1990), the court ruled that losses incurred in complying with a DOJ investigation and grand jury subpoena constituted covered D&O claims, rejecting the carrier's argument that a claim should not be deemed made until the grand jury issued a criminal indictment against an insured person. The court reasoned that: '[t]he function of a subpoena is to command a party to produce certain documents and therefore constitutes a "claim" against a party.' It reached this conclusion despite its recognition that the subpoena 'was directed to the [insured company]' as opposed to its directors and officers, concluding that when 'a

reasonable construction may be given to the [policy] which would justify recovery, it is the duty of the court to adopt that construction' (*Id.* at 463 (quotation omitted)).

A similar ruling issued in *Servidyne, Inc v St Paul Mercury Ins Co*, No 1:07-cv-96-TCB, slip op. at 11 (N.D. Ga Nov 7, 2007), in which the court adopted a pro-policyholder construction of the terminology 'administrative or regulatory proceeding' in rejecting that carrier's argument that a grand jury subpoena could not be a claim because a criminal indictment never issued.

When the policy contains vague, unclear language, the carrier's argument that a governmental investigation does not constitute a 'claim', ignores reality, practicality, and the reasonable expectations of its insureds.

In addition to the foregoing cases, courts in at least four other US jurisdictions have upheld claims seeking coverage for the cost of responding to governmental investigations, including both federal and state agency investigations. For instance, in *Bornstein v National Union Fire Ins Co of Pittsburgh, PA*, 828 F 2d 242, 244 (4th Cir 1987), the federal circuit court decided that a DOJ investigation was 'a proceeding . . . seeking non-pecuniary relief' and adopted the policyholder's reasonable interpretation of the policy to allow coverage. In *Muckleshoot Indian Tribe v Washington Dept of Ecology*, 50 P 3d 668, 677 (Wash Ct App 2002) the state appellate court ruled that the policy language regarding 'agency proceedings' covered 'any agency action' and not just the 'formal, adjudicative processes'. *See also Bodell v Walbrook Ins Co*, 119 F 3d 1411, 1413-15 (9th Cir 1997) (coverage for a federal grand jury proceeding); *Tele Tech of Connecticut Corp v Department of Public*, 855 A 2d 174, 185 (Conn 2004)(coverage for a state agency proceeding).

Some D&O policies (as quoted above) define 'claim' by including a requirement that an insured person actually receive a 'formal' SEC subpoena or Wells notice, but others merely refer to an administrative or regulatory 'proceeding'. When the policy contains vague, unclear language, the carrier's argument that a governmental investigation does not constitute a 'claim', ignores reality, practicality, and the reasonable expectations of its insureds. Absent a clearly expressed exclusion, neither the corporation nor the individuals affected should be penalised for cooperating with both formal and informal government investigations. In either case, it is contrary to the best interests of the insureds and the insurance carrier to force the government to undertake more vigorous enforcement action, thereby possibly exposing the insured organisation and its insured directors and officers to more significant liability and costs.

Finally, as noted above, it is important to send a notice of circumstances to the carrier when the government investigation first commences. Then, if the carrier eventually acknowledges that the investigation has become a claim, the applicable policy language may allow coverage for all the 'defence costs' previously incurred, beginning with the date of the original notice of circumstances.

Allocation of insured and uninsured defence costs

What if a covered securities claim is made against an insured at the same time that the SEC is investigating the same or 'related wrongful acts' that are alleged in the pending claim? In such circumstances, some, if not all, of the expenses incurred in the parallel proceedings should be covered; but the issue of allocation of the costs between insured and uninsured claims can still generate controversy. For example, in *Pepsico, Inc v Continental Cas Co*, 640 F Supp 656 (SDNY 1986), securities lawsuits were filed against PepsiCo, its officers and directors, and its accounting firm after PepsiCo restated its financials as a result of accounting irregularities. The SEC initiated a parallel investigation and, after interviewing several officers and directors, the SEC charged PepsiCo with securities violations. PepsiCo subsequently settled the lawsuits and then sued its D&O insurer for reimbursement of the settlement and defence costs incurred, including the costs of the SEC investigation. (*Id.* at 657-58.) Among other issues, the court had to decide whether the carrier's reimbursement obligation included the corporation's expenses incurred in indemnifying its officers' and directors' for the costs of defending the lawsuits *and* the costs of responding to the SEC investigation. (*Id.* at 658-59, 666.)

The court ruled that the carrier had to reimburse all the side B defence costs PepsiCo had incurred in indemnifying the individual insureds, including the costs of the SEC investigation: 'Because the litigation and the investigations were each directed at the same allegedly fraudulent activity, were directed against both PepsiCo and its directors and officers, it would seem that these defence costs, like the costs of defending the class action, are properly the subject of indemnification, and therefore a covered loss within the policy.' (*Id.* at 666.)

However, because PepsiCo did not have organisation (side C) coverage, the court ruled that the carrier could allocate its payment between the uninsured costs PepsiCo incurred for its own defence and the costs PepsiCo incurred on behalf of the insured persons. (*Id.* at 666.)

Conclusion: seek clarity in policy language

Like most issues arising under D&O policies, the question of coverage for governmental investigations is determined either by the policy wording, if clear, or by the courts' interpretations of the sometimes vague wording used. As a result, because the costs incurred in responding to investigatory demands, whether by the SEC or other federal and state agencies, can be substantial – sometimes running into millions of dollars in attorneys' fees and related costs – careful review of policy wording is essential in determining whether or not, and to what extent, such investigations may be covered claims. It is essential also to enlist the services of a knowledgeable insurance professional to aid in the policy review and to advise regarding the scope of coverage that may be available. Especially during the policy placement or renewal process, a knowledgeable insurance broker may be able to negotiate policy language that would extend, or at least clarify, the coverage available for governmental investigations of arguably wrongful corporate acts. Added clarity in the policy language may avoid future controversy between the D&O carrier and its insureds regarding coverage for governmental investigations. ■

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EFFECTIVE BOARD OVERSIGHT OF RISK MANAGEMENT

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Against the background of the global financial crisis and the still uncertain global economy, companies are reassessing their strategies for responding to the challenges and pressures of the new environment. Risk – and in particular the risk oversight function of the board of directors – has taken centre stage in this reassessment. The public and political perception that undue risk taking was central to the breakdown of the financial and credit markets has fueled an extensive legislative, regulatory, and even judicial focus on risk management and risk prevention. While the business judgment rule's deference to board decision making should survive the financial crisis intact, boards and companies should remain mindful in the current environment of the possibility that courts may apply new standards, or interpret existing standards, to increase board responsibility for risk management.

In this context, what exactly is the proper role of the board in corporate risk management? The board cannot and should not be involved in actual day-to-day risk *management*. Directors should, instead, through their risk *oversight* role, satisfy themselves that the risk-management processes designed and implemented by the company's risk managers are consistent with the company's corporate strategy and are functioning as directed, and that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision making throughout the organisation. Establishing the right 'tone at the top' of the corporation is one of the most important factors in ensuring that a board functions effectively and is able to meet all of its responsibilities, particularly with respect to risk oversight. Through its oversight role, the board can send a message to the company's management and employees that comprehensive corporate risk management is neither an impediment to the conduct of business nor a mere supplement to a firm's overall compliance programme, but is instead an integral component of the firm's corporate strategy, culture and value-generation process.

The risk oversight function of the board of directors

State law fiduciary duties

In the United States, the Delaware courts have taken the lead in developing a framework for assessing whether board oversight of risk management, in any given case, satisfies the directors' fiduciary duties. The basic rule is that directors can only be liable for a failure of board oversight where there is 'sustained or systemic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists' (*In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, 971 (Del. Ch. 1996)). In cases since *Caremark*, the Delaware courts have made clear that there would be no liability under a *Caremark* theory unless the directors intentionally failed entirely to implement any reporting or information system or controls or, having implemented such a system, intentionally refused to monitor the system or act on warnings it provided.

The February 2009 Delaware Court of Chancery decision in *In Re Citigroup Inc. Shareholder Derivative Litigation*, Civil Action No. 3338-CC (Feb. 24, 2009), demonstrates that the *Caremark* standard remains intact, even in the current environment. The plaintiffs in the case alleged that the defendants, current and former directors of Citigroup, had breached their fiduciary duties by not properly monitoring and managing the business risks that Citigroup faced from subprime mortgages and securities, and by ignoring alleged 'red flags' that consisted primarily of press reports and events indicating worsening conditions in the subprime and credit markets. Declaring that 'oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk', the court dismissed these claims. In doing so, the court reaffirmed the 'extremely high burden' plaintiffs face in bringing a claim for personal director liability for a failure to monitor business risk and that a 'sustained or systemic failure' to exercise oversight is needed to establish the lack of good faith that is a necessary condition to liability. The decision also drew an important distinction between oversight liability with respect to business risks and oversight liability with respect to illegal conduct, emphasising that Delaware courts will not permit 'attempts to hold director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly'. Bad business decisions are not evidence of bad faith.

The *Citigroup* court observed that its decision to block further litigation against the Citigroup directors could be thought to be at variance with the result in another 2009 Delaware case involving shareholder claims arising out of conduct by American International Group, Inc. ('AIG'): *American International Group, Inc., Consolidated Derivative Litigation; AIG, Inc. v. Greenberg, et al.,* 965 A.2d 763 (Del. Ch. 2009). In the *AIG* case, the Court of Chancery allowed claims based on alleged fraud and illegalities at AIG to survive a motion to dismiss, relying in part on a theory that the defendants (some of whom were AIG directors) had 'consciously failed to monitor or oversee the company's internal controls'. However, the individual defendants in the *AIG* case were executives and inside directors who were allegedly 'directly knowledgeable of and involved in much of the wrongdoing', rather than independent, non-executive directors. Moreover, the *Citigroup* court relied on the distinction between business decisions and matters of corporate fraud and violations of law.

Overall, the cases reflect that it is difficult to show a breach of fiduciary duty for failure to exercise oversight and that the board is not required to undertake extraordinary efforts to uncover non-compliance within the company, provided a monitoring system is in place. In light of the ongoing political and legislative focus on risk oversight, however, boards should recognise the possibility that what constitutes a 'red flag' and what constitutes conscious disregard may be evaluated in the future with heightened scrutiny. Moreover, it is important to note that the courts have taken the view that if a breach of duty for failure to exercise oversight is found, directors are not protected by corporate exculpation or indemnification provisions.

US federal laws and regulations

Proposed legislation

In response to the financial crisis, the United States Congress and federal agencies have proposed new legislation regarding risk-management disclosure and oversight. For example, the Shareholder Bill of Rights Act of 2009, introduced in May 2009, would require all US public companies to create separate risk committees responsible for the establishment and evaluation of risk-management practices and comprised entirely of independent directors. Similarly, legislation proposed in November 2009 would require covered financial institutions to establish such a committee for supervising enterprise-wide risk-management practices. While the risk committee requirement has been dropped from subsequent versions of this legislation, the issue of whether a board should establish a separate risk committee remains alive.

Securities and Exchange Commission Rules

In December 2009, the Securities and Exchange Commission ('SEC') adopted rules requiring companies to provide greater disclosures about their risk-oversight practices, including information as to the board's role. The relationship between a company's overall compensation policies and its risk profile must also be disclosed. In addition, the SEC has made policy changes to facilitate the ability of shareholders to submit shareholder proxy proposals relating to risk oversight and management. This reflects the SEC's conclusion that 'the board's role in the oversight of a company's management of risk is a significant policy matter regarding the governance of the corporation'.

Private organisations

National Association of Corporate Directors - Blue Ribbon Commission on Risk Governance

In October 2009, the National Association of Corporate Directors ('NACD') published a report that provides guidance on and principles for the board's risk-oversight activities, the relationship between strategy and risk, the board's role in relation to particular categories of risk and ten principles for effective risk oversight. These principles include understanding key drivers of success for the business and associated risks in the company's strategy; crafting the right relationship between the board and its standing committees as to risk oversight; establishing and providing appropriate resources to support risk-management systems; monitoring potential risks in the company's culture and incentive systems; and developing an effective risk dialogue with management. Categories of risks include governance risks, critical enterprise risks, board approval risks, business-management risks and emerging and non-traditional risks.

Committe of Sponsoring Organizations of the Treadway Commission ('COSO')

COSO, a private sector organisation sponsored by professional accounting associations and institutes, published an integrated enterprise risk-management framework in 2004 that is now internationally recognised. Promoting an enterprise-wide perspective on risk management, the framework provides a benchmarking tool and offers detailed guidance on how a company may apply and implement enterprise risk management procedures in its strategic planning and across the entire organisation. The COSO approach presents eight interrelated components of risk management: the internal environment (the tone of the organisation); setting objectives; event identification; risk assessment; risk response; control activities; information and communications; and monitoring. COSO periodically releases guidance to supplement the framework and assist companies in shaping conforming procedures. A COSO 2009 enterprise risk management release stresses the specific importance of the board of directors to enterprise risk management and the need for the board to understand and shape the organisation's risk appetite, risk philosophy and risk portfolio and to assure that risk-management mechanisms are aligned and effective.

Recommendations for improving risk oversight

In fulfilling its risk oversight role, the board should focus on the adequacy of the company's risk-management process and overall risk-management system. Risk management should be tailored to the specific company, but in general an effective risk-management system will (1) adequately identify the material risks that the company faces in a timely manner; (2) implement appropriate risk-management strategies that are responsive to the company's risk profile, business strategies and specific material risk exposures; (3) integrate consideration of risk and risk management into business decision making throughout the company; and (4) include policies and procedures that adequately transmit necessary information with respect to material risks to senior executives and, as appropriate, to the board or relevant committees.

The following sets forth recommendations that may help the board in carrying out its risk-oversight role:

Tone at the top and corporate culture

Of critical importance in effective risk oversight and day-to-day risk management is having the right 'tone at the top' of the corporation. The board and relevant committees should work with management to promote and actively cultivate a corporate culture and environment that understands enterprise-wide risk management, incorporates it into overall corporate strategy and day-to-day business operations and gives high priority to risk-aware and risk-adjusted decisionmaking.

Comprehensive risk management should not be viewed as hindering corporate progress, or isolated as a specialised corporate function, but instead should be treated as an integral component that affects how the company measures and rewards its success. Companies will, of course, need to incur risk in order to run their businesses, and there can be danger in excessive risk aversion, just as there is danger in excessive risk taking. But the assessment of risk, the accurate calculation of risk versus reward, and the prudent mitigation of risk should be incorporated into all business decision making.

In setting the 'tone at the top', transparency, consistency and communication are key: the board's vision for the corporation, including its commitment to risk oversight, ethics and intolerance of compliance failures, should be set out in the annual report and communicated effectively throughout the organisation. Risk-management policies and procedures and codes of conduct and ethics should be incorporated into the company's strategy and operations, with appropriate supplementary training programmes for employees and regular compliance assessments.

Risk oversight roles of the board and its committees

Most US public company boards delegate oversight of risk management to the audit committee, which is consistent with the New York Stock Exchange ('NYSE') rule that requires the audit committee to discuss policies with respect to risk assessment and risk management. For some companies, the scope and complexity of risk management may make it desirable to create a dedicated risk management committee or subcommittee to permit greater focus at the board level on risk management and oversight. The appropriateness of a dedicated risk committee often depends on the industry and specific circumstances of the company. Regardless of the delegation of risk oversight to committees, however, the full board should satisfy itself that the activities of the various committees are coordinated and that the company has adequate risk-management processes in place. To the extent risk oversight is a focus of one or more committees, those committees should report key findings periodically to the full board. If the company keeps the primary risk oversight function in the audit committee and does not establish a separate risk committee or sub-committee, the audit committee should schedule time for periodic review of risk management outside the context of its role in reviewing financial statements and accounting compliance.

Risk oversight activities

In overseeing risk management, the types of actions that the board and appropriate committees may consider taking include the following:

- review with management the company's risk appetite and risk tolerance, the ways in which risk is measured on an aggregate, company-wide basis, and the setting of aggregate and individual risk limits (quantitative and qualitative, as appropriate) and the actions taken if those limits are exceeded
- review with management the categories of risk the company faces, including any risk concentrations and risk interrelationships, as well as the likelihood of occurrence, the potential impact of those risks and mitigating measures
- review with committees and management the board's expectations as to each group's respective responsibilities for risk oversight and management of specific risks to ensure a shared understanding as to accountabilities and roles
- review the risk policies and procedures adopted by management, including procedures for reporting matters to the board and appropriate committees and providing updates, to assess whether they are appropriate and comprehensive
- review management's implementation of its risk policies and procedures, to assess whether they are being followed and are effective
- review with management the quality, type and format of risk-related information provided to directors
- review the steps taken by management to ensure adequate independence of the risk-management function and the processes for resolution and escalation of differences that might arise between risk management and business functions
- review with management the design of the company's risk-management functions, including as to potential coverage gaps and reporting lines of authority, as well as the qualifications and background of senior risk officers and the personnel policies applicable to risk management, to assess whether they are appropriate given the company's size and scope of operations
- review with management the means by which the company's risk-management strategy is communicated to all appropriate groups within the company so that it is properly integrated into the company's enterprise-wide business strategy
- review internal systems of formal and informal communication across divisions and control functions to encourage the prompt and coherent flow of risk-related information within and across business units and, as needed, the prompt escalation of information to management (and to the board as appropriate); and
- review reports from management, independent auditors, internal auditors, legal counsel, regulators, stock analysts and outside experts as considered appropriate regarding risks the company faces and the company's risk-management function.

Board training and tutorials

Understanding the material risks faced by a company and assessing the adequacy of the company's response to those risks requires an understanding of the company's underlying business. The content of orientation and training programmes for new directors should be reviewed to make sure that such programmes enable directors to gain an understanding of the company's business quickly, and the company's risk profile should be incorporated into that training. In addition to new director training, a company should consider the usefulness of tutorials for directors on a continuing basis, as a supplement to board and committee meetings, to help keep directors abreast of current industry and company-specific developments and specialised issues.

Board and committee composition

One result of the trend towards increased independence and diversity on corporate boards is that many companies may have a number of directors who come to board service without personal detailed knowledge of the industry in which the company operates and/or without personal experience in private sector management. This makes director training, as discussed above, all the more important. Given the challenging and complicated current risk environment, a board may also want to consider a director's background and experience in determining the composition of any committees charged with risk-management oversight and with respect to the composition of the board as a whole.

When considering new director candidates, a board may want to place a greater emphasis on seeking candidates with directly relevant industry or business expertise, to the extent such expertise is not already well represented on the board. Where appropriate, consideration should also be given to seeking candidates with technical sophistication in risk disciplines relevant to the company and solid business experience that will provide relevant perspectives on risk issues. For a board on which the CEO is the sole management representative, consideration may also be given to adding a second or third management representative to provide an additional source of direct input and information on the company's business, operations and risk profile in the boardroom.

Lines of communication and information flow

The ability of the board or a committee to perform its oversight role effectively is, to a large extent, dependent upon the relationship and the flow of information between the directors, senior management, and the risk managers in the company. If directors do not believe they are receiving sufficient information – including information regarding the external and internal risk environment, the specific material risk exposures affecting the company, how these risks are assessed and prioritised, risk-response strategies, implementation of risk-management procedures and infrastructure, and the strength and weaknesses of the overall system – they should be proactive in asking for more. Directors should work with management to understand and agree on the types, format and frequency of risk information required by the board. Any committee charged with risk oversight should hold sessions in which it meets directly with key executives primarily responsible for risk management. In addition, senior risk managers and senior executives should understand they are empowered to inform the board or committee of extraordinary risk issues and developments that need the immediate attention of the board outside of the regular reporting procedures.

Legal compliance programmes

Senior management should provide the board or committee with an appropriate review of the company's legal compliance programmes and how they are designed to address the company's risk profile and detect and prevent wrongdoing. While compliance programmes will need to be tailored to the specific company's needs, there are a number of principles to consider in reviewing any programme. There should be a strong 'tone at the top' from the board and senior management emphasising that non-compliance will not be tolerated. Compliance policies should be reviewed periodically in order to assess their effectiveness and to make any necessary changes. There should be consistency in enforcing stated policies through appropriate disciplinary measures. Finally, there should be a clear reporting system in place so that employees understand when and to whom they should report suspected violations.

Anticipating future risks

The company's risk management structure should include an ongoing effort to assess and analyse the most likely areas of future risk for the company, including how the contours and interrelationships of existing risks may change. Anticipating future risks is obviously a key element of avoiding or mitigating those risks before they escalate into crises. In reviewing risk management, the board or relevant committees should ask the company's executives to discuss the most likely sources of material future risks and how the company is addressing any significant potential vulnerability. Significant changes in the external environment, demographics, key relationships, technology, strategies, competitors, people and processes relevant to a company all create risks to be managed and overseen. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN AUSTRALIA

Oscar Shub, Partner
Philip Hopley, Senior Associate
Allens Arthur Robinson

In Australia, there is an increasing trend to impose personal liability on corporate officeholders for a company's shortcomings. In some circumstances, officers are deemed to be liable for certain outcomes unless they can exculpate themselves. This trend is reflected in legislation at the federal as well as at the state and territory levels.

Legislation in Australia limits the extent to which a company may indemnify its directors and officers and the extent to which insurance may be taken out by a company for directors' and officers' liabilities.

In the face of the global recession in 2008/2009, the market for directors' and officers' ('D&O') insurance in Australia has tightened significantly. Both the number of insurers and the capacity of the market are in decline. Insurers are either placing limits on cover or are less willing to negotiate policy extensions and premiums have increased to some extent. Clearly, start-up and other small to medium-sized businesses, as well as companies in higher-risk sectors, will face more difficulty in obtaining cover than established companies in stable sectors.

Recent legal developments

Significant recent developments in this area include:

(a) the publication of proposals by the Commonwealth Government's Corporations and Markets Advisory Committee (*CAMAC*) to widen the current definition of directors and officers

(b) new legislation that limits the ability of companies to indemnify their directors and officers for the consequences of breaching competition law; and

(c) new draft legislation to introduce a national consumer law that prohibits and penalises the use of unfair contract terms.

Who can be liable?

Recent developments

Of these recent developments, the most significant in terms of identifying likely future trends in legal liability was the publication of the CAMAC proposals in 2006. The impetus behind CAMAC's report was the final report of the HIH Royal Commission in 2003, which investigated the circumstances of the collapse of HIH Insurance in 2001 – Australia's largest ever corporate collapse.

Specifically, the Royal Commissioner recommended that the duties imposed by the Corporations Act 2001 (Cth) ('the *Corporations Act*') on directors and officers should also apply to middle managers, consultants and contractors. CAMAC agreed with this recommendation and put forward an alternative definition of an 'officer' to achieve this effect. This definition included all persons who take part in, or are concerned with, the management of a corporation.

While it remains to be seen whether (and when) the federal government will act on CAMAC's proposals, the initial signs are that these will be incorporated in any future review of the Act. CAMAC's recommendations therefore have obvious potential implications for all insureds, underwriters and brokers who operate in the Australian D&O market. As a result, companies, directors and D&O insurers are advised to keep abreast of developments here when negotiating or renewing cover.

In addition, CAMAC published separate proposals in 2006 to reform the way in which individual officers can be made personally liable for certain corporate breaches of the law. This is considered in more detail below.

Personal liability of directors and officers

Directors and other officers of Australian corporations are exposed to significant risks of personal liability arising from the performance of their professional duties. In particular, an increasing trend has been for legislation to impose personal liability on directors and other officers by virtue of the office they hold, rather than as a direct result of their acts or omissions.

For example, directors' personal liability is reflected in the civil penalty provisions of the Corporations Act, which empower a court to impose civil penalties for breaches of the duty of care and diligence, the duty of good faith, the duty not to use their position or information improperly, the duty not to trade while insolvent, and so on. In addition, other legislation in Australia (particularly in the fields of environmental protection and occupational health and safety) can impose personal liability on directors where there has been no relevant conduct by the director in breach of these laws or, more generally, any breach of their statutory duties under the Corporations Act.

CAMAC's first report in 2006 recommended that a number of the statutory duties owed by directors and officers should apply to individuals by reference to the functions they perform rather than simply by reference to their employment position within a company. In turn, this prompted a Federal Parliamentary inquiry into the personal liability of directors and officers, which is outlined in this section.

Broadening the scope

CAMAC has recommended that the following directors' duties:

- of care and diligence
- to act in good faith
- to act for a proper purpose; and

- the restrictions on indemnification and insurance that companies can provide to directorsshould be expanded to apply to '*any person who takes part in, or is concerned in the management of a corporation*'.

In addition, CAMAC also recommended that the following obligations on directors and officers be extended to persons who perform functions for, or otherwise act on behalf of, a corporation:

- the prohibition on the improper use of corporate position or information
- the requirement to take reasonable steps to ensure that information provided to certain classes of persons relating to the affairs of the corporation is not materially false or misleading; and
- offences for misconduct concerning corporate records.

It is expected that such an amended regime would also involve the extension of a number of the existing protections currently available under the Corporations Act to this expanded group. For example, this would include:

- the business judgment defence
- the protection afforded to directors of wholly owned subsidiaries who are taken to have acted in good faith and in the best interests of the holding company; and
- the protection given to directors who are entitled to rely on information or advice provided by another person.

While CAMAC does not recommend that the definition of an 'officer' should be changed it is clear that, if its recommendations are adopted by the federal government, there will be a very significant new class of persons who are potentially liable for their conduct. In that event, it seems likely that there will be a significantly wider class of persons seeking D&O or equivalent insurance.

Focus on liability

As already mentioned, CAMAC has reviewed the tendency of Australian legislation to impose personal criminal sanctions on directors and officers. CAMAC's view is that while compliance with the law should be encouraged, the imposition of personal liability on directors without regard to their actual conduct is objectionable. In addition, having compared the liability provisions contained in federal and state and territory legislation, it found that compliance was obfuscated by the wide variance in the standards of responsibility imposed.

As a result, CAMAC recommended that, in general, directors and officers should only be held to be personally liable where they can be shown to have been personally or accessorily involved in offending conduct. In addition, and perhaps more optimistically, CAMAC has urged a more consistent approach to drafting legislation at all levels of government in order to provide greater certainty for individual directors and to promote good corporate compliance and risk management.

Who can sue?

The following issues are likely to have an impact on both the likelihood of claims being made and the manner in which such claims are brought:

CAMAC

As we have seen, CAMAC's proposals to apply more broadly the duties that currently apply only to directors and officers has the potential to expand the categories of potential defendants and therefore present a larger corporate target for future litigants.

Litigation funding

Following the High Court of Australia's decision in *Campbell's Cash & Carry Pty Ltd v Fostif Pty Ltd* (2006) HCA 41, litigation funding for class actions – particularly shareholder class actions against publicly listed companies (and their directors) for breaches of market disclosure rules – is now confirmed as legal and is increasingly common. Indeed, many D&O insurers now regard the Australian market as being second only to North America in terms of the risk of a listed company facing a class action.

However, a recent decision of the Federal Court of Australia, in *Brookfield Multiplex Limited v International Litigation Funding Partners Pte Ltd* [2009] FCAFC 147, has highlighted the need for greater regulation of litigation funding and, as a result, introduced some uncertainty into the area of class action litigation. In its decision, the full federal court held that a class action funded by a third-party litigation funder constituted a managed investment scheme for the purpose of the Corporations Act. As such, this required the litigation funding arrangement, for the first time, to be registered with the financial services regulator, the Australian Securities and Investments Commission ('*ASIC*'), and for it to comply with various product disclosure and other formal requirements.

So as not to delay the conduct of current litigation, ASIC's response to this decision has been to grant transitional relief from the requirement to comply with the Corporations Act to all class actions commenced prior to 9 November 2009. Any applications for relief for class actions commenced after that date are being considered by ASIC on their merits while it

considers its long-term response to this issue. Ultimately, the effect of this decision is considered likely to lead to the formal, prudential regulation of third-party litigation funders and, more generally, litigation funding arrangements.

Shareholder actions against insolvent companies and their directors

Another decision of the High Court of Australia, in *Sons of Gwalia Limited (subject to Deed of Company Arrangement) v Margaretic* [2007] HCA 1, has had an impact on the prevalence of claims against directors and officers of companies.

The High Court held that shareholders who have a claim against a company for misleading or deceptive conduct or for breach of continuous disclosure obligations can prove in the administration or liquidation of the company. Those claims will, for the first time, rank equally with those of unsecured creditors.

The effect of the decision from the perspective of directors and officers is that there is now a significant additional potential class of creditors in any insolvent external administration of a company and, therefore, a larger number of potential beneficiaries to any action taken by an administrator or liquidator against a company's directors.

Such claims may often conveniently be brought by way of representative proceedings which, as a result of the *Fostif* decision, are now likely to be much more attractive to third-party litigation funders. In January 2010, the federal government announced its intention to legislate to overturn the *Sons of Gwalia* decision. It remains to be seen precisely how this will be achieved, when this will take place and what, if any, retrospective application the new law will have.

Proportionate liability

Many claims against directors are made in circumstances where claims may also lie against others in respect of the same loss or damage. Traditionally, third parties (and especially those with insurance), would either be joined as defendants or cross-claims would be made against them. A claimant's right to recover its entire loss was seen as paramount and all defendants would have been jointly and severally liable to meet any judgment.

As a result of legislative reforms in 2004 and 2005 at Commonwealth level and in each state and territory, certain common types of claims for failure to take reasonable care and misleading and deceptive conduct are now subject to a regime of proportionate liability. This has the effect that, where one or more wrongdoers cause a loss, their individual liability is now limited to the extent of their individual culpability. This places an onus on claimants to sue all potential wrongdoers if they wish to recover their loss in full.

In practice, the operation of the Australian proportionate liability regime can be complex, particularly where claims involve several different state or territory jurisdictions, as the various laws do not operate consistently across the country.

Claimants will generally have an incentive to avoid proportionate liability applying to their claims wherever possible and so the challenge for defendants, particularly those that have D&O insurance, will be to identify whether a claim should be properly characterised as attracting proportionate liability in the hope of reducing their share of any damages claim. This incentive helps to explain why the regime is still regarded as relatively new and the courts have only in the last few years begun to provide detailed guidance on its practical application. As a result, it is too early to say whether the proportionate liability reforms have gone any meaningful way towards achieving one of its stated aims of reducing companies' insurance premiums.

Can a company indemnify its directors and officers under Australian law?

Recent legislative developments

There have been two recent developments that affect companies and indemnities in the areas of competition law and consumer law.

The first is the Trade Practices Legislation Amendment Act (No 1) 2005 (Cth), which took effect from January 2007. This inserts new sections into the Trade Practices Act 1974 (Cth) ('TPA') to limit the ability of companies to indemnify their officers (including senior managers) for the consequences of breaching Australian competition law.

Specifically, the new s77A of the TPA prohibits companies from indemnifying officers for any liability to pay a pecuniary penalty under s76 of the TPA for anti-competitive conduct such as price-fixing and abuse of market power.

Companies are also now prohibited from indemnifying their officers for legal costs incurred in defending or resisting proceedings in which the person is found to have a liability under s76. The new s77B also voids any purported attempt by a company to grant an indemnity.

The second legislative development is the Trade Practices Amendment (Australian Consumer Law) Bill 2009, that was passed by the federal parliament in March 2010 and which will commence from 1 July 2010 if it receives royal assent by that date. This is being enacted through an amendment to the TPA, with ancillary amendments to the ASIC Act 2001 (Cth).

This legislation, that will be known as the Australian Consumer Law, introduces provisions that regulate unfair contract terms in standard-form consumer contracts that supply goods or services or which involve the sale of, or the granting of an interest in land. An example of an unfair term will be one that allows a supplier to unilaterally vary the term of a contract or terminate it.

The consequences of including an unfair contract term in a contract after July 2010 is that it will be void and the contract will continue without it if possible. The proposed legislation introduces civil pecuniary penalties for unconscionable conduct and certain consumer protection provisions – the maximum penalties are $1.1m for corporations or $220,000 for individuals. The

Australian Competition and Consumer Commission and ASIC will also have new enforced powers, including the power to issue public warning notices, substantiation notices and infringement notices.

From an underwriting and claims perspective, it is possible that insurers will see claims being brought against insured entities and their directors and officers for breach of this new legislation. Multiple claims may be made against insureds as a result of the striking out of terms of their standard form contracts, giving rise to issues around the aggregation of claims.

As with the new competition law, one of the consequential amendments to the ASIC Act will be to include a provision that mirrors s77A of the TPA in order to prohibit a company from indemnifying a director or officer against a liability to pay a pecuniary penalty associated with breaches of the new consumer law or legal costs incurred in defending proceedings in which the person is found to have that liability.

Recent case law

Two recent cases illustrate how a policy wording can restrict, rather than facilitate, novel claims for indemnity.

In *NRMA v Whitlam* [2007] NSWCA 82, the NSW Court of Appeal held that a contractual indemnity provided by NRMA to its former president, Mr Whitlam, against '*all losses, liabilities, costs, charges or expenses…incurred…as an officer*' of NRMA did not extend to cover him for legal defence costs incurred in bringing defamation proceedings. These proceedings related to television and radio interviews in which Mr Whitlam was questioned on his actions as president of the NRMA.

Although, in giving the interviews, Mr Whitlam was acting as an officer of NRMA, the Court of Appeal held that his duties did not extend to cover the commencement of defamation proceedings in order to protect his personal reputation. In addition, it was held that, absent any explicit recognition in the deed of indemnity, a loss of reputation was not intended to be covered by the 'loss' for which the deed provided indemnity.

In *Intergraph Best (Vic) Pty Ltd v QBE Insurance Ltd* (2005) 11 VR 548, the Victorian Court of Appeal was required to determine whether Intergraph was entitled to be indemnified for legal defence costs that it paid on behalf of its directors. In finding that it was not, the Court of Appeal confirmed that the D&O policy in question, in keeping with many other policies in the market, did not insure the company in respect of its own liabilities. Instead, the policy indemnified Intergraph only in respect of liabilities incurred by the directors that it agreed to indemnify (as well as insuring the directors themselves against liabilities they incurred that were not indemnified by Intergraph). Clear wording in the policy would have been required to achieve the result contended for by Intergraph.

Recent regulatory guidance

Australia has some of the most punitive insolvent trading laws in the world. For directors (and others) who would like to review a concise summary of the insolvent trading provisions in the Corporations Act, ASIC published *Consultation Paper 124* in November 2009. This paper also includes draft proposals to help directors understand and comply with their duties to prevent insolvent trading. While this does not represent final ASIC policy or a definitive interpretation of the law, it is nonetheless a helpful starting point for directors who wish to understand their obligations.

What D&O cover is available?

The market for D&O insurance in Australia is a mature and competitive one in which a broad range of cover is available to be purchased both locally and from overseas. In respect of the purchase of insurance in overseas markets, regard must be had to the Australian 'DOFI' legislation that places some restrictions on buying insurance from 'Direct Offshore Foreign Insurers'.

In addition to providing direct cover for directors and reimbursement cover for the company, recent developments have seen insurers agreeing to provide the following additional cover:

- automatic advance payment of defence costs. In respect of fraud and misconduct, insureds can expect to obtain advance payment of their costs until such time as the exclusionary conduct is established by an admission or finding by a court
- waiver of statutory cancellation rights and fully severable cover for innocent directors
- bail bond or civil bond expenses
- challenges to detention, deportation, extradition, or orders seizing or freezing assets
- challenges to disqualification
- entity cover, although this is becoming a little more difficult to obtain
- costs of inquiries, including royal commissions, commissions of inquiry and stock exchange investigations as well as investigations and examinations by regulators and liquidators
- excess limits for non-executive directors.

For the full range of insurance cover that is available for directors in Australia, and in order to assess the level and nature of any cover that should be purchased, we suggest that you contact your insurance broker. ■

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CLEAR THINKING

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN BRAZIL

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Traditionally in Brazil the grounds upon which the personal liability of directors and officers could be incurred for damage caused by their company to third parties were quite limited. However, in the past 10 years, further legislative and administrative reforms have imposed on directors and officers more rigorous standards of management, accounting and financial disclosure, all of which enhance the potential for claims against them.

Although Directors' & Officers' ('D&O') insurance is still a recent innovation in Brazil, the stricter laws and corporate governance guidelines, the phenomenon of globalisation and the ongoing internationalisation and professionalisation of the Brazilian market and economy have fuelled the growth in demand for D&O cover in Brazil.

Corporate organisation

In order to explain the definition of directors and officers under Brazilian law and their duties and liabilities, it is important to note the forms of corporate organisation in Brazil.

The two most common forms of corporate organisation in Brazil are (i) privately-held companies incorporated mainly as limited liability companies (the so-called 'Limitada') or (ii) publicly-held companies incorporated as 'Sociedades Anonima' (the so-called 'S/A'; S/As are governed by Law 6.404/76 (as amended by Laws 9.457/97 and 10.303/01) (the 'S/A Law') and Limitadas are governed primarily by the Brazilian Civil Code (Law 10.406/2002) (the 'BCC').).

The S/A is essentially designed for larger companies and its capital is divided into shares. S/As have just one corporate charter, called '*Estatuto Social*' ('by-laws'). S/As must be registered with the Brazilian equivalent to the US Security and Exchange Commission (the Comissao de Valores Mobiliarios') ('CVM').

A Limitada, on the other hand, is commonly formed by two or more individuals, and the capital is divided into 'quotas'. The obligations of the quota holders and of the management of the Limitada are provided for under the '*contrato social*', equivalent to articles of association.

For the purposes of this chapter, we will refer to both the S/A and Limitada as the 'company', unless stated otherwise.

Who are directors and officers?

The terminology 'directors and officers' does not have a formal definition per se under Brazilian law. It is commonly understood as a reference to the management of the company. The management of an S/A may be entrusted to both its board of directors ('diretoria') and its board of officers ('conselho de administração').

A board of directors is required only for companies with authorised capital or for publicly-listed companies. A board of directors must have at least three members, all of whom must be individuals, shareholders and resident in Brazil. Common functions of a board of directors are the determination of general corporate policy, election and dismissal of officers, supervision of officers, calling of shareholders' meetings, and the selection of independent auditors.

A board of officers is comprised of at least two officers and is responsible for the execution of corporate policy as determined by the board of directors, for managing the daily affairs of the S/A and representing the S/A before courts, tribunals and third parties.

The directors and officers responsible for the management of the S/A are those elected and appointed in accordance with the by-laws. Directors and officers cannot delegate their managing powers to a third party.

As for Limitadas, these have no board of directors and/or officers – Limitadas are managed by one or more individuals referred to as 'administrators'. Administrators of Limitadas must be individuals. A Limitada must be managed by at least one administrator who is an individual resident in Brazil. An administrator is not required to be a quotaholder of the Limitada.

In summary, the management of the company will include the board of directors and administrative council of S/As, the administrator of a Limitada (and/or its legal representative), and, according to recent trends, anybody else empowered by the company to perform managerial duties or represent the company.

For the purposes of this chapter, we will refer to the management of any company, ie an S/A or Limitada, as 'administrators' generally, unless stated otherwise.

Liability of administrators

The duties and liabilities of administrators under Brazilian law are specified in various codes and statutes. The the main codes and/or statutes include:

- the Brazilian Civil Code ('BCC') of 2002
- Law 6.404/76 (as amended by Laws 9.457/97 and 10.303/01) (the 'S/A Law')
- the Brazilian National Tax Code ('NTC') of 1966
- the Brazilian Consumer Protection Code of 1991 ('BCPC')
- Tax Enforcement Law no. 6.830 of 1980 ('Lei de Execuções Fiscais')
- Antitrust Law 8.884 of 1994 ('Lei Antitruste')

- Money Laundering Law 9.613 of 1998 ('Lei de Lavagem de Dinheiro')
- Banking Intervention and Extra-Judicial Liquidation Law 6.024 of 1974 ('Lei da Intervenção e Liquidação Extra judicial de Instituições Financeiras')
- The Financial Institutions Law 4.595 of 1964
- Environmental Law 9.605 of 1998
- The Brazilian Criminal Code of 1940
- Law Decree no. 2.321 of 1987.

The S/A Law and the BCC

Broadly speaking, the duties and liabilities of administrators of an S/A are mainly dealt with under the S/A Law, whilst the corresponding duties and liabilities of administrators of Limitadas are dealt with under the BCC. However, whilst the S/A Law deals with such duties and liabilities in some detail, the BCC simply states that administrators of the Limitadas are liable, on an unlimited basis, to the company and to a third party for abuse of their powers, ie for acts performed in breach of the company charter or in breach of any applicable law.

Given the generality of the provisions under the BCC on the liability of administrators of Limitadas, it is widely considered that the provisions under the S/A Law supplement the provisions of the BCC in respect of duties and liabilities of administrators of Limitadas, ie the S/A Law provisions with regards to liability of directors and officers also apply to administrators of Limitadas. However, given the lack of clarity in this area, particularly in the BCC, most Brazilian lawyers recommend that when a Limitada is formed, the S/A law should be applied to the Limitada.

We set out below the main provisions under the S/A Law and BCC concerning the duties and liabilities of administrators. For the purposes of our analysis, all references to 'administrator(s)' should be read as being applicable to both directors and officers of S/As and administrators of Limitadas (unless stated otherwise).

Duty of care and diligence

The S/A Law states that administrators must exercise their duties with care and diligence such as would every honest, diligent and active person managing his own business (Article 153 of the S/A Law). The BCC imposes similar duties on administrators of Limitadas (Article 1011 of the BCC).

Pursuant to that, the S/A Law provides that administrators should comply with the law and the company's by-laws with a view to acting in the best interest of the company and to fulfil its corporate purposes (Article 154 of the S/A Law). They should observe the public welfare requirements and the company's business objectives. Additionally, any administrator elected by a group of shareholders, representing a certain class of shares, has the same duties as any other administrator of the company. In other words, an administrator must not defend the interests of those who have elected him to the detriment of the company's interests.

The administrator is expressly prohibited from:

- gratuitous acts for the account of the company
- taking loans or assets from the company, or using the company's services, assets or credibility, for his own benefit, for the benefit of a company in which he has any interest or third-party interest, without prior authorisation from a general shareholders' meeting or from the board of directors
- receiving from third parties, any kind of (direct or indirect) personal advantage as a result of his position in the company without authorisation from a general shareholders' meeting or from the by-laws.

Duty of loyalty

Article 155 of the S/A Law also imposes a duty of loyalty on administrators and requires that:

- any monies received by administrators by virtue of their position must be accounted to the company
- an administrator must not use for his own benefit and advantage, or for someone else's benefit, any business opportunities that come to him by virtue of his position, even if no detriment to the company accrues
- an administrator is liable to the company if he fails to exercise or protect the company's rights, and loses business opportunities, with a view to obtaining a personal advantage for himself or any third party
- the administrator must not purchase an asset or acquire rights in order to resell them at a profit if such assets or rights are essential to the company or if the company has an interest in acquiring them as well.

Duty of confidentiality and insider dealing prohibition

An administrator is further required to keep confidential all information which comes to his knowledge as a result of his position (Article 155 § 1º of the S/A Law). Liability is incurred by an administrator if he takes direct or indirect advantage of any confidential information obtained by virtue of his position in the company, and this has not been disclosed to the securities market, and in such a way as to affect the share price of that company on the stock market. An administrator must exercise due diligence in order to avoid any confidential information being disclosed by a junior person or someone else in his confidence.

An administrator will be liable to compensate any person for any direct loss and damage suffered by that person as a result of a transaction involving insider dealing unless the information in question was known to that person (Article 155 § 3º of the S/A Law).

Naturally, insider dealing rules only apply to publicly-listed S/As, not Limitadas.

Duty of disclosure

An administrator of a publicly-listed S/A should, at the time he takes office, give full information about the number of shares, subscription bonus, share purchase options and convertible debentures issued by the company or any controlled company or companies of the same group to which he is entitled.

An administrator is obliged to provide information at an ordinary general meeting, at the request of shareholders representing 5% or more of the company's capital, as to the following:

- the number of securities issued by the company, controlled companies or companies of the same group, which he has acquired or sold, directly or indirectly, during the preceding year
- the share purchase options which he has exercised or acquired in the preceding year
- any benefits and advantages, indirectly or complementary, which he has been receiving or has already received from the company and/or from an affiliated or controlled company or from companies of the same group
- the terms of employment contracts which have been executed by the company relating to the directors, officers and top-level employees;
- any fact or act relevant to the company's activities.

Administrators of a publicly-listed S/A are obliged to inform the stock market and the press of any resolution made by the board of directors or board of officers, or of any relevant event occurring in the company's business which may influence stock exchange investors' decisions whether to sell or purchase any security in the company.

Administrators are entitled to refuse to provide such information if it is regarded as prejudicial to the company's interests. The CVM – at the request of an administrator or any shareholder, or at its own discretion – must decide whether such information must be disclosed, and whether an administrator is responsible for not disclosing it.

Conflicts of interest

For both S/As and Limitadas, an administrator is not allowed to participate in any transaction where a conflict of interest exists with the company or with any resolution made by the other administrators (Article 156 of the S/A Law). In S/As, a director or officer should inform the board of directors or the board of officers of any conflicting interest and take the necessary measures to have the nature and consequences of that conflict registered in the appropriate board meeting minutes.

In the event that an administrator does not comply with the above rules regarding conflict of interest, the relevant transaction is considered voidable and the administrator is required to account to the company for any payment or advantage he has received as a result.

Finally, the S/A Law provides that administrators will be personally liable for their acts while representing the company (i) when acting within their corporate powers with fault or malice/wilful misconduct; or (ii) in breach of any statute or regulation. An administrator will also be jointly liable for the acts of his co-administrators should he have acted in connivance with them or if he fails to investigate or take steps to prevent such wrongful acts, despite knowledge of that conduct. An administrator will not be held personally liable for commitments he undertakes on behalf of the company and by virtue of action taken in the ordinary course of business and in accordance with his corporate authority.

Pursuant to the BCC, administrators of Limitadas are personally liable (on an unlimited basis) for the negligent exercise of their duties (Articles 1016 and 1053 of the BCC). This has been perhaps one of the most significant developments of the scope of administrators' duties and liabilities under Brazilian law since the BCC 2002 (which came into force in January 2003) introduced the concept of unlimited liability for administrators of Limitadas.

Tax laws

The following rules applies to both S/As and Limitadas.

The National Tax Code provides that directors, officers, managers, employees and legal representatives of legal entities are

personally liable for overdue taxes if such administrators have acted in abuse of their corporate authority and in breach of law, corporate charter or by-laws (Article 135 of the NTC). Furthermore, pursuant to the so-called Tax Enforcement Law ('Lei de Execuções Fiscais')(Article 4 of Law 6.830 of 1980), tax enforcement proceedings may be brought against those responsible for overdue taxes of legal entities.

The National Treasury (Fazenda Pública) has been instituting legal proceedings, based on the Tax Enforcement Law and the National Tax Code, with a view to attaching shareholders' and quotaholders' personal assets when they are also administrators/managers of the company. The judges of the federal and State Treasury courts have given judgments to the effect that the non-fulfilment of tax obligations represents a violation of the relevant tax laws, and have, as a result, attached administrators' assets.

Administrators generally present defences challenging these rulings by arguing that the simple fact that the company failed to pay taxes on time does not necessarily mean that there has been a violation of the relevant tax laws. If so, all and any overdue debts of a company would give rise to legal proceedings against administrators. Such defences are basically to the effect that the administrators did not act in abuse of corporate authority or in breach of law.

These arguments are often rejected by First Instance Treasury Courts. Having said that, there are some Courts of Appeal which are prepared to decide in favour of administrators when the company has sufficient assets and is willing to pay the debt or if bank guarantees are offered instead.

Where, however, the company does not have sufficient assets to cover tax liabilities, the administrators' personal assets may be attached up to the amount of the overdue taxes. However, the Brazilian Supreme Court has recently issued a decision to the effect that administrators are not personally liable for the company's tax liabilities. Despite the fact that court decisions in Brazil are non-binding on other courts, this ruling is like to result in a change of approach by the inferior courts.

Environmental law

This law was issued on 12 February 1998 and has changed the law with respect to the liability of officers, directors, auditors, managers and legal representatives. It applies to S/As and Limitadas.

It provides that if any one of these individuals is aware of wrongful conduct of the company, or of another person, with regard to the environment and does not prevent it from happening, he will also be prosecuted for that same wrongful conduct. Both the company and the individuals can be sued on the grounds of civil, criminal and administrative law.

The law goes even further in that it allows the corporate veil to be lifted if the company itself seeks in any way to obstruct any recovery action for damages caused to the environment.

Liability towards third parties

The basic principles of administrators' civil liability to third parties under Brazilian law are established in Article 159 of the BCC, as well as other related articles of the S/A Law, BCC and additional legislation.

Article 159 of the BCC provides that whoever, by an act or voluntary omission, negligence or imprudence, causes loss or damage to third parties, is liable for damages. Further, Article 159, paragraph 7, of the S/A Law, which establishes procedures for bringing a lawsuit against S/A administrators, provides that *'the action permitted under this article shall not preclude any action available to any shareholder or third party directly harmed by the acts of the administrator'*.

Article 1016 of the BCC provides that administrators of Limitadas are jointly liable to the company and to any third parties who suffered losses arising from fault with regard to their actions as administrators.

Based on the above provisions, administrators of both S/As and Limitadas may be liable to third parties for any damage and loss suffered.

In addition, the Financial Institution Law of 1964 imposes personal liability on administrators if they act with fraud, malice or in breach of the relevant laws and regulations.

The Banking Intervention and Extra Judicial Liquidation Law of 1974 ('the Banking Intervention Law') provides that administrators of financial institutions are jointly responsible for the total indebtedness of the bank until all the bank's obligations to third parties have been fully discharged (Article 40 of the Banking Intervention Law).

The administrative sanctions imposed by the Banking Intervention Law are quite severe; sanctions may also be imposed against former officers and directors of such S/As who left their positions 12 months prior to the Central Bank's intervention. Should the Central Bank decide to intervene and investigate the operations of a financial institution or bank so as to ascertain whether there was any violation of the relevant banking regulations and/or losses which might prejudice any creditor's rights, the personal assets of the officers and directors will be blocked (ie impossible to sell or divest) by the Central Bank until a conclusion is reached regarding the facts which gave rise to the intervention.

Who can sue?

Article 159 of the S/A Law establishes the procedures for bringing a suit against officers and directors and also sets out who is entitled to sue them. By a resolution passed at a general shareholders' meeting, the company may bring an action for civil

liability against any officer for losses caused by that officer's wrongful act to the company's property. Such a resolution could also be passed at an extraordinary general shareholders' meeting, if included in the agenda or arising directly out of any matter included therein.

Any shareholder may bring an action if proceedings are not instituted by the company within three months from the date of the resolution of the general shareholders' meeting.

Should the general shareholders' meeting decide not to institute proceedings, proceedings may nevertheless still be instituted by shareholders representing at least 5% of the capital. Any damages recovered by proceedings instituted by a shareholder shall be transferred to the company, but the company shall reimburse that shareholder for all expenses incurred, including 'monetary correction' (compensation for inflation).

For both S/As and Limitadas, employees are entitled to bring legal proceedings against administrators for sexual harassment and discrimination. Normally, claimants in these cases bring legal suits for damages for pain and suffering ('danos morais'). Further, an employee is entitled to sue for discrimination under the Brazilian federal constitution.

By a resolution passed at a general shareholders' meeting, the company may bring an action for civil liability against any officer for losses caused by that officer's wrongful act to the company's property.

For both S/As and Limitadas, the government is always entitled to sue when the public interest is involved, for instance in case of environmental, anti-trust or consumer protection matters. With regard to environmental issues, the initiative for bringing the suit for damages caused to the community lies with the Attorney General's Office and also with the foundations, state-owned companies, autonomous government agencies and associations engaged in the relevant activities.

For S/As, in the case of competition law infringement, the government can sue through the Conselho Administrativo de Defesa Econômica ('CADE'), which is an autonomous government entity linked to the Ministry of Justice or through the Attorney General's Office. Competitor companies can sue the directors and officers of another company for anti-trust, restraint of trade, cartel or price-fixing activities through the Economic Law Office (Secretaria de Direito Econômico, 'SDE').

The Consumer Protection Law (enacted September 1990) establishes the principle that a company's being a separate legal entity is disregarded for civil purposes when an administrator of an S/A or Limitada has acted, to the detriment of customers, in abuse of his powers in breach of the law. The company's being a separate legal entity may also be disregarded when a company goes into liquidation, bankruptcy or inactivity due to poor administration.

Can the company indemnify its directors and officers under Brazilian law?

Brazilian corporate laws and regulations do not specifically address this issue. There are, however, provisions concerning the indemnification of directors and officers in S/As but this is only allowed if it can be demonstrated that they acted within their corporate authority and in the best interests of the company. Accordingly, this would have to be determined on a case-by-case basis.

Punitive damages are not usually considered indemnifiable or insurable items under the Brazilian insurance law. They could be insurable, provided it is proved that the directors/officers acted in the best interests of the company and within their corporate authority, and depending on the nature of that conduct (eg where acts were performed by mistake or negligently).

Contractual indemnification is permitted provided it does not offend public order and does not violate Brazilian law.

There is also no express provision under Brazilian corporate law as to whether the company is entitled to indemnify its directors and officers for losses suffered by the company arising from their serving, at the company's request and directions, as directors of another company or non-profit making organisation, whether or not the latter is related to the company either by shareholder interest or creditor interest. It is acknowledged that the directors and officers, to whom such a request is made by another company, be justified in contractually protecting themselves vis-á-vis the company. There is no restriction on a company indemnifying its directors and officers if they act under its instructions and in its best interests.

The role of corporate governance

As a result of the continuous growth of the capital markets, S/As have shown increasing interest and initiative in recent years in complying with corporate governance practice so as to become more attractive to investors.

Brazilian law still does not provide for a specific set of rules in relation to corporate governance. S/As will follow the guidelines on corporate governance provided by the CVM and/or the rules of the New Market ('Novo Mercado') scheme instituted by the Sao Paulo Stock Exchange ('BOVESPA'). The New Market scheme is not compulsory: S/As can decide whether they wish to adhere to the scheme or not and, if they decide to do so, will also be free to choose the level of governance applicable. Broadly, the main aspects covered by the CVM guidelines are:

- Transparency with regard to the shareholding structure and group control
- The structure and responsibility of the board of officers; and
- Protection of minority shareholders.'

The so-called 'Novo Mercado' (New Market) was established by an internal regulation; the Novo Mercado Regulation, which lays down a number of rules of conduct for companies, administrators and shareholders, aimed at improving the value of companies' shares. Brazilian companies wishing to adhere to the Novo Mercado Regulation can subscribe to the scheme through the BOVESPA. The scheme provides for different levels of corporate governance as follows:

- Level 1
- Level 2
- Novo Mercado

Companies are free to choose the level of corporate governance they wish to subscribe to. Once they subscribe to a particular level they are required to comply with the rules of conduct set out under the regulations and applicable to that particular level. Failure to comply with the rules will affect the value of the shares.

The highest level of corporate governance is that of the Novo Mercado. The list of companies and shares produced by the BOVESPA will indicate the level of corporate governance expected of those companies which subscribe to the scheme.

With regard to the shareholders' actions, in the past few years there has been a significant increase in the number of shareholders' actions in Brazil. Most disputes relate to the distribution of profits and dividends, share valuations and breach of shareholders' agreements.

Following the issuance of the Brazilian Arbitration Law 1996, it is becoming quite common to have these disputes resolved by arbitration. The main arbitral institutions which deal with shareholders' actions are the Brazil-Canada Arbitration Chamber, the Brazil-United States Arbitration Chamber and the Chamber of Commerce of the Novo Mercado.

Claims trend and recent developments

Until recently, the number of claims against administrators was quite restricted. In the past five years, however, the number of claims has been increasing rapidly. Although the impact of the sub-prime and credit crisis was not felt by the Brazilian economy in the same way as it was by other world economies, Brazilian companies and their management have been subjected to greater scrutiny and criticism and an increased number of claims against administrators have been made.

Originally only the directors and shareholders of companies (in particular S/As) were held liable. Nowadays, as noted above, personal liability also attaches to the managers of a company or anybody appointed by a company who has decision-making powers. The relevant areas of liabilities are also more far-reaching in that the duties and liabilities of administrators range from general (as provided under the S/A Law and BCC) to specific duties and liabilities in respect of tax, environmental, consumer, financial and criminal matters, as detailed above.

With regard to tax liability in particular, Brazilian case law has interpreted Article 135 of NTC ('*The following will be personally liable for credits corresponding to tax obligations resulting from the acts carried out in excess of power or in breach of the law, company charter and statutes: (…) (iii) the directors, managers and representatives of private corporations)* and Article 28 of the BCPC ('*The judge may disregard the legal personality of the company in the event of abuse of rights, abuse of power, breach of law, or unlawful act or breach of statute or corporate charter to the detriment of the consumer.*') as meaning that administrators may be held personally liable for the company's unpaid debts or damages resulting from (i) their malicious or negligent acts or (ii) breach of the company's by-laws or articles of association.

Brazilian case law has now also established that administrators may also be in the firing line as regards employment-related liabilities. Although there is no specific provision under the Brazilian employment law providing for the liability of administrators to employees in respect of the acts of the company, in cases where the administrator exceeds its powers, commits an illicit act or acts fraudulently, he may be answerable for employment liabilities of the company. This is particularly the case with Limitadas.

Additionally, an important development is the use by the Brazilian courts of a system called BACEN JUD to effect the electronic 'freezing' of the administrator's assets. The BACEN JUD system is the result of a cooperation between the Brazilian judiciary and the Brazilian Central Bank through which judges can make an order on-line for disclosure of financial information in respect of a particular company or administrator. It was originally introduced to assist or guarantee the execution of judgments by employment tribunals, but its use has now been extended to the civil and tax areas. The BACEN JUD system currently allows the electronic 'freezing' by the court (the so called *'penhora on-line'*) of the administrator's bank accounts and/or funds and/or assets up to a value of 100% of any liability of the company/administrator to employees, or any debt of the company to the tax authorities. The use of the BACEN JUD system has been very controversial in Brazil, causing considerable alarm to administrators.

To sum up, Brazilian law has not only become more stringent in recent years, but the courts have also broadened their interpretation of the existing rules in respect of administrators' duties and liabilities. The theoretical protection of the 'limited liability' of corporate entities is no longer as solid as it once was and, as a result, the number of claims against administrators in Brazil is soaring.

The first coverage dispute under a D&O policy in Brazil was filed in 2005 (*Banco Santos v Unibanco AIG (2005)*). As result of the increasing number of claims against companies and administrators, we are slowly seeing an increase in the number of D&O coverage disputes.

Is D&O insurance available in Brazil?

D&O insurance coverage is available in Brazil and nowadays is offered by various Brazilian insurance companies.

There is no regulation under Brazilian law dealing specifically with D&O insurance coverage. Broadly speaking, D&O insurance is governed by the general rules applicable to insurance contracts provided for under the BCC, as well as the rules and/or regulations established by the National Council of Private Insurance ('CNSP') and the Brazilian Superintendence of Private Insurance ('SUSEP') – in particular: Circulars 256/04, 252/04, 336/07 (as amended by Circular 348/08) and 392/09.

Due to the internationalisation of the Brazilian market and the developing legislative framework, companies and administrators are slowly becoming aware of the need to obtain D&O insurance coverage. Although D&O insurance is commonly purchased by medium-sized and large companies or by directors and/or officers of companies in Brazil (the demand for D&O is growing though the number of companies which have contracted coverage is still small), it is not mandatory.

Due to the internationalisation of the Brazilian market and the developing legislative framework, companies and administrators are slowly becoming aware of the need to obtain D&O insurance coverage.

Most of the insurers offering D&O insurance in Brazil use their own policy wording. Given that the IRB no longer has a monopoly in the Brazilian reinsurance market it is expected that the Brazilian insurance and reinsurance markets will slowly assimilate aspects of international insurance and reinsurance practice, including those related to D&O insurance.

Below is a summary of the general principles of D&O insurance in Brazil:

- Coverage is usually purchased by Limitadas, S/As and other business organisations in Brazil
- The insured parties will be the administrators of the company elected and/or appointed in accordance with the applicable law or company by-laws, articles of association or equivalent during the period of the policy. Coverage is also extended to legal representatives acting on behalf of the company in relation to third parties and may be extended to the spouse in the event of claim against the director depending on the regime
- Coverage will usually include (i) the indemnification for any loss and/or damage suffered by the insured as a result of any claim filed or investigation instigated against him arising from his activities as administrator of the company (the basic coverage includes coverage for the administrator's tax, employment, pension, environmental responsibilities, fines and/or

penalties, moral damages, amongst others); and (ii) reimbursement of defence costs (coverage for defence costs may be subject to the prior approval of the insurer if that is so provided in the policy)

- Coverage is more commonly purchased as a twin-type coverage. The first coverage will indemnify the insured(s) in circumstances where the insured cannot and/or has not been indemnified by the company (equivalent to Side A coverage). The second coverage indemnifies the company in circumstances where it can or has indemnified the insured(s) (equivalent to Side B coverage). Type C coverage is however also available and it will indemnify the company and the administrator;
- A number of exclusions to the basic coverage will apply. For example, coverage in respect of legal costs and expenses does not extend to claims by investors against administrators of companies listed on the stock exchange. It also does not extend to damage to the company's reputation (coverage may be contracted however for the costs arising from crisis management and measures taken to avoid damage to the company's reputation)
- Policies may be purchased and denominated in foreign currency (the CNPS Regulation 197/09 and SUSEP Circular 392/09)
- Finally, D&O policies are typically written on a 'claims made' basis (SUSEP Circular 336/07 as amended by SUSEP Circular 348/08).

There are a number of D&O insurance providers in Brazil. Although the basic D&O policy terms are quite similar, coverage can vary from provider to provider. Given that the product is quite standardised, it is often not easy to negotiate major amendments to the terms originally provided and insureds will often compare the products available before deciding on the provider.

Can D&O insurance be contracted outside Brazil?

There is a general prohibition on the placement of risks located in Brazil with a non-authorised insurer in Brazil, ie non-admitted placement (a non-authorised insurer is an insurer who is not registered with and authorised by the SUSEP to carry out insurance business in Brazil; foreign insurers are authorised to register with the SUSEP; further, there are no restrictions as to the foreign ownership of Brazilian insurance companies).

Pursuant to Law Decree 73/66, only companies which are duly registered and authorised by the SUSEP to carry out insurance business in Brazil are entitled to sell insurance in Brazil. Further, pursuant to Law 126/07, the CNPS Regulation 197/09 and SUSEP Circular 392/09, insurance coverage for risks based in Brazil must be obtained locally with an authorised domestic insurer; there are a number of very limited exceptions to this 'non-placement rule' which are also dealt with by the above legislation but it is very unlikely that they could be successfully relied upon to place D&O insurance outside Brazil for the benefit of a Brazilian company or its administrators in Brazil. The obtaining of non-admitted insurance contravenes Brazilian legislation and may result in penalties being applied by the SUSEP.

The general consensus, therefore, is that a company based in Brazil and/or its administrators in Brazil must obtain D&O insurance in Brazil from an authorised local insurer so as to avoid contravening the law. There is no legislation relating specifically to multinational insurance programmes or multinational insurers and such insurances and insurers are therefore subject to the same rules as all other insurances and insurers in Brazil.

'Fronting' could offer a solution to a company or subsidiary that wishes to obtain coverage abroad. There is no express prohibition to fronting operations in Brazil. However, CNPS Reinsurance Regulation 168 provides for various limitations applicable to the volume of cessions which may be carried out by an insurer during any given year, and these limitations will have the effect of limiting or preventing the use of fronting. In any event, pursuant to Regulation 168, Brazilian insurers are only permitted to cede risk to reinsurers authorised to carry out reinsurance business in Brazil, and duly registered with the SUSEP.

Conclusions

Whilst Brazil does not (yet) have a very litigious culture, the growing legislative trend in respect of the personal liability of administrators, and the scrutiny of companies with regard to their management (this also being the result of the Brazilian market sophistication), is attracting a growing number of claims against administrators.

D&O insurance is becoming an extremely important issue in Brazil in view of the Brazilian courts' trend to make higher awards of damages in legal actions concerning civil liability in general.

Although D&O insurance is a relatively new product in Brazil and the market for it is still small, claims against administrators are set to become a fact of life in Brazil, and thus D&O insurance is likely to become commonplace and part of the cost of running a business in Brazil, or 'custo Brasil' as it is known locally. ■

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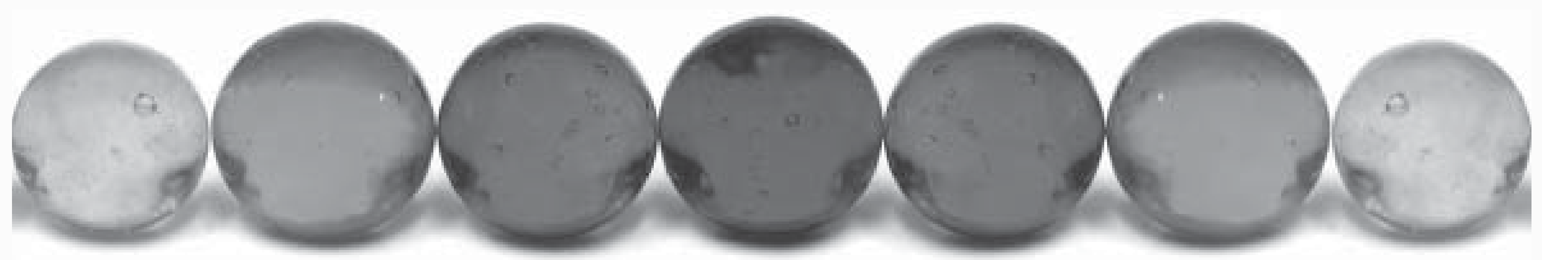

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN CANADA

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The authors wish to thank Laurent-Alexandre Duclos-Bélanger, articling student at Lavery, de Billy, for his valuable assistance in the preparation of this text.

Over the past few years, there have been significant developments in both legislation and case law which have had an impact on corporate governance and the obligations and liabilities of directors and officers in Canada.

In Canada, directors' and officers' statutory liability arises generally from two principal sources: the applicable Canadian and provincial corporate statutes and the provincial securities statutes. Directors and officers may also incur liability arising from various other statutes which impose specific liabilities to ensure compliance with their dispositions.

It is important to note that the federal Canadian crown, the ten provinces and the three territories each have their own set of statutes by which corporate entities can be created and regulated. Each of these is slightly different, although most of the provinces have based their statutes in large measure on the federal statute, the Canada Business Corporations Act (R.S.C. 1985, c. C-44, 'the CBCA').

Securities statutes have been enacted by the provincial legislatures and securities matters are governed by these statutes which are enforced by provincial regulators. There is no central Canadian regulator and while many believe having one would be preferable, the issue has been hotly debated for some time without resolution.

Other federal and provincial statutes provide for specific liabilities for directors and officers. Some of the more significant examples are found in tax and excise legislation, employment standards legislation and environmental protection legislation.

This chapter is a summary of the significant recent developments in legislation and case law that have an impact on corporate governance and the duties, obligations and liabilities of directors and officers in Canada.

The Supreme Court of Canada: the decisions in *Peoples* and *BCE*

Two important decisions from the Supreme Court of Canada have helped shape and refine a number of the fundamental concepts in Canadian corporate law. While rendered a few years apart, it helps to examine them together to understand better the extent of their full impact on corporate governance rules and on directors' and officers' liability.

The context

In *Peoples Department Stores Inc. (Trustee of)* v. *Wise*, [2004] 3 S.C.R. 461 ('*Peoples*'), three directors of the bankrupt Peoples Department Stores Inc. were sued by the trustee of Peoples who claimed that they had favoured the interests of the parent corporation Wise Stores Inc. (of which they were major shareholders) over the interests of Peoples, to the detriment of Peoples' creditors, in breach of their duties as directors.

In *BCE Inc.* v. *1976 Debenture holders*, [2008] 3 S.C.R. 560, the dispute arose with respect to the acquisition the shares of BCE Inc. ('BCE') by a consortium of purchasers. The transaction was approved by nearly 98% of BCE's shareholders, but was opposed by a small but important group of financial and other institutions that held debentures issued by a subsidiary of BCE, Bell Canada. These debenture holders contended that the increased debt resulting from the terms of purchase agreement would reduce the value of their securities and claimed, therefore, that the transaction would be unfairly prejudicial to their rights. They invoked the oppression remedy recourse available under the provisions of the *CBCA* and filed proceedings to block the transaction.

The fiduciary duty of Canadian directors and officers

In *Peoples*, the Supreme Court underlined that directors and officers were required to act at all times 'honestly and in good faith with a view to best interests **of the corporation**', and that this fiduciary duty is owed only to the corporation. The court emphasised that the interests of the corporation were not to be confused with the interests of the creditors or those of any other stakeholders, contrary to the arguments of some. As if to be sure it had been clearly understood, the court later reinforced this point in *BCE*.

However, the Supreme Court did acknowledge that to determine whether directors were acting in the best interests of the corporation, it might be legitimate to consider, *inter alia*, the interests of other stakeholders, to place matters in the proper context and to consider the impact of their decisions, for example, on shareholders or another particular group of stakeholders.

While the court refused to recognise that such other stakeholders had a recourse based on such a fiduciary duty, it did note that these other stakeholders had other potential recourses at their disposal, in particular, the oppression remedy.

This is exactly the situation that the Supreme Court had occasion to examine two years later in *BCE*.

The oppression remedy

The oppression remedy is a very powerful remedy that is specific to Canadian corporate law. Essentially, it provides a recourse for a wide range of stakeholders when their rights have been negatively affected by oppressive or unfair conduct of the corporation or its directors or officers.

BCE involved the fiduciary duty of the directors to the corporation and, particularly, the 'fair treatment' component of this duty, which is considered fundamental to the assessment of the reasonable expectations of stakeholders claiming an oppression remedy. In that case, the court was of the opinion that while the corporation and shareholders were certainly entitled to maximise profits and share values, they could not do so in such a manner as to treat other individual stakeholders

unfairly. Fair treatment – the central theme running through the case law on this remedy – is essentially what stakeholders are entitled to 'reasonably expect'. In the specific context of that case, where the corporation was being put up for sale, the maximisation of shareholder value was deemed not to be the only factor to be considered.

While a powerful tool to ensure directors and officers act with fairness, the oppression remedy should not be considered 'a blank cheque for any stakeholder alleging unfair treatment' to block business decisions from being made by a corporation.

Generally, the directors of the corporation are required to resolve conflicting interests regarding the corporation in accordance with their fiduciary duty to act in the best interests of the corporation, viewed as a good corporate citizen. However, this duty also requires that they treat individual stakeholders affected by corporate actions equitably and fairly.

While a powerful tool to ensure directors and officers act with fairness, the oppression remedy should not be considered 'a blank cheque for any stakeholder alleging unfair treatment' to block business decisions from being made by a corporation. Directors and officers should still have to exercise their judgement in the interests of the corporation and the courts will continue to afford deference to those business decisions, so long as they are taken reasonably, within a range of reasonableness, as is provided for by the business judgment rule.

The business judgment rule

Both the Supreme Court decisions in *Peoples* and *BCE* dealt with the business judgment rule, by which is meant the courts will treat with deference a business decision, so long as it is taken with appropriate care and process and lies within a range of reasonable alternatives. This rule applies to decisions made by the directors and officers in the context of the fiduciary duty owed by them to the corporation. According to these rulings, as long as directors exercise care and use appropriate process in reaching their decision, respecting the legal rights and having reasonable regard for the interests of all stakeholders affected by their decision, their balancing of conflicting stakeholder interests in determining the best interests of the corporation will be treated as a matter of business judgement, not to be overturned by the courts unless it falls outside the range of reasonableness.

The *BCE* case illustrates how the business judgment rule provides limits to the oppression remedy. The Supreme Court reiterated that everything depends on the particular situation faced by the directors or officers and whether, in that context, they exercised business judgement in a responsible way. In a situation of conflicting interests between the corporation and other stakeholders, the court noted, the decisions of directors cannot be governed by any specific priority rules, but rather must be a function of their business judgement as to what is in the best interests of the corporation in any particular situation.

In the particular circumstances of *BCE,* the Supreme Court found that in making their decision, the directors had considered their interests but acted in what they perceived to be the best interests of the corporation, even though this turned out to have a negative impact on the debenture holders. The debenture holders' recourse in oppression was thus dismissed, highlighting that the business judgment rule can provide a defence to oppression remedy lawsuits.

In *Peoples*, the court had the opportunity to discuss the business judgment rule with respect to the duty of care owed by directors and officers. The Supreme Court of Canada concluded that decisions made by directors and officers must be reasonable business decisions in light of all the circumstances about which the directors knew or ought to have known at the time they were made and that perfection is not demanded of them. Accordingly, the court applied the business judgment rule to the duty of care in this manner:

> 'Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an

appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made (par. 67).'

The Supreme Court also stated clearly in that case that good corporate governance rules should provide a shield against claims:

> 'The emergence of stricter standards puts pressure on corporations to improve the quality of board decisions. The establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care (par. 64).'

The duty of care

- **Raising the standard:** Article 122 (1) b) *CBCA* sets a minimum standard of conduct for directors and officers in the conduct of affairs of the company. In *Peoples*, the Supreme Court set aside the 'objective/subjective' standard of care previously adopted by the courts in this regard and chose an objective standard of conduct instead. This tightening of the standard of conduct reflects the willingness of the courts to heighten the accountability of the directors and officers and to promote the adoption of good corporate governance rules by the corporations.

- **The beneficiaries:** Since the Supreme Court decision in *Peoples,* it is established that while no fiduciary duty is owed by the directors to creditors or other stakeholders of the corporation, creditors and other stakeholders may nevertheless have a recourse against directors and officers of *CBCA* companies for breach of their duty of care towards them, where there are facts to support it.

Certain provinces, including the two largest, Quebec and Ontario, have adopted provisions to limit the effect of this interpretation with respect to corporations regulated by their corporate statutes, which specify that the duty of care is owed only to the corporation. In Quebec, this new legislation, the Business Corporations Act (S.Q. 2009, c. 52), was assented to on 4 December 2009 but has not yet come into force.

Directors and officers can take some solace in the fact that Canadian courts, while also raising standards of conduct for directors and officers, have nevertheless refused any dramatic changes and, if anything, have continued to apply and even reinforce certain important defences such as the business judgment rule.

Recent developments in Canadian securities laws and litigation

In the past two decades, many jurisdictions have amended their corporate and securities legislation in response to growing concerns of shareholders and the general public regarding the accountability of directors. Canada was no exception, and in the late 1990s, it followed this trend when the regulators, the Canadian Securities Administrators ('CSA'), proposed amendments to Canadian securities legislation to provide remedies to shareholders who had purchased their shares on the secondary market.

Shareholder class actions had until then been largely unsuccessful in Canada and it was felt that one of the more effective ways to ensure better governance practices and full continuous disclosure was to amend the legislation to facilitate such class actions and, in particular, to remove the previously next to insurmountable obstacle of having to prove reliance. By 2008, most Canadian jurisdictions with significant securities activity, including Ontario, Quebec, Alberta and British Columbia, had adopted similar amendments, providing for facilitated class-action recourses in which reliance on the misrepresentations was presumed.

On 31 December 2005, the modifications to Ontario's Securities Act (Securities Act, R.S.O. 1990, c. S-5) introduced by *Bill 198* (an Act to Implement Budget Measures and other Initiatives of the Government, S.O. 2002, c. 22) finally came into force. These amendments created a statutory cause of action for misrepresentations made in public documents and statements for those purchasing shares in the secondary market. These modifications were designed to ensure accurate and complete disclosure by reporting issuers and others involved in the preparation and dissemination of such public documents and statements, which the legislators considered to be an essential element in the healthy functioning of the securities market.

These legislative changes emphasise the use of private recourse instead of regulatory enforcement. By facilitating class actions and eliminating one of the main obstacles to such proceedings, it was hoped by the legislators that investors would be in a better position to take action in cases of violation of the new standards of disclosure.

The scope of these new provisions is broad. They permit an applicant to claim from the directors and officers of an issuer when there has been a violation of the disclosure requirements and misleading information is contained in a public document issued or an oral statement. This liability arises even if the director or officer did not participate in the preparation or dissemination of the document or statement. Furthermore, the new legislative provisions apply not only to issuers reporting in Ontario, but also to issuers who have 'a real and substantial connection to Ontario', thus permitting potential lawsuits against companies registered in a foreign jurisdiction. The new legislation thus exposes directors and officers to a risk of significant and lengthy litigation, even if they are innocent or if their company is not registered in the province where the suit is filed.

Although relatively few cases have been filed so far (in contrast to some dire predictions), the frequency and severity of these suits has become significant: in 2008 and 2009, 18 such suits were filed.

It should be noted that while the legislation imposes limits on the damages that may be claimed, most of these claims are for damages far exceeding these limits as the limits do not apply in cases of knowing misrepresentation which is inevitably alleged.

While none of the cases has proceeded to trial, in December 2009 the Ontario Superior Court has certified the first of these class actions, ***Silver v. Imax Corp.*** ([2008] O.J. No. 1844, '*IMAX*').

One of the more significant features of these cases is the question of early discovery of defendants by plaintiffs on the affidavits provided by defendants at the authorisation stage. In *IMAX*, plaintiffs had brought an application in Ontario relating to the refusal of their request to cross-examine certain witnesses who had submitted affidavits in support of the contestation of the application for leave. The court held that plaintiffs were entitled to at least some degree of discovery at this stage of the proceedings and the decision was upheld on appeal.

This outcome is in significant contrast to the situation in the US, where discovery is stayed under the Private Securities Litigation Reform Act of 1995 ('PSLRA') while a motion to dismiss is pending. As these proceedings are frequently filed in multiple jurisdictions, the *IMAX* ruling may enable plaintiffs to file in Canada to avoid the discovery stay provisions of the PSLRA by bringing an action in Canada.

In a ruling subsequent to the *IMAX* decision in first instance, ***Ainslie v. CV Technologies Inc.*** (93 O.R. (3d) 200, '*Ainslie*'), the court placed some limits on the right of cross-examination by the plaintiffs. In that case, plaintiffs sought to compel each defendant to file affidavit evidence and/or be examined. The court dismissed their application stating:

> 'The section was not enacted to benefit plaintiffs or to level the playing field for them in prosecuting an action under Part XXIII.1 of the Act. Rather, it was enacted to protect defendants from coercive litigation and to reduce their exposure to costly proceedings. No onus is placed upon proposed defendants by section 138.8. Nor are they required to assist plaintiffs in securing evidence upon which to base an action under Part XXIII.1. The essence of the leave motion is that putative plaintiffs are required to demonstrate the propriety of their proposed secondary market liability claim **before** a defendant is required to respond (par. 15).'

While plaintiffs sought and were granted leave to appeal this order, the case has since been settled and thus the issue remains for the moment unresolved.

Conclusion

The Canadian environment for directors and officers has changed significantly over the last few years as Canadian legislatures and courts have followed the worldwide trend towards greater accountability. In particular, the adoption of new provisions providing for class-action recourses for investors in the secondary market has resulted in increased severity and frequency of litigation involving directors and officers. However, directors and officers can take some solace in the fact that Canadian courts, while also raising standards of conduct for directors and officers, have nevertheless refused any dramatic changes and, if anything, have continued to apply and even reinforce certain important defences such as the business judgment rule. ■

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MONTREAL QUEBEC CITY LAVAL OTTAWA

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN CHINA

Mun Yeow, Partner
Frank Voon, Senior Associate
Allens Arthur Robinson

This chapter provides a summary of D&O liability in the PRC, particularly with regard to the Company Law that covers multinationals domiciled in the PRC as well as private and publicly quoted companies.

Directors' statutory duties

The significantly amended PRC Company Law ('Company Law') came into effect on 1 January 2006 and sets out the duties owed by directors to companies under PRC Law.

General duties

The general duty of a director is to comply with the laws, administrative regulations and the terms of the company's articles of association. The director must display diligence and be loyal to the company. The Company Law also provides that:

(i) a director must not accept bribes or other illegitimate income, or seize the assets of the company; and

(ii) a director must not use his or her related-party relationship to damage the interests of the company.

General prohibitions

The Company Law prohibits a director from:

(i) misappropriating company funds

(ii) depositing company funds in his or her own personal account or another's personal account

(iii) lending company funds to a third party or using company property to provide security for a third party in breach of the company's articles of association, without the consent of the board of directors or approval of a shareholders' general meeting

(iv) concluding contracts or carrying out transactions with the company in breach of the articles of association or without the approval of the shareholders in a general meeting

(v) using his or her position to obtain commercial opportunities rightly belonging to the company or engaging in serving (on his or her behalf or otherwise) businesses that are identical to the business of the company, without the approval of the shareholders in a general meeting

(vi) accepting commissions from transactions between other parties and the company

(vii) disclosing any secrets of the company without authorisation; and

(viii) committing any act of disloyalty to the company.

Directors' liabilities

Statutory

As individual members of a corporation's decision-making body, directors do not usually bear personal liability for the actions of the corporation unless the directors are in breach of their duties.

Under the Company Law, if a director is in breach of his or her duties (including by violating laws, administrative regulations or the company's articles of association) and causes the company to suffer loss, then he or she shall be liable for damages and shall give up any income derived from the breach. The Company Law permits a shareholder of a company to take action against a director who has acted in breach of his or her duties. Administrative and criminal penalties may also be imposed, depending on the circumstances.

The Company Law also provides that if a resolution of the board of directors is in violation of the law, administrative regulations, the company's articles of association or the resolutions of the shareholders' general meeting and it results in serious loss to the company, the directors who took part in the resolution shall be liable to the company for damages. However, if the director is proved to have expressed his or her opposition to such resolution when it was put to the vote and that opposition is recorded in the minutes of the meeting, then the director may be released from such liability.

The Company Law also sets out certain penalties for 'persons with direct responsibility', who may include directors. These persons may be the subject of (this list is not exhaustive):

- a fine of up to RMB 300,000 (but no less than RMB 30,000) for providing financial accounting reports and other such materials by a company to the relevant authority which contain fraudulent entries or conceal material facts
- revocation of their qualifications as directors for providing sham materials or a report containing serious omissions due to negligence while undertaking asset valuation, investment verification or other verification; and
- a fine of up to RMB 100,000 (but no less than RMB 10,000) if a company in liquidation conceals property, records false information in its balance sheet or financial statement, or distributes company property before it has paid its debts.

The Company Law prohibits certain persons from serving as a director for a period of three to five years. For example, a person who was serving as a director of a company when it was liquidated for insolvency and who had personal responsibility for the insolvency of the company, will not be qualified to serve as a director, supervisor or senior officer of any PRC company for three years after the liquidation. The PRC Bankruptcy Law which came into effect as of 1 June 2007 makes reference to this obligation.

Under the PRC Securities Law, which also came into effect as of 1 January 2006 ('Securities Law'), investors also have a statutory cause of action against various parties, including directors, if they incur a loss in securities trading due to false or misleading statements or material omissions (Article 69 of the Securities Law).

Under the PRC Criminal Law, a 'person with direct responsibility' (which may include a director) for the criminal act of the company under criminal prosecution may be subject to criminal prosecution.

Legal representatives' liabilities

Additional obligations can be imposed on the legal representatives of PRC companies. The legal representative:

(a) may be a director as well as the chairman of the board of directors or a manager of the company

(b) is registered with the State Administration for Industry and Commerce ('SAIC') as the person authorised to represent the company in the capacity of a legal representative

(c) has authority to affix the corporate chop or official stamp to documents and to bind the company; and

(d) has authority to take action on behalf of the company, subject to the company's articles of association and the terms of its business licence.

Commonly, the legal representative is a director as well as the chairman of a company.

As the legal representative is frequently required to sign documents or authorise actions, the regulators may apply a higher standard of care to that person than that imposed on directors.

A legal representative is also subject in general to other duties under PRC law. For example, Article 49 of the Civil Code provides that a court may impose fines on a company's legal representative if the company illegally carries out business activities beyond its approved scope of business or conceals information from the industry and commerce authorities. According to Article 63 of the Supreme Court Opinions on Implementing the Civil Code, the fines for these offences are generally less than RMB 2,000. A legal representative is also responsible for the settlement of the company's tax liabilities. He or she will be prevented from leaving China if the company's taxes have not been paid in full according to Article 44 of the Tax Collection Law. Under the Company Law, if a company has had its business licence revoked and has been ordered to close down due to a violation of law and where the legal representative bears personal responsibility for such violation, that legal representative is not qualified to serve as a director, supervisor or senior officer of a PRC company for three years.

The Kelon story

Guangdong Kelon Electrical Holdings ('Kelon') is China's biggest refrigerator and air-conditioning manufacturer. It is listed on both the Hong Kong and Shenzhen stock markets. The utilisation of these new PRC laws is exemplified by Kelon's experience. This matter has been carefully watched in China by both PRC and foreign interests. In 2005, Kelon reported the largest loss of any publicly-traded mainland company – RMB3.7 billion, or approximately US$529 million. The H Shares in Kelon were suspended from trading from June 2005 until recently, when the China Securities Regulatory Commission ('CSRC') launched a fraud investigation. The former Kelon chairman was dismissed in August 2005, together with eleven other Kelon executives. An investigation found that Kelon overstated its profits by RMB387 million (US$55 million) and revenues by RMB1.2 billion (US$171 million).

The Regulator

Under the Securities Law, the CSRC has imposed fines of between RMB300,000 and RMB600,000 – being the maximum prescribed fines available under the new law.

More specifically:

- in early July 2006, Kelon was fined RMB600,000 (US$86,000) for providing false information and other offences; and
- its former chairman was fined RMB300,000 (US$43,000) in mid-July 2006.

Although these fines are, in an international context, very mild penalties, they do have significant symbolic significance. As one PRC ratings manager puts it: 'it is good to see penalties imposed on financial wrongdoing in China. In the past, CSRC mostly censured companies for wrongdoing but rarely fined them.'

In addition:

- in March 2006, subsidiaries of Kelon initiated recovery proceedings against the former chairman seeking RMB331.6 million (approximately US$47.3 million); and
- the CSRC utilised its new-found power to ban the former chairman from any future role in the Mainland's stock markets. Article 233 of the Securities Law provides that, if laws, administrative regulations or relevant provisions of the State Council's securities regulatory authority are violated and the circumstances are serious, the State Council's securities regulatory authority may ban the relevant persons responsible from the securities market. The phrase 'ban from the securities market' means that the affected person may not engage in the securities business or is prohibited from serving as a director, supervisor or senior officer in a listed company for a certain period of time or for life.

On 9 April 2009, the Guangdong People's High Court ordered the former chairman to pay damages of RMB304 million (US$43 million) to the subsidiaries of Kelon.

A court may impose fines on a company's legal representative if the company illegally carries out business activities beyond its approved scope of business or conceals information from the industry and commerce authorities.

Shareholder actions

On 6 July 2006, shareholders filed a lawsuit against Kelon and its former auditor. The majority of the claimants agreed to court-supervised mediation with Kelon (which the former auditor opted out of), and on 11 June 2009, the mediator asked Kelon to compensate the A-share shareholders RMB14.5 million (US$2 million). The claim brought by the H-share shareholders was unsuccessful on the basis that the dispute should be resolved by arbitration under the articles of association of Kelon.

Twenty-nine of the claimants refused to accept the mediator's recommendation and proceeded with the claim against Kelon and its former auditor in court. The case is ongoing but the Guangzhou Intermediate People's Court has accepted the claim against the former auditor (which has denied any failing on its part). An earlier claim against the former auditor brought by an investor in Kelon was rejected by a Shanghai court in March 2006 on the basis that the matter must not be heard without the CSRC first reaching its conclusions regarding its inquiry into the audits performed, some of which were in fact qualified audit reports and accounts. The former auditor has stated that it performed its audit role to a high professional standard.

The claims against Kelon may be the first high-profile test for China's laws designed to improve protection for small and minority shareholders.

Shareholder claims, under the Company Law, may either be direct or derivative suits.

In addition, under the Securities Law, companies and their directors and officers have an exposure if they release any misleading information that results in loss to investors.

After Kelon

Some recent cases after Kelon in this area would include:.

- Yangling Qinfeng was fined RMB600,000 (US$86,000) by CSRC on 31 March 2008 for understating its liabilities, and its chairman and certain officers were also fined a sum of RMB30,000 (US$4,300) to RMB200,000 (US$28,571) by CSRC.
- On 27 May 2009, the Jiangxi People's High Court ordered the chairman and directors of Changlin Tianyuan to pay damages of RMB3,436,000 (US$490,000) to the minority shareholders of Changlin Tianyuan for engaging in connected transactions on unfair terms.
- Amoi Electronics was fined RMB600,000 (US$86,000) by CSRC on 15 November 2009 for overstating its profits, and its chairman and certain officers were also fined a sum of RMB30,000 (US$4,300) to RMB 100,000 (US$14,285) by CSRC.

Corporate governance in the PRC

The Company Law and Securities Law contain important rules concerning corporate governance of PRC companies.

Duties of loyalty and diligence

The Company Law expressly requires the directors, supervisors and senior officers of PRC companies to fulfil the 'duties of loyalty and diligence' to their companies. This expression is an extension to the duties of 'faithful performance and maintaining the interest of the company' under the old PRC company law. This, together with new avenues for recourse by the shareholders against directors, supervisors and senior officers, are designed to create an improved corporate governance regime in the PRC.

Piercing the corporate veil

In an attempt to curtail and restrain any abuse of the rights of shareholders, the Company Law introduces, for the first time, the doctrine of 'piercing the corporate veil'. This provides that the shareholders of a company are jointly and severally liable with the company where the shareholders abuse either the independent legal status of the company as a separate corporate legal person or their limited liability status to evade the debts of the company and cause substantial losses to the company's creditors. A shareholder is also liable to the company or other shareholders for any abuse of such shareholders' rights.

Supervisory board

The Company Law introduces provisions to entrench the importance of independent supervision of the supervisory board. That is, shareholders are allowed to request the supervisory board to commence legal proceedings against a director or a senior officer. Also, a supervisory board must now have employee representation of no less than one-third of the supervisory board, and these representatives must be democratically elected by employees.

Independent directors

The Securities Law tightens the insider trading rules applying to directors, supervisors and senior officers of listed companies. In addition to the express qualifications that a director, supervisor and senior officer must possess, the securities exchange is empowered, in certain circumstances, to remove a director, supervisor or senior officer who has not been totally responsible and diligent to the company. The Company Law requires a listed company to have independent directors.

Who can be liable?

Much of PRC law is drawn originally from German law, or German legal concepts, and so the structure of the bodies controlling and managing a PRC company is similar to the German system. That is, a two-tiered structure with:

- a board of directors which supervises and oversees the company management; and
- a supervisory board which oversees the board of directors.

In practice, the board of directors is the ultimate decision-making body within the company.

As a result, claims may primarily be made against directors, supervisors and senior officers. It is these individuals who owe the duty of 'loyalty and diligence' to the company (Article 148 of the Company Law) and who may be sued for breaches of the law under Articles 150 and 153 of the Company Law.

Apart from directors and supervisors, 'senior officers' include a company's manager, deputy manager, financial officer, the secretary to the board of directors of a listed company and other persons specified in the company's articles of association.

PRC government authorities, including those responsible for company registration, labour protection, taxation, customs, environmental protection, fire protection, and overall employee and public safety, in some instances have powers to impose administrative penalties (including warnings, fines, confiscation of illegal income or property, and administrative detention) on the 'responsible persons' of a company that are in breach of relevant laws and regulations.

Personal liability of directors and officers

The primary sources of personal liability in the context of recent developments – namely, the introduction of the Company Law and Securities Law, include:

Specifically, Articles 150 and 153 of the Company Law which state that:

- if a director, supervisor or senior officer violates laws, administrative regulations or the company's articles of association in the course of performing his or her company duties, thereby causing the company to incur a loss, he or she shall be liable for damages (Article 150); and
- if a director, supervisor or senior officer violates laws, administrative regulations or the company's articles of association, thereby harming the interests of a shareholder, the shareholder may institute legal proceedings in a People's Court in respect thereof (Article 153).

Article 69 of the Securities Law states that if the share prospectus, method of offer of corporate bonds, financial accounting reports, listing report documents, annual report, interim report, ad hoc reports or other disclosed information published by an issuer or listed company contain false or misleading statements or material omissions, thereby causing investors to incur

a loss in securities trading, the issuer or the listed company shall be liable for damages. The issuer's or listed company's directors, supervisors, senior officers and other persons directly responsible as well as the sponsor and the securities company acting as underwriter shall be jointly and severally liable with the issuer or listed company, unless they are able to establish that they were not at fault. If the issuer's or listed company's controlling shareholder or de facto controller is at fault, they shall be jointly and severally liable with the issuer or listed company.

Who can sue?

Under the PRC Company Law and Securities Law, the most relevant provisions creating exposure for directors and officers include:

(a) **the company** itself has a claim in damages against a director, supervisor or senior officer if they violate laws, administrative regulations or the company's articles of association in the course of performing their duties, which causes loss to the company (Article 150, Company Law). Such a violation of law may include a breach of directors' duties as now defined in the Company Law, and summarised above

(b) **a shareholder** may institute legal proceedings if a director, supervisor or senior officer violates laws, administrative regulations or the company's articles of association, thereby harming the interests of the shareholder (Article 153, Company Law). Such a violation of law may include a breach of directors' duties as now defined in the Company Law, and summarised above

(c) **an investor** has a statutory cause of action against various parties if they receive false or misleading statements or material omissions in information, which cause the investor to incur a loss in securities trading. Such information/statements are specified to potentially arise in a share prospectus, offer of corporate bonds, financial accounting reports, listing report documents, annual reports, interim reports, ad hoc reports, or other disclosed information published by an issuer or listed company. Those liable may include the issuer, the listed company, the directors/supervisors/ senior officers who are directly responsible, the sponsor, the underwriter and any controlling shareholder (Article 69).

A shareholder may institute legal proceedings if a director, supervisor or senior officer violates laws, administrative regulations or the company's articles of association, thereby harming the interests of the shareholder.

Under the PRC Civil Procedure Law, the concept of a 'joint action' is permitted; similarly a 'representative action' is available. For a joint action (Article 53), two or more persons with the same litigious objective or the same category of claim, can pursue a claim jointly. This is the equivalent of a 'class action' in other jurisdictions. A representative action is possible (under Article 55) where 'numerous persons' have a claim in the same category. In these circumstances, a People's Court may issue a public notice stating the particulars of the case and inviting claimants to join the action – via the representative – by registering their interest.

Can the company indemnify its directors and officers under PRC Law?

PRC companies seeking listings overseas are subject to the relevant Chinese laws and regulations which include the Special Regulations on the Overseas Offering and Listing of Shares by Joint Stock Limited Companies and the Mandatory Provisions for Companies Listing Overseas. In particular, the Mandatory Provisions enhance basic shareholder protection under a PRC company's articles of association, to a similar standard to that provided under (for example), Hong Kong company law, such as provisions relating to the rights of shareholders, directors' fiduciary duties, corporate governance

matters, financial disclosures, situations requiring a separate vote by holders of overseas listed foreign shares, and a mechanism for resolving disputes by arbitration.

However, neither the requirements nor PRC law specifically address the ability of a PRC company to grant an indemnity to its directors and officers.

In the context of public offerings, however, the provisions of the company's articles of association would be subject to approval by the regulators, such as the CSRC. It is the case that, despite the lack of express law in this regard, PRC regulators have approved revised articles of association which do grant an indemnity to directors. There is, however, no consistency at present as to what is a permissible, or a prohibited liability or exposure for which indemnity is granted.

What types of directors' insurance are available?

The D&O insurance market in PRC is developing, but is still at a relatively early stage. Having said that, the D&O insurance products offered in PRC are similar to those in Western economies and can only be offered by authorised insurers and reinsurers (which now includes Lloyds' of London). ■

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CLEAR THINKING

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN GERMANY

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The legal provisions governing the liability of directors and officers ('D&O') in Germany have been enforced on numerous occasions. Well-known court decisions concerning D&O liability include cases involving Mannesmann, Volkswagen and SIEMENS. In the current financial crisis, the trend for holding directors and officers liable – in particular, in the banking sector – will no doubt increase, while recent changes in legislation have also resulted in a tightening of D&O liability. The Act on the Adequacy of Managerial Salaries (*Gesetz zur Angemessenheit der Vorstandsvergütung* – 'VorstAG') has put forward a number of major requirements in this respect. In this chapter, we describe the considerable impact on D&O insurance policies of the tightened liability regime in Germany.

The first part of this chapter provides an overview of the important aspects of the standard of care applicable to directors and officers of German companies and the liability arising from a breach of that standard of care. We differentiate between managing directors of a *limited liability company* ('GmbH') and members of the management board and of the supervisory board of a *stock corporation* ('AG'). In addition, we look at public listed companies. In the second part, we describe the D&O insurance policies currently available in Germany, paying particular attention to new requirements set out by the VorstAG. Finally, we highlight the substantial changes in the practice of setting managerial salaries as set out by the VorstAG.

Standard of care and liability of directors and officers

Managing directors of a GmbH

The GmbH is the most common legal form in Germany. Its board consists only of managing directors – non-executive members are not known under German law. Managing directors must apply the care of a prudent businessman in the conduct of their office. The most important aspects of the managing director's duty of care are:

- observance of the law, articles of association, rules of procedure and compliance with instructions of shareholders
- fiduciary duty of confidentiality and duty of non-competition
- Business judgment rule (codified in Sec. 93 (2) of the German Stock Corporation Act (*Aktiengesetz* – 'AktG') and also applicable to GmbH): broad entrepreneurial discretion but careful preparation of business decisions (risk evaluation) and documentation required
- observing share capital maintenance rules (prohibition on refund of contributions to shareholders or repayments of loans replacing shareholders´ equity)
- monitoring of the liquidity and financial situation of the company (in case of over-indebtedness or illiquidity, duty to file for insolvency proceedings without undue delay) and introduction of a risk-management system;
- payment of taxes and social security contributions.

In the case of a breach of duties, managing directors are liable to the company for damages. The burden of proof is reversed, ie the company has only to prove that it has suffered damages as a result of the actions of the managing director, while the managing director has to prove that he observed his duties. The shareholders' meeting decides by simple majority whether to assert a claim. The shareholders' meeting may waive a claim for damages, or settle a dispute thereon. The time limit for claims for damages is five years.

In general, managing directors are not liable *vis-à-vis* shareholders or third parties. Only in exceptional cases does such liability arise; for example, if a managing director personally performs a tortious act. Also, in cases of a violation of protective law, a liability *vis-à-vis* third parties may result (eg the duty to file for insolvency proceedings).

Members of the management board of an AG

In contrast to a limited liability company, a stock corporation has a two-tier board system. The company is represented by the management board members who are elected and controlled by the supervisory board.

Members of the management board have to observe the same standard of care as managing directors of a GmbH; in particular, the business judgment rule applies. Further, management board members are not obliged to take orders from shareholders or supervisory board members concerning the management of the company.

A waiver or a settlement of claims for damages is only admissible after three years, and then only if (i) the general meeting consents and (ii) there is no objection from shareholders holding 10% of the share capital.

Claims for damages are asserted by the supervisory board or by a resolution of the general meeting. Further, minority shareholders (representing 1% or €100,000 of the registered share capital) may demand the assertion of claims for damages.

Members of the supervisory board of an AG

The members of the supervisory board of a stock corporation have to perform their duties (in the first instance controlling the management board) guided only by the interest of the company and in accordance with the business judgment rule. The supervisory board is not obliged to follow instructions from the shareholders. Stock options cannot be granted to

supervisory board members in order to secure their independence. Members of the supervisory board are subject to a confidentiality obligation. As opposed to the management, the supervisory board members are not prohibited on competition but they must avoid any conflicts of interest.

Any contracts, in particular advisory agreements, with supervisory board members or with consulting firms where a supervisory board member has some involvement, require the consent of the supervisory board (the respective member has no right to vote) and have to describe in detail the scope of the services to be rendered (these must differ from general consulting activities). Such activities are deemed to be already within the scope of duties of the supervisory board member and may not be the subject of a separate consulting agreement with additional remuneration.

The supervisory board decides on the remuneration of the management board members. Bonus payments granted to management board members are only admissible if already stipulated in the employment contract. Without such provision, bonus payments for past performance (eg in relation to a successful merger) may be held void.

Claims for damages are asserted by a resolution of the general meeting. Further, minority shareholders (representing 1% or €100,000 of the registered share capital) may demand the assertion of claims for damages.

Higher demands for listed companies

The management board and the supervisory board of a listed stock corporation must declare once a year that they comply with the recommendations of the German Corporate Governance Code (under the 'comply-or-explain' principle).

In addition, and in accordance with the Securities Law, board members have to observe certain duties:

- prohibition of insider trading: nobody who has gained access to inside information is permitted to use such information for trading
- insider lists: obligation to maintain and submit to the supervisory authority a list of persons active on behalf of the company who are authorised to access inside information
- ad-hoc disclosure: any information about circumstances must be disclosed without undue delay, provided that such circumstances have a significant effect on the stock price
- prohibition of market manipulation: it is prohibited to make false or misleading statements regarding circumstances which are significant for the valuation of the securities, or to fail to disclose such circumstances
- directors' dealings: board members must notify the company about any trading in securities of the company
- takeover: the management board of a target company may only take defensive actions against a takeover offer if authorised by a resolution of the general meeting.

In January 2007 an oath on the financial statement of a listed stock corporation was introduced. All members of the management and supervisory board have to confirm in a written statement that, to their best knowledge, the financial statements are true and correct.

Recent trends in the practice of the Federal Court of Justice

In recent years D&O liability has been sustainably tightened effectively through case law established by the German Federal Court of Justice (*Bundesgerichtshof* – 'BGH'). Two decisions of the Criminal Division are particularly noteworthy in connection with the scope of D&O liability:

Extended definition of 'breach of trust'

In a judgment dated 29 August 2008 (case no. 2 StR 587/07), the BGH held that the divestment and withholding of substantial assets by setting up covert accounts through executive employees of a commercial undertaking already causes a definite disadvantage within the meaning of Sec. 266 (1) of the German Criminal Code, and thus entails a criminal liability on grounds of breach of trust. Any intention to use the money in the company's economic interest is irrelevant in this context. Hence, there is no possibility for the employee in question to relieve his liability.

Increased risk for compliance officers

In another ruling, dated 17 July 2009 (case no. 5 StR 394/08), the BGH stated for the first time that compliance officers are exposed to particular risks of criminal liability. According to the judgment, compliance officers may be subject to a guarantor duty as defined in Sec. 13 (1) of the German Criminal Code, depending on the provisions of the service contract, the relationship of mutual trust and the job description. A mere omission by the compliance officer, specifically failure to prevent criminal acts by employees of the company, is treated as if the compliance officer himself had actively committed the criminal act.

D&O insurance

The character of D&O insurance

From a legal perspective, D&O insurance is a liability insurance against financial loss. D&O insurance coverage consists of (i) the verification of liability, (ii) the settlement of non-contested claims and (iii) the rejection and legal defence of unfounded claims.

Unlike many other jurisdictions, D&O insurance is still not compulsory under German law, notwithstanding D&O liability has been sustainably tightened by recent case law.

The conditions and coverage of the products offered by the leading insurance companies are diverse. In general, the insurance contracts are based on the claims-made principle so that the first claim is fixed as the insured event. The D&O insurance policy holders are the companies concerned, while the directors and officers are integrated as insured persons.

When effecting D&O insurance based on the claims-made principle, the following points must be observed:

- accurate and sufficient description of the insured activity of the insured person
- timely and sufficient retroactive cover
- timely and sufficient run-off liability period
- cover of slight and gross negligence
- sufficient amount of cover
- transparent and understandable contractual terms and conditions.

D&O insurance contracts regularly do not cover and insure intentional (ie knowingly and willingly committed) breaches of duty by the insured. Furthermore, contractual conditions often provide for an expiry of the run-off liability in case of a change in control of the insured company. Moreover, claims for damages covering contractual penalties, administrative fines, fines or indemnities as punishment (punitive damages or exemplary damages) are regularly excluded.

New legal guidelines for D&O insurance policies in Germany

Compulsory personal deductible

Unlike many other jurisdictions, D&O insurance is still not compulsory under German law. But if stock corporations do provide D&O insurance for their directors, they will have to comply with new mandatory requirements set out by the VorstAG. This reform act has amended Sec. 93 (2) sent. 3 AktG. Starting from the commencement of the VorstAG, companies purchasing D&O insurance for their executives must impose a personal deductible to be borne by the directors equivalent to at least 10% of the relevant loss up to an annual maximum figure calculated by the reference to the fixed remuneration of the director from time to time. Practical guidance is to be found in the legislative intent (cf. BT-Drucks. 16/13443), which states that the required personal deductible shall consist of at least 10% of *each loss*, subject to an *annual cap* that must be set at not less than one-and-a-half times the annual fixed remuneration of the director. The aggregate cap is to be reviewed annually to reflect changes in the fixed elements of the director's remuneration.

These requirements are applicable to *all* German stock corporations – listed companies are affected as well as privately held companies. Although German stock corporations have a two-tier board system, Sec. 93 (2) sent. 3 AktG only applies to the members of the board of directors. Supervisory board members are explicitly excluded from the scope of application (Sec. 116 AktG). Nevertheless, D&O insurance for supervisory board members with a compulsory personal deductible are expected as a matter of good practice as set out in no. 3.8 of the German Corporate Governance Code. This Code is indeed not mandatory, but there is the requirement according to Sec. 161 AktG that listed companies must declare once a year in their filings whether they are in compliance with the Code's recommendations, and if not they must provide a satisfactory explanation (again, the 'comply-or-explain' principle).

The provisions of Sec. 93 (2) sent. 3 AktG apply with immediate effect to all newly concluded D&O insurance contracts, while those already in existence are to be amended with effect from 1 July 2010 at the latest. There is a transitional exception for those companies that are already obliged under an existing service contract to provide D&O insurance cover to the director without deductible. In those cases, the policy terms may remain unchanged until the appointment of the relevant director and the underlying service agreement expires. The statutory maximum appointment term of a board member is five years.

The new D&O provisions in Sec. 93 (2) sent. 3 AktG expressly do not apply to German limited liability companies (Sec. 52 (1) of the German Limited Liability Company Act).

D&O deductible insurance

The new legislation (the VorstAG) does not prevent directors from insuring their personal deductible exposure separately. Premiums for such policies have to be borne privately by the directors. Though it may appear possible to adjust the directors' remuneration in order to cover the cost of the premium, both companies and directors should be careful when agreeing to such an adjustment as this could easily be seen as an act of avoidance with regard to Sec. 93 (2) sent. 3 AktG.

Recent developments in the German D&O market

In practice, the new line of D&O deductible insurance is already established in Germany. Furthermore, D&O policies are often extended to criminal proceedings against insured board members. The recent developments in the banking sector in particular have fed through into insurance pricing. D&O policies taken out by banks have become substantially more expensive in the German market, on average by about 40%. However, the rates for medium-sized companies are still generally on the decline due to a fiercely competitive German D&O market in the SME sector.

Substantial change in the practice of setting managerial salaries

The VorstAG also brings about an amendment to Sec. 87 (1) AktG, which obliges the supervisory board members to ensure that the total remuneration of members of the board of directors is a suitable reflection of their tasks, their performance, and of the performance of the relevant company and requires that the customary remuneration of a director is not to be exceeded without specific reasons. Furthermore, in the case of listed companies, the directors´ remuneration has to be consistent with the sustained development of the company; the performance elements of directors´ remuneration are to be assessed on the basis of several years up to the entire term of appointment and short-term performance measures are no longer acceptable. The new provisions also stipulate that the supervisory board shall reduce the directors´ remuneration if and when the remuneration seems to be inequitable because of a deterioration of performance of the company (Sec. 87 (2) sent. 1 AktG).

Conclusion

In the current economic climate and following the tightening of regulations, directors and officers in Germany have to fear increased D&O liability. In view of the multitude of contractual conditions of D&O insurance offered on the market, as well as the frequently non-transparent and non-comparable insurance terms and conditions, it is advisable to have an insurance broker specialised in this specialist market to select the insurance product offering the most suitable and sufficient terms and conditions. Since the policyholder of such insurance is typically the company, the insured person (ie the board member) should insist that the signed policy is clearly transparent so that he is able to understand fully whether and to what extent he is covered, along with the extent of his personal liability towards the company. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN HONG KONG

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This chapter provides a summary of the D&O duties and liabilities in Hong Kong, particularly with regard to the recent company law reform and other significant legal developments in this area of law.

Directors' duties

Directors' duties in Hong Kong mainly arise from the general law at equity and common law. Directors are fiduciaries vis-à-vis the company. Such duties are owed to the company, rather than the individual shareholders. Directors are expected to act in the best interests of the company as a whole.

The Hong Kong Companies Registry, therefore, published the 'Non-statutory Guidelines on Directors' Duties' which is now retitled as 'A Guide on Directors' Duties' for directors' ease of reference.

A Guide on Directors' Duties

The Guide sets out 11 general principles governing directors' duties in Hong Kong, but these are not meant to be exhaustive statements of the law.

Principle 1: Duty to act in good faith for the benefit of the company as a whole

Principle 2: Duty to use powers for a proper purpose for the benefit of members as a whole

Principle 3: Duty not to delegate powers except with proper authorisation and duty to exercise independent judgement

Principle 4: Duty to exercise care, skill and diligence

Principle 5: Duty to avoid conflicts between personal interests and interests of the company

Principle 6: Duty not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law

Principle 7: Duty not to gain advantage from the use of position as a director

Principle 8: Duty not to make unauthorised use of a company's property or information

Principle 9: Duty not to accept personal benefit from third parties conferred because of position as a director

Principle 10: Duty to observe the company's memorandum and articles of association and resolutions

Principle 11: Duty to keep proper books of account

Although these principles are not statutory in nature, they reflect the position of the general law. Any breach may therefore result in a director potentially incurring personal liability.

Rewrite of the Companies Ordinance: standard of care

Principle 4, the duty to exercise care, skill and diligence, is of paramount importance. It reflects the modern case law position in *Re City Equitable Fire Insurance Co Ltd* (*Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.) which was affirmed by *Law Wai Duen v Boldwin Construction Co Ltd* in Hong Kong (*Law Wai Duen v Boldwin Construction Co Ltd* [2001] 4 HKC 403.) More importantly, it combines the dual standards of care expected of a director – both objective and subjective, mirroring the codified directors' duties in section 174(2) of the UK Companies Act 2006.

The common law reserves the right for shareholders to sue any wrongdoers on behalf of the company if such wrongdoers are in control of the company.

A director of a company must exercise the care, skill and diligence that would be exercised by a reasonable person with the general knowledge, skill and experience reasonably expected of a director (objective test). In determining whether a director has fulfilled this duty, the court will also consider whether he has exercised the care, skill and diligence that would be exercised by a reasonable person in possession of any additional knowledge, skill and experience held by the director (subjective test).

On 2 April 2008, the Financial Services and Treasury Bureau launched its consultation on the rewrite of the Companies Ordinance concerning directors' duties. Given the fact that there is no clear judicial authority as to how far the mixed objective and subjective standards will be applied in Hong Kong, the draft Companies Bill will incorporate a clear statutory statement on the dual standards of care expected of a director. This will include a period of further public consultation. This significant development is intended to clarify the law and enhance corporate governance in Hong Kong.

Directors' liabilities

Directors and officers, in the course of performing their duties, are exposed to significant legal risks of personal liabilities and the risk of disqualification. During 2009, the companies regulator (the Securities and Futures Commission (the **SFC**) has been quite active in its applications to the Court for orders banning or disqualifying certain individuals from acting as directors or being involved in the management of companies. The SFC has been successful in many of these applications.

Otherwise, if directors fail to perform the duties as summarised above, they may be subject to lawsuits brought by the company, shareholders and also the regulatory body.

Companies are permitted to indemnify any officer of the company and to purchase insurance against liability incurred, except for fraud.

Who can sue?

Company

The proper plaintiff rule laid down in *Foss v Harbottle* (*Foss v Harbottle* (1843) 2 Hare 461.) is applicable in Hong Kong. The rule states that if the directors have inflicted wrong on a company, the proper plaintiff is the company itself. So a company may bring an action against directors for breach of fiduciary duties. Most commonly, liquidators standing in the shoes of the company would bring actions against directors.

Shareholders

Common law rights

The common law reserves the right for shareholders to sue any wrongdoers on behalf of the company if such wrongdoers are in control of the company. Shareholders may bring derivative actions against directors if there is fraud on the minority, illegality or unfair and oppressive abuse of powers on the part of directors.

Statutory rights

Section 168A of the Companies Ordinance (the **CO**) provides that any member of the company can apply to the court for an order on the ground that the affairs of the company are being or have been conducted in a manner which is unfairly prejudicial to the interests of the members generally or of some part of the members (including himself).

Moreover, Part IVAA of CO provides for a statutory derivative action. Section 168BC, as newly added in 2005, provides that a member of a specified corporation (a Hong Kong incorporated company or a non-Hong Kong company) has a statutory right to bring proceedings on behalf of the corporation or intervene in proceedings to which that corporation is a party. This right can be exercised by the shareholders if the directors have committed misfeasance against the company (misfeasance is defined under section 168BB(2) to include fraud, negligence, default in compliance with any enactment or rule of law or breach of duty), and the company itself fails to bring proceedings or diligently continue, discontinue or defend the proceedings, provided that leave is granted by the Court.

Regulatory body

The Securities and Futures Commission (SFC), the securities market watchdog, has exercised its statutory power to seek court orders to disqualify 13 directors of four listed companies since 2003. Under section 214 of the Securities and Futures Ordinance (the **SFO**), the court may make orders disqualifying a person from being a company director or being involved, directly or indirectly, in the management of any company for up to 15 years, if such person is found to be wholly or partly responsible for the company's affairs having been conducted in a manner which involves defalcation, fraud or other misconduct. A recent case involves Warderly International Holdings. The SFC filed a writ with the High Court in September 2009, alleging the six current and former directors of Warderly:

- failed to manage the company with the necessary degree of skill, care, diligence and competence as is reasonably expected of persons of their knowledge and experience holding their offices and functions within the company; and
- failed persistently to ensure the company fully complied with disclosure requirements under the Listing Rules, specifically related to disclosure of the true financial situation of the company.

Criminal liability of directors

Amended Copyright Ordinance

An amendment to the Copyright Ordinance (Cap 528) came into effect in mid-2008. Section 118 (2H) provides that directors and senior management may be subject to criminal liability if the companies have committed copyright offences. This provision exposes directors to a higher risk of incurring personal liability, including jail and monetary fines.

Recent case law: To Shu Fai v Securities and Futures Commission

In the recent case *To Shu Fai v Securities and Futures Commission* (To Shu Fai v Securities and Futures Commission [2009] HKCU 423), the Court of Final Appeal held that a director is criminally liable by virtue of section 390 of the SFO if a company is guilty of providing the Stock Exchange of Hong Kong with false and misleading information in breach of section 384(1) of the SFO.

Corporate rescue bill: potential liability of directors

If the Corporate Rescue Bill is passed, directors may be held liable for insolvent trading. The global financial crisis in 2008 highlighted the need to introduce United States Chapter 11-style bankruptcy protection in Hong Kong. The government released a consultation paper on the revised draft of the Corporate Rescue Bill in October 2009, attempting to revisit the rescue plan despite its two previous failures.

The bill attempts to introduce the idea of insolvent trading which would be applicable to companies in general. Insolvent trading refers to the situation in which a company incurs a debt at a time when it is unable to pay its debts on the due date. The responsible persons, including directors and shadow directors but exempting senior management, might be held liable for insolvent trading if they knew or ought reasonably to have known the company was insolvent or knew or ought reasonably to have known that there was no reasonable prospect that the company could avoid becoming insolvent; and if such persons failed to take any steps to prevent the insolvent trading. Yet, mere reasonable suspicion would not be sufficient to hold a director liable for insolvent trading.

An amendment to the Copyright Ordinance provides that directors and senior management may be subject to criminal liability if the companies have committed copyright offences.

If a positive response is received in the three-month consultation, the government will put the bill on table for further discussion by the end of 2010 or early 2011.

Can the company indemnify its directors and officers under Hong Kong Law?

By virtue of section 165 of CO, companies are allowed to indemnify directors and officers. It is clear from the provision that a company is able to provide an indemnity for directors' liability incurred to third parties, including shareholders and creditors, in the course of performing duties and exercising powers.

Section 165(3) provides that:

> 'A company may purchase and maintain for any officer of the company, or any person employed by the company as auditor:
>
> (a) insurance against any liability to the company, a related company or any other party in respect of any negligence, default, breach of duty or breach of trust (save for fraud) of which he may be guilty in relation to the company or a related company; and

(b) insurance against any liability incurred by him in defending any proceedings, whether civil or criminal, taken against him for any negligence, default, breach of duty or breach of trust (including fraud) of which he may be guilty in relation to the company or a related company.'

Companies are permitted to indemnify any officer of the company and to purchase insurance against liability incurred, except for fraud. D&O insurance is not a mandatory requirement in Hong Kong. Yet, as recommended by the Listing Rules, it is a good practice that "an issuer should arrange appropriate insurance cover in respect of legal action against its directors".

What types of directors' insurance are available?

D&O insurance is essential in enhancing corporate governance. According to the Office of the Commissioner of Insurance, there is increasing focus on corporate governance and directors in Hong Kong are held more accountable to the company, shareholders and other stakeholders. Indeed, the market for D&O insurance is growing in Hong Kong. ■

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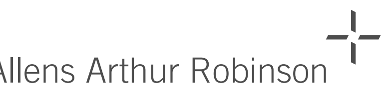

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CLEAR THINKING

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN IRELAND

Eoin Caulfield, Partner
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The changed economic climate, leading as it has to greater levels of insolvency, together with repercussions spreading out from the recent financial crisis, have given added focus to the law applicable to directors of Irish companies. The Office of the Director of Corporate Enforcement ('ODCE') was established in 2001 as a statutory body charged with upholding and enforcing the Companies Acts. The broad scope and use of its powers is increasingly evident. There have been case law developments, in particular a number of Supreme Court judgments, which have re-visited findings made by lower courts around the liabilities of directors. There is also a prospect of US-style shareholder class action litigation against directors. There will be more developments in this area.

The main areas explored here are:

- *Fyffes plc v DCC plc and Ors*
- Directors' restriction and disqualification orders
- Directors' loans
- Compliance statements and Companies Consolidation Bill
- Administrative sanctions and criminal exposures of directors.

Fyffes plc v DCC plc and Ors

The report of the inspector appointed by the High Court to investigate matters around insider dealing in the shares of Fyffes plc was published in early 2010. This followed a long-running court case. In 2007, the Supreme Court overturned aspects of the High Court's verdict in the case. The litigation, partially at the behest of Fyffes plc institutional shareholders, was taken against DCC plc, its managing director and two of its subsidiaries. The case, and the court-sanctioned inspectorship which followed, had the role of directors as a central focus.

The facts of the case concerned a substantial holding by DCC plc of shares of Fyffes plc, acquired while the latter company was privately held and dating back to 1981. Following a number of intra-group transfers of the shares, in 2000 the group disposed of the shares externally through trading in the open market. There had been a common director and other involvement between relevant DCC plc entities and the board of directors of Fyffes plc, including access to information in management reports.

The court's findings revolve around the insider dealing provision in Part V of the Companies Act 1990, which has since been generally superseded by the introduction of the Market Abuse Directive in Ireland (in the context of companies which are listed on a regulated market e.g. full lists on the Irish or London exchanges). Much of the case turned on the extent to which trading had occurred while in possession of price-sensitive information not available to the market. The High Court judgment also involved the creation of the concept of the 'reasonable investor' and the effect the information might have on the trading activity of such a person. However, the Supreme Court in its interpretation disagreed with the use of this form of test and allowed the appeal (finding against the defendants). The consequence of this was an exposure for both the DCC plc companies involved and the individual director to material levels of damages. The final quantum of the damages was the subject of an out-of-court settlement.

In the aftermath of the Supreme Court judgment, the ODCE applied to the High Court for the appointment of an inspector to investigate areas of suspected wrongdoing in three of the companies involved; the inspector's report was published in January 2010. It had been anticipated that, subject to the findings of the inspector, the ODCE might pursue an order seeking the disqualification of persons sitting on the board of directors of DCC plc at the relevant time (in particular, its managing director) from acting as a director pursuant to Section 160 of the Companies Act 1990 (see further below). However, the report concluded that the companies involved and their directors, officers and employees had behaved in a generally appropriate and proportionate manner and there had been good levels of system and control, including the taking of external professional advice when it was appropriate and the following of the advice when proffered. The ODCE has indicated it will now take no further action.

The Fyffes plc case highlights a trend towards more vocal shareholder-led involvement in the context of public companies. There has been some conjecture that there will be a move towards shareholder class action litigation against directors in the context of banking failures such as the much-publicised Anglo Irish Bank (which the Irish government nationalised during 2009). These types of claim could be grounded on areas such as losses incurred by the holders of shares arising from alleged breaches by directors of the Market Abuse Directive. There is no case law on this to date.

Sections 150 & 160 Companies Act 1990 - restriction and disqualification orders

Restriction orders

Changes made to the Companies Acts in 2001 have made it a mandatory requirement that on the liquidation of an insolvent company, a liquidator applies to the High Court for the restriction of the directors of the company pursuant to Section 150 of the Companies Act 1990, unless relieved of the duty by the ODCE. The increasing number of corporate failures in Ireland has

led to far greater activity in this area. Save where a director has acted 'honestly and responsibly' (and certain other limited exceptions), the High Court is required to 'restrict' such persons for a period of up to five years. This is a restriction from acting in any way, however indirect, as a director or secretary, or in the promotion or formation of a company. It applies unless the company meets minimum capital thresholds, and includes other limitations, for example, with regard to certain relations between it and a restricted director.

The increased focus on these Companies Acts provisions has led to a number of recent High Court and Supreme Court pronouncements, in particular, around the notion of acting 'responsibly'. A number of the cases involve non-executive directors who held what were effectively nominee or titular directorships and who largely did not involve themselves in the businesses conducted out of the companies of which they were officers.

In the 2004 High Court case *360 Atlantic (Ireland) Ltd,* the directors of an Irish company abstained from involvement in the business activities of a company which existed as part of a tax-planning structure. The company was a subsidiary of a Danish company, which itself was ultimately owned out of Canada. While the directors argued that, given their lack of capacity to influence group policy, they should not be culpable for merely implementing decisions made at a group level, it was held in the High Court that there could be no modification of the ultimate requirement that directors must act in the interests of their company. It was therefore held that the directors had failed to act 'honestly and responsibly' by their failure to involve themselves.

The 2008 Supreme Court case *Tralee Beef and Lamb Limited (In Liquidation)* overturned High Court findings around the proposed restriction of an accountant appointed to a board of directors, where his appointed role was principally taken to protect the interests of an investment fund. There had been limited board engagement and much of the work was performed not by the director but by officers of the accountant's firm acting on the nominee's behalf (ie not at the direct behest of the director). The Supreme Court determined that the director should not face restriction. While not the basis for overturning the High Court's finding, the Court stated that heightened levels of responsibility applied to a non-executive nominee may be excessive and that 'there is a yet unmet need to make authoritative findings after full debate as to the respective duties of an executive and a non-executive director and, perhaps, a non-executive director appointed… for a particular purpose'. This statement was made having also considered the leading English case, *Re Barings Bank & Others* (1999) which made similar *obiter* comment on the potential need for greater demarcation by the courts of the respective roles of executive and non-executive directors.

The 2009 Supreme Court case *Worldport Ireland Limited (In Liquidation)* brings some clarity to the whole area of 'shadow directors' in the context of director restrictions. A shadow director is defined by the Companies Act 1990 as 'a person in accordance with whose directions or instructions the directors of a company are accustomed to act' – the same level of liability pursuant to aspects of the Companies Acts can attach to such persons as to individuals formally sitting at board level. The case involved an application by the liquidator of Worldport Ireland Limited seeking the restriction of two directors of the Irish company, together with a restriction of the US parent company of the Irish subsidiary (i.e. on grounds that the latter was a shadow director). The Supreme Court held that, while a corporate entity can be a shadow director and shadow directors are capable of restriction (important points in themselves), the US parent was a corporate not capable of restriction in the same manner as an individual in these contexts.

Disqualification orders

As well as restriction, the High Court may disqualify persons from acting as directors of Irish companies, usually for five years, pursuant to Section 160 of the Companies Act 1990. Disqualification can extend beyond the role of director and may include disqualification from any direct or indirect involvement in the promotion of companies. The grounds upon which the court may disqualify, as well as direct breaches of specific areas of the Companies Acts, such as instances by directors of fraud, reckless trading or failure to keep proper books of account, include broader areas of scope around 'breach of duty' by a director and 'conduct making the director unfit to be concerned in the management of a company'.

Cases involving the ODCE in the context of the activities associated with National Irish Bank have led to recent case law around the disqualification of directors, including most recently the Supreme Court's judgment in *Director of Corporate Enforcement v Byrne* (2009). This was one of a number of cases relating to directors and senior management of National Irish Bank and National Irish Bank Financial Services Limited arising from the 2004 report by the High Court inspectors appointed to investigate activities facilitating tax evasion and the levying of unwarranted fees and interest charges. Following the report, applications were granted in the High Court for the disqualification of nine individuals who were previously either directors or senior officers of the relevant entities. Some of the applications were unopposed, while others have been contested through the courts.

The judgment in the *Byrne* case involves a distinction made by the Supreme Court between the restriction procedure (ie see above) and the disqualification procedure and a statement that conduct necessary to lead to a disqualification must of its nature be manifestly more blameworthy than merely failing to exercise an appropriate degree of responsibility (e.g. as might merit restriction). The Supreme Court also found that, in the exercise of judicial discretion, the courts are entitled to

take into account the greater effect of a disqualification on a professional person (as in this case). Judgment in another related case, with similar factual background, is currently awaited.

Directors loans and Companies (Amendment) Act 2009

Attention to issues stemming from activities in the Irish banking sector led to the enactment of the Companies (Amendment) Act 2009, aimed at immediately addressing perceived deficiencies in the Irish statute book around areas including those concerning directors. This is in advance of the results of the ODCE and Garda (Irish police) investigations into activities at Anglo Irish Bank, which remain on-going.

Key changes in the Act involve extensions to the powers of the ODCE together with amended provisions relating to transactions between companies (and, in particular, credit institutions) and directors and their 'connected persons' (including spouses, children and associated vehicles). The Act also seeks to improve the transparency around loans made by credit institutions to their directors.

Section 31 of the Companies Act 1990 prohibits loans to be made to directors and connected persons above low thresholds; this has been an area which has seen far greater levels of prosecution for breach in recent years. The new Act has extended this further. Previously, in order to prosecute a breach of the legislation against the officers of a company there was some difficulty in satisfying the test that a person had actual or sufficient imputed knowledge to believe the occurrence of an offence. The onus is now reduced and if a company contravenes the provision, every officer 'in default' (ie who authorises or, who in breach of duties, permits a transaction) is guilty of an offence – regardless of whether they were aware that it was a contravention of the provision. The consequence of this will be a far greater obligation on directors to monitor compliance.

Although perhaps of lesser scope, the area around disclosures with respect to directors (and their connected persons) of licensed banks has also been tightened and itemised details relating to director/connected person loans above low *de minimis* levels must be provided in the financial accounts. The need for compliance with the declarations of interests by directors in respect of their dealings with a company is further strengthened.

As well as restriction, the High Court may disqualify persons from acting as directors of Irish companies, usually for five years, pursuant to Section 160 of the Companies Act 1990.

Companies Consolidated Bill

Compliance statements

The greater focus on corporate governance and compliance issues has put the need for a general annual compliance statement given by the directors of a company back on the legislative agenda. It is already a criminal offence for a director to fail to take all reasonable steps to comply with the legal requirements relating to the production and content of directors' reports. The extension of the law in this area is likely to require a statement given by the directors of any company over applicable turnover and net asset thresholds (to be determined). The statement would be given in the context of each financial year end and cover the existence of an appropriate compliance policy, and the company's adherence to this policy. While compliance statements are an existing feature of certain types of companies with a regulatory authorisation, they are not currently required more generally. A compliance statement procedure was included in the Companies (Auditing and Accounting) Act 2003 but was not brought into law and instead was referred by the relevant minister to the Company Law Review Group (ie the statutory group established to assist in the updating of Irish company law). The view was expressed that the scope of the compliance statement as proposed be reduced and the applicable thresholds raised before the law is brought into effect. The directors' compliance statement is something which the Government has indicated will form part of the codification of the Irish companies legislation through the Companies Consolidation Bill. This process has been on-going for a number of years and will lead to a consolidation and general overhaul of the entire Irish company statute book.

In addition to the compliance statement requirement referred to above, the European Communities (Directive 2006/46/EC) Regulations 2009 provides that Irish companies whose securities are admitted to trading on a regulated market (ie main market) must include a corporate governance statement in their annual report. This must refer to any corporate governance

codes to which the company is subject (eg the Combined Code) and describe the main features of the company's internal control and risk-management systems. It puts existing best practice relating to listed company corporate governance on a statutory footing.

Codification of directors' duties

The Companies Consolidation Bill includes a proposal to partially codify the common law duties of directors which are currently based on court judgments. These will instead be set out as eight non-exhaustive principles, similar to the approach in the UK. While this should not in itself add to the duties owed by directors, codification is expected to mean a sharper focus on the behaviour of directors where issues arise.

Administrative sanctions and exposure to criminal liability

A trend in recent Irish legislation and regulation is to extend criminal liability and administrative sanction from attaching solely to corporate entities to those behind the 'corporate veil' – ie the imposition of liability on a company's directors and officers where a company has committed an offence. This is a partial erosion of the doctrine of separate corporate personality and limited liability.

Potential liability of directors for the acts of a company has been included in implementing legislation including safety, health and welfare at work, employment law, competition law and the area of financial services. It is likely that this area of legal risk for directors will further expand. The legislation adopts a common formula, typically including wording such as '… where an offence has been committed by a body corporate and the offence was committed with the consent, neglect or connivance of a director, manager, company secretary or other similar officer of the body corporate then that individual shall also be guilty of that offence'.

The focus by the Irish courts on this area is evident in the context of cartel arrangements contrary to the Competition Acts. In the 2007 and 2009 cases, *DPP v Denis Manning* and *DPP V Duffy*, owner-directors involved in activities relating to price fixing in the motor sector received severe sentences – eg 12 months in prison (suspended for five years) and a fine of €30,000. The courts have expressed the view that a prison sentence in respect of these types of breach is perhaps only a matter of time.

An increased willingness to seek direct sanction against directors can be seen in the area of health and safety legislation (e.g. *DPP v Michael Murphy* (2006)). The 2006 Australian case *Kumar v David Aylmer Ritchie* has also been cited in Ireland as grounds for suggesting that an Irish court may be minded to attach extensive personal liabilities to directors and senior managers, even in cases where there may have been no direct involvement, on grounds that such persons have a duty to ensure appropriate checks and balances are always in place.

As part of the creation of the Irish Financial Services Regulatory Authority in 2003/2004, a range of new administrative sanctions powers was given to the supervisory authority with regard to regulated financial services activities. The enforcement powers allow the Financial Regulator to conduct inquiries in public, fine regulated entities up to €5m, fine individuals up to €500,000 and, in certain circumstances, disqualify persons from working in the financial services industry.

The Financial Regulator had indicated it will use its administrative sanctions powers sparingly, however, it has been increasingly visible in the context of recent perceived failures in the sector. In the context of directors, this includes a substantial fine handed down in 2008 to Sean Quinn Senior, a director of Quinn Insurance Limited, of €200,000. The company received a fine of €3.25m. In conjunction with the press release relating to the settlement, Mr Quinn stood down as a director. The fines related to the use of insurance company funds for lending purposes to non-regulated parts of the Quinn Group without the consent of the Financial Regulator.

Conclusion

The role and responsibilities of directors and senior officers of Irish companies have seen renewed focus. There is a move towards greater levels of personal exposure, evidenced through recent court judgments, statutory changes and through the greater role of the ODCE. The final form of the Companies Consolidation Bill when it is enacted is likely to add further to this, including a new directors' compliance statement and the codification of the principal duties of directors. There will be more developments in this area. ■

WILLIAM FRY

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN JAPAN

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Until quite recently, lawsuits against directors of a Japanese company were rare. Whether due to the current global financial crisis, a change in corporate governance standards arising from new Japanese corporate laws and stock exchange regulations, and/or a rise in shareholder activism in general, director lawsuits in Japan are rising and show few signs of abating (but are still relatively low in comparison to the United States). For example, the Japanese Supreme Court has recently supported various lower court decisions ordering company directors to pay significant damages for failing to comply with their corporate responsibilities. In *Janome Sewing Machine Co., Ltd.* (Supreme Court decision of October 2, 2008), five ex-directors were ordered to pay JPY58.3bn in damages to the company, arising from the directors yielding to extortion demands from an organised crime operative. In *Duskin Co., Ltd.* (Supreme Court decision of February 12, 2008), two former directors were ordered to pay JPY5.3bn for failing to disclose past sales of food contaminated with unlawful chemicals that were later discovered in an official inspection. In *Hokkaido Takushoku Bank* (Supreme Court decision of January 28, 2008), 14 ex-directors were ordered to pay JPY10.1bn due to their negligence in connection with various loans that had become uncollectable.

Given this clear change in the trend of lower court precedents endorsed by the Japanese Supreme Court, it is important that directors and executive officers of Japanese companies, as well as other relevant parties such as shareholders, have a precise understanding of the position and responsibilities of directors and executive officers under Japan's corporate statute – the Companies Act of Japan (*kaisha-ho*, Law No. 86 of 2005) (Companies Act).

Who can be held liable for corporate misconduct?

Who can be held responsible for corporate malfeasance depends on the corporate form selected. The joint stock company (*kabushiki kaisha*) is the most common organisational form used in Japan, and all references in this chapter to a 'company' mean a joint stock company. A company's directors (*torishimari-yaku*), executive officers (*shikko-yaku*) and statutory auditors (*kansa-yaku*) are normally the primary focus when claims are made against a company. A company will have executive officers if it adopts a corporate governance structure of a board of directors with committees (as discussed below). Statutory auditors are separate from management and play a unique corporate governance role in Japan in comparison to other jurisdictions by being tasked with monitoring the directors' adherence to corporate governance and reviewing the company's financial statements. The duties and liabilities of statutory auditors themselves are very different from those of directors and executive officers, a discussion of which is beyond the scope of this article. Instead, this chapter focuses on the duties and liabilities of directors and executive officers of a Japanese company (collectively, 'company representatives'), and the liability insurance available for such persons.

A company organised in Japan can have a board of directors with or without committees. For a company without committees (which is the most common corporate governance structure in Japan), directors are appointed to make decisions as a board on corporate affairs, the board selects one or more directors to serve as the representative directors who are responsible for executing the business of the company, and statutory auditors play the role described above. For a company with committees, directors are appointed to make decisions on high-level corporate affairs since the board cannot directly execute the business affairs of the company. Instead, the board appoints executive officers (who may also serve as directors) to execute the business of the company, some of whom have the power to bind the company in a manner similar to representative directors (such executive officers are often referred to as representative executive officers).

Principal duties of company representatives under Japanese corporate law

The relationship between a company and its company representatives is governed in Japan by the principles of agency. As an agent for the company, a company representative has an obligation to conduct the affairs of the company with the care of a 'good manager' (the duty of care). More specifically, company representatives are obligated to perform their duties faithfully on behalf of the company (the duty of loyalty). The Japanese Supreme Court has indicated that a company representative's duty of loyalty compliments a company representative's duty of care and has deemed both duties to be part of a company representative's fiduciary duty.

Japanese courts have developed the duty of care by requiring company representatives to comply with the following obligations:

Duty of compliance with law and the Articles of Incorporation

A company representative has an obligation to comply with applicable law and the articles of incorporation of the company. Since compliance with the company representative's fiduciary duty is required under the Companies Act, any breach of the company representative's fiduciary duty constitutes a breach of Japanese law. However, a breach of law extends far beyond a breach of fiduciary obligations, encompassing any violation of any law related to the company, including, without limitation, public order. While a company representative does not need to have a thorough knowledge of all laws applicable to his company, with the assistance of the company's business units and legal department he should understand the regulated activities and an outline of the main laws applicable to the company's corporate activities, including sanctions and damages that may be imposed in the case of a violation.

Duty of reasonable management

Recently, lower courts in Japan have applied towards company representatives a Japanese version of Delaware's 'business judgment rule,' in which a court limits its inquiry to whether or not the board exercised reasonable business judgment in light of the circumstances at the time of the relevant decision. While the Supreme Court of Japan has not rendered a decision on this matter that would serve as a conclusive precedent regarding the force and effect of the business judgment rule, many Japanese courts

hearing shareholder derivative lawsuits generally apply the business judgment rule. The rule essentially holds that, so long as a company representative shows (i) that there were no negligent errors in the finding of the material facts relevant to the decision making, and (ii) there was no material unreasonableness in the contents and the process of the business decision according to the standard of ordinary management, the company representative should not be held liable for damages resulting from such a decision. However, Japanese courts are unlikely to follow the business judgment rule in cases that involve a conflict between the interests of the company and the interests of the company representative(s) and cases where violations of laws are in question.

Duty to monitor

The Companies Act requires that the directors of a Japanese company oversee the activities of the other directors, and, for companies that have adopted a board of directors with a committees corporate governance scheme, directors also have a duty to monitor the activities of the executive officers. The duty to monitor was powerfully highlighted on 20 September 2000 when the Osaka District Court awarded US$775m against some of the defendant directors of Daiwa Bank due in part to their breach of their duty to monitor. In this decision, which involved the fallout from the scandal and cover-up at Daiwa Bank in 1995 in relation to trading losses incurred at its New York branch, the court indicated that representative directors and certain managing directors are subject to the obligation to establish internal control systems and that other directors have the obligation to monitor the obligations of such representative directors and certain managing directors. In the case of large companies, the court conceded that it is practically difficult for all directors to monitor the day-to-day operations of other directors and stated that directors who have reasonably relied upon the sound management of other directors would not be liable for any damage incurred as a result of any breach of such other directors' obligations, thereby limiting the liability of directors of large companies. Instead, the Companies Act stipulates the duty of the directors of a large company to establish and maintain an internal control system and other systems necessary to assure the appropriate operation of the company.

Liabilities of company representatives due to breach of their duties

Article 423 of the Companies Act states that a company representative is only liable when he is negligent in performing his duties ('the General Liability Provisions'), except in the following three instances where strict liability applies (ie, there are no defences that a company representative can raise, such as having met his duty of care):

(1) for directors, the actual value of an asset contributed to the company in exchange for shares to be issued at the time of incorporation is much less than the minimum value of the shares stated in the company's articles of incorporation when the incorporator solicited subscribers for the shares issued on the incorporation

(2) a company representative engages in a transaction that is in contravention of Japan's conflict of interest provisions; and

(3) a company representative offers a pecuniary benefit to a shareholder in exchange for the shareholder voting.

If any of the actions are taken pursuant to a resolution adopted by the board of directors, then the directors who assented to such resolution are also presumed to have performed such act. Directors who participated in the board resolution are presumed to have assented to such resolution unless they specifically expressed their dissent in the board minutes.

Company representatives owe duties to the company. Accordingly, it is the prerogative of the company (acting through its statutory auditors or its audit committee) to sue company representatives for any breaches of their duties. However, a company representative breach of duty claim can form the basis of a shareholder derivative action. In addition, if a company representative performs an act in violation of law or the company's articles of incorporation and such action can cause irreparable damage to the company, then a shareholder may bring an action for injunctive relief on behalf of the company. A shareholder derivative lawsuit may be initiated against a public company only by a shareholder who has held shares continuously for at least six months.

Company representative malfeasance may also give rise to claims by third parties. Pursuant to Article 429 of the Companies Act, company representatives are liable to third parties for acts that exhibit 'wrongful intent or gross negligence' in the performance of their duties. This is a special statutory liability provision intended to protect third parties engaging in transactions with a Japanese company. Among other things, if a company representative provides false information in any of the following activities, he is liable to compensate any third party for damages incurred as a result of such activities, unless he successfully proves he did not act negligently (a shift in the burden of proof to the company representative):

- Giving false notice about any material information that needs to be notified when making an offering of shares, stock options, corporate bonds or bonds with stock options, or making false statements in explanatory documents that are used for such offering.
- Making false statements regarding any material information in a financial statement, a business report or supplementary schedules attached to any of these, or an extraordinary financial statement.
- Making a false registration or giving a false public announcement.

In addition to civil liability, a company representative can be held criminally responsible. For example, a company representative who violates certain obligations under Japan's Financial Instruments and Exchange Act or certain Japanese health and safety, environmental and anti-trust laws can be held criminally liable. However, in Japan a company representative generally cannot be held criminally responsible for the criminal acts of the company.

Methods to limit company representative liability

The civil liability of a company representative can be limited in the following ways:

Statutory cap (for a breach of a General Liability P rovision only)

If a company representative acted without gross negligence or wilful misconduct, then the maximum amount of his liability to the company arising from the breach of a General Liability Provision can be fixed subject to certain strict approval procedures. Depending on the status of the company representative at the time of the cause of liability, the Companies Act has specific monetary caps on liability based on a multiple of the company representative's 'total annual remuneration' (which is the sum of the company representative's (i) highest annual base salary, (ii) highest annual bonus, and (iii) the equivalent of one year's retirement allowance):

- **Representative director and representative executive officer** (which means a company representative who is responsible for executing the company's business and has binding, signing authority): the sum of six times total annual remuneration, plus the value of stock option benefits.
- **Outside director** (which means a director who does not manage and has never managed the corporate affairs of the company or any of its subsidiaries as a director, executive officer, manager, or other employee and who is not currently an employee of the company or any of its subsidiaries): the sum of two times total annual remuneration, plus the value of stock option benefits.
- **Ordinary director and executive officer** (a company representative who is not a representative director, representative executive officer or an outside director): the sum of four times total annual remuneration, plus the value of stock option benefits.

To effect a statutory cap on liability, either (1) all the statutory auditors or the members of the company's audit committee agree to propose the liability limitation to the shareholders and two-thirds or more of the company's shareholders approve the liability limitation, or (2) all the statutory auditors or the members of the company's audit committee agree to propose the liability limitation to the board, and the company's board of directors must approve the cap (so long as the company's articles of incorporation permit the directors to approve this type of arrangement), unless shareholders holding 3% or more of the total voting power of the company object to the board's approval.

As a result of the foregoing approval sequence, it is important to note that the statutory cap can be perfected only after the director has committed the misconduct. Therefore, a director cannot assume upfront that his conduct always will benefit from the statutory cap and will be exposed to the risk of its ultimate unavailability.

Liability limitation agreement (for a breach of a General Liability Provision only)

An outside director (only) is permitted to execute an agreement with the company limiting his liabilities to the company arising from the breach of a General Liability Provision, if such director has performed his duties without gross negligence or wilful misconduct. Pursuant to such an agreement, the potential liabilities of an outside director may be contractually limited to the amount specified in the articles of incorporation or an amount equal to the statutory cap for an outside director (as discussed above), whichever is higher. This type of agreement is permissible only when the company is authorised to enter into such agreements by its articles of incorporation. Furthermore, the material provisions of the liability limitation agreement and the remuneration of the outside directors should be disclosed to the shareholders in the company's annual business report.

A liability limitation agreement can be more favourable in comparison to the statutory cap because no shareholder approval is required to enter into the agreement and the arrangement is typically executed in connection with the appointment of the outside director; therefore, the liability cap is effective before the misconduct has been committed (which provides the outside director with upfront comfort concerning liability limitation).

Unanimous approval

A company representative can be exempted from liability with the unanimous consent of all shareholders. For a company with many shareholders, attaining unanimity could be difficult.

Insurance

As discussed in greater detail below, D&O insurance in Japan generally covers damages and defence costs payable in relation to claims by shareholders or third parties against company representatives for the economic damage incurred by them due to their negligent mismanagement. In our experience, D&O insurance generally is not available if the company representative acted with gross negligence or the subject transaction represented a conflict of interest.

The D&O insurance market in Japan

In Japan, it is common for companies to purchase D&O insurance. Many non-life insurance companies offer D&O insurance products and most public companies purchase D&O insurance for their company representatives. There is no standard D&O policy form, and insurance companies in Japan use policy forms that differ from one another, but Japanese D&O insurance policies share a number of common features that are discussed below.

Insured

Japanese law permits D&O insurance to cover a company's directors, statutory auditors, executive officers and senior operating officers (*shikko-yakuin*). The company may also include the directors, statutory auditors, executive officers and senior operating officers of its subsidiaries as an insured.

Coverage

D&O insurance in Japan is typically underwritten on a claims-made basis, not an occurrence basis. When a policy is written on a claims-made basis, the insured will be covered pursuant to the terms of the policy in effect at the time the claim is made so long as the act giving rise to the claim did not occur prior to the starting date of the initial policy period (whereas under an occurrence-based policy, even though the policy may have expired, a claim still can be made provided the policy was in force at the time that the incident occurred). A claims-made basis policy can be advantageous because every time the company increases the limits of its policy, the insured will be covered for the higher limits during the policy period (which makes it easier to keep pace with inflation and rising damage awards).

D&O insurance in Japan normally covers the damages and the defence costs arising from lawsuits, arbitration, mediation, settlement and other proceedings. The D&O insurance policy will stipulate an aggregate limit amount that the insurance company will pay during the policy period. However, in Japan most insurance companies will not pay all of the damages – the insured will need to pay a deductible amount before the insurance company's payment obligation is applicable. In addition, a common feature in Japanese D&O insurance policies is for the policy to cover only a certain percentage (eg, 95%) of the damages and defence costs in order to create an incentive for the insured to reduce the damages. Advance payment for defence costs is permissible under many D&O insurance policies in Japan provided that if it is determined that the D&O insurance does not cover the concerned claim the insured must return the advanced defence costs.

Exclusions

In general, Japanese D&O insurance policies do not cover damages arising from:

- Conflict of interest transactions or illegal acts, such as bribery, insider trading, committing a criminal act etc
- Derivative lawsuits, as it would appear improper for the company to fund premium payments under such circumstances. However, as discussed below, such damages can be covered by an endorsement paid by the insured.
- Violations of the US Employee Retirement Income Security Act, the US Racketeer Influenced and Corrupt Organization Act, or the insider trading regulations under the US Securities Exchange Act of 1934. This exemption applies to Japanese companies that have subsidiaries and/or branches operating in the United States. Many of the foregoing violations are exempted under standard US underwritten D&O insurance policies, and so Japanese insurance companies have followed suit and may expand the specific exemptions in the future in line with US D&O insurance practices.
- Other exclusions include (i) acts that occurred prior to the starting date of the first policy period, (ii) extraordinary risks such as environmental pollution and asbestos, and (iii) claims made by other insureds, a parent company, subsidiaries or major shareholders (in order to avoid potential collusion or an internal battle relating to a change of control situation).

Premiums

Premiums for a D&O policy are determined by the insurance company. There are no specific Japanese laws or regulations that set a floor or ceiling on the premium amount that an insurance company may charge in Japan, so prices are typically determined by market forces and other factors selected by the insurer (eg, the industry in which the policyholder operates, financial condition of the policyholder, claim history, etc). In addition, most D&O insurance policies in Japan require the insured to pay, via an endorsement clause, approximately 10% of the premium amount as consideration for coverage against the risk of loss associated with derivative lawsuits (without the possibility for reimbursement by the company).

Endorsement

In order to cover certain excluded risks and costs, an endorsement clause can be acquired. The most common endorsement clauses available in Japan include: (i) an endorsement to cover damages due to a derivative lawsuit (as discussed above), (ii) an endorsement to cover acts that occurred prior to the starting date of the current D&O policy period (typically requested when the company changes D&O insurance providers), and (iii) an endorsement to cover defence costs when a company intervenes in derivative suits to support an insured. ■

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CREATING AN EFFECTIVE BOARD OF DIRECTORS IN MEXICO

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Recent years have seen a significant number of amendments to Mexico's corporate governance provisions, and other specific regulations have been incorporated following the Securities Law in June 2006 along with all the Mexican financial laws and regulations. In addition, the Best Practices Code ('BPC') has provided non-legally binding recommendations to assist the development of the Mexican securities market through the introduction of more secure and effective protection mechanisms for individuals investing in securities listed on the Mexican Stock Exchange. The BPC contains recommendations reflecting 'best practices' for boards of directors.

It is therefore important that organisations operating in Mexico give greater emphasis to corporate governance, which is considered essential by investors looking for some measure of confidence that the appropriate checks and balances are in place and that risks are being monitored. However, situations will arise where there has been a breakdown in these controls, even where all practical steps to avoid such a breakdown have been taken.

In order to create an effective board of directors, appointed by the shareholders, companies must be aware of the key aspects of the corporate governance regulations that now apply in Mexico.

Overall duties of the board

Companies must provide more information on their administrative structure and the functions of their management bodies. They must adopt mechanisms to ensure that their financial information is adequate, that promote communication between the directors of the company, and that provide for adequate disclosure of information to the shareholders of the company.

Directors are responsible for the management of the company and are authorised to resolve all matters that are not the exclusive responsibility of the shareholders' meetings.

In addition to the traditional functions of boards under Mexican law, the board of directors must determine the strategic vision of the company, ensure the disclosure of public information, develop and approve internal audit and control mechanisms, and approve mechanisms to ensure that the company complies with applicable regulations, including evaluating periodically the performance of the CEO and high-level officers.

In the case of insurance companies in Mexico, the board of directors must approve all operations of the company outside of the ordinary course of business; any operation between the company and its shareholders, or individuals acting in the management of the company, or individuals linked through patrimonial or family relationships with these; the purchase and sale of 10% or more of the assets of the company; the granting of guarantees exceeding 30% of the assets of the company; and any other activities that exceed 1% of the assets of the company.

Structure

The board of directors must be in charge of evaluation and compensation and of the audit and finance and planning functions, through one or more intermediate committees formed for this purpose. In all cases, the objective of such committees should be clearly defined and their composition must avoid conflicts of interest.

Committees must comprise only proprietary directors; they should have no fewer than three and not more than seven members; and they must report periodically to the board of directors of their activities. Board members must report in writing to the audit committee and to the external auditors any irregularities that they encounter in connection with the company or its subsidiaries.

The chairman of the audit committee should be an independent director.

The board of directors must have an audit committee, and submit to the shareholders' meeting the audit report prepared by the audit committee.

Composition

To comply with the recent corporate governance provision, Mexican public companies have created internal committees comprising independent members whose primary function is to support the board of directors in their duties, enabling the management to implement more effective and objective decisions.

The board of directors must be composed of no fewer than five and not more than 15 proprietary members. In the case of public companies, 25% of the board members must be independent directors who are appointed for their experience, and who come without any personal or financial conflict of interest. It is recommended that the board of directors be composed of only proprietary members. However, in case alternate members are required, proprietary members should suggest who should be their alternates. Alternates may be members of the company or partners or employees of organisations that act as advisors or consultants to the company or its affiliates.

The board of directors must comprise at least 20% independent directors. In addition, 40% of independent and patrimonial directors, appointed because of their experience, capacity and professional prestige, must not, at the time of their appointment, be:

- individuals with decision-making authority over the officers of the company (without being employees or directors)

- employees or officers of the company
- partners or employees of a company that is an important client, supplier, debtor or creditor
- employees of a non-profit organisation, university, or non-governmental organisation that receives important donations from the company
- partners or employees of firms that act as advisors or consultants of the company or its affiliates, whose income significantly relies on this relationship.

Board members must act with loyalty and in accordance with fiduciary duties. If faced with a conflict of interest in any matter, they should abstain from participating in, or deliberating or voting on, that matter.

Board members are bound to keep confidential any information or matters of which they are aware through their position in the company.

The board of directors of public companies must be composed of not fewer than five and not more than 20 proprietary members and at least 25% of board members must be independent directors. For each proprietary member, an alternate member should be appointed. Alternates of independent directors may only replace proprietary independent directors.

Operations

The board of directors must meet at least four times in a calendar year. At one of its meetings, it should define the long-term strategy of the company.

Information required for discussions pursuant to a board meeting agenda should be distributed among the members of the board of directors at least five business days prior to the meeting.

The company must provide any newly appointed director with sufficient information regarding his duties, obligations, responsibility and authority.

The board should ensure that it meets regularly; that there is a formal schedule of matters that is reserved to it for decision; that there is a procedure for directors to take independent professional advice; that all directors have access to the company secretary (who is responsible for board compliance with procedures, rules and regulations); that the directors exercise their independent judgement on issues of strategy, performance, resources, key appointments and standards of care; and that directors receive appropriate training.

There should be a clear division of responsibilities at the head of the company to ensure no one individual has unfettered power.

The board should be supplied with information in a timely manner and of sufficient quality to ensure that members are able to discharge their functions effectively. The chairman must ensure that all board members are properly briefed on all matters arising during board meetings.

There should be a transparent procedure for appointment of new directors during the shareholders' meetings.

The board of directors of public companies must meet at least every quarter. Meetings may be called by the chairperson of the board, or by members of the board representing at least 25% of the directors, or by any statutory examiner.

Duties provided by law

Directors must act in good faith and in the best interests of the company and of the entities under its control. Furthermore, they must act with discretion and confidentiality when providing information to the board and they must inform the chairman and secretary of the board of any matter that may have as a consequence a conflict of interest and refrain from participating in any discussions related to such a matter.

Directors must use the assets and services of the company only to advance the company's corporate interests and should enact clear policies on the use of the assets and services of the company for personal matters. Information discussed at board meetings relating to the operations of the company, whose disclosure may affect the company, must be kept confidential.

Directors must provide opinions, recommendations and guidance based on their analysis of the company's results, and, where relevant, these should be supported by independent experts, to help the board make decisions.

Proprietary directors must attend at least 70% of the meetings to which they are called to.

Directors are liable to the company for the actual payment of shareholder contributions, compliance with the legal requirements and those provided in the by-laws regarding the payment of dividends to the shareholders, the existence and maintenance of the accounting, control, registry, filing and information systems required by law, as well as the proper resolutions approved by the shareholders' meetings as well as the creation of the legal reserve pursuant to the corporate laws.

The administration of the company is required to give to the shareholders' meetings, on an annual basis, a report on the

business, policies and financial performance of the company, including the opinion of the statutory auditor. This report must be available to the shareholders at least 15 days prior to the shareholders' meeting where it will be discussed. Non-compliance with this obligation is sufficient reason to remove the administrators.

All information required to discuss each item on the agenda of shareholders' meetings must be provided to the shareholders in order that they can give specific instructions to their attorneys on how they want view each item of the agenda.

Information to be provided to shareholders prior to the shareholders' meetings should include the proposed composition of the board of directors of the company and a copy of the professional profile of each candidate. The board should include in its annual report to the shareholders' meetings, a brief summary of the activities carried out by each committee, and the names of the members of each committee. Also, the reports submitted by each committee to the board should be made available to the shareholders, except for confidential information. Each company should have policies and mechanisms in place – and an individual responsible – to maintain communication with the shareholders and potential investors.

Evaluation and compensation

Companies must have mechanisms to evaluate the officers of the company and their compensation packages. An evaluation and compensation committee should be formed to assist the board of directors in the evaluation and compensation of the Director General and high-level officers of the company, and to suggest individuals for these positions. This committee should propose to the board general guidelines and criteria for evaluating the Director General and high-level officers; review proposals from the Director General on compensation for high-level officers of the company; assist the board in ensuring that the company complies with its general guidelines on the contracting of the General Director and high-level officers and on severance packages for such officers; and submit an annual report to the board with the policies of the company and composition of their compensation packages.

The board should maintain a sound system of internal controls to safeguard shareholders' investment and the company's assets, conducting, at least annually, a review of the effectiveness of the company's system of internal controls. Members must report to the shareholders that they have done so.

Audit committee

The board of directors should present a balanced and understandable assessment of the company's position and prospects, which should include an explanation of the directors' responsibilities and a statement from the auditors as to their reporting responsibilities. The board should establish formal and transparent arrangements for considering how to apply the financial reporting and internal control principles and for maintaining a relationship with auditors who must be named in reports and accounts. The board's duties should include keeping under review the objectivity of the auditors and, where the auditors supply a substantial amount on non-audit services, the audit committee must keep the nature and extent of those services under review.

The audit committee must:

- recommend to the board candidates to act as external auditors
- recommend to the board the conditions for the contracting and scope of the services to be provided by the external auditors
- advise and assist the board in the supervision of the audit services provided to the company
- act as a communication channel between the board and the external auditors and assure that they act with independence and objectivity
- review the plan of action, observations and audit reports of the external auditors and inform the board of the results of their audits
- recommend to the board the steps to be followed in the preparation of the financial information
- assist the board in reviewing the financial information and the procedures followed in their preparation
- contribute to the definition of the general guidelines on internal control systems and evaluate their effectiveness
- assist the board in the coordination and evaluation of the annual internal audit programmes
- coordinate the activities of the external and internal auditors of the company and its statutory examiner (*comisario*), and
- ensure that the company has mechanisms in place to verify that it complies with applicable law and regulation.

Audit firms that receive more than 20% of their total income from services provided to a company should not be recommended to the board of directors to audit the financial statements or provide any other review or audit service to the company.

To ensure that the audit reports are objective, the audit committee should recommend that the board of directors rotates the partner in charge of auditing the company at least every six years. The auditor and the statutory examiner of the company may belong to the same auditing firm but they should be different individuals.

The board of directors should know the professional profile of the statutory examiner of the company and the professional profile of the statutory examiner of the company must allow him to comply with his legal obligations.

The accounting policies used in the preparation of the financial statements of the company should be submitted to, and approved by, the board, and any change thereof should be duly explained to the board.

Companies should have an internal audit or compliance department. The board should verify that the financial statements prepared during a calendar year (eg monthly, quarterly) are prepared using the same policies, criteria and practices employed in the preparation of the annual financial statements.

The board should approve mechanisms that ensure that the financial statements submitted to the board are accurate. For such purposes, the internal and external auditors and the statutory examiner of the company may assist the board.

The general guidelines on the internal control systems should be submitted for the approval of the board of directors. The committees and auditors of the company should assist the board in evaluating these and give their opinion on the effectiveness of the internal control system and financial and operational controls.

The company should have mechanisms in place to determine whether it is in compliance with applicable law and regulations. For these purposes, the corresponding mechanisms implemented by the company should be reviewed on an annual basis. The board of directors should receive periodically reports on the legal status of the company.

Finance and planning

The finance and planning committee of a company has the following responsibilities:

(i) to evaluate the investment policies of the company prepared by the Director General and, make a recommendation on them to the board of directors

(ii) to evaluate the financing policies (capital and debt) for the company prepared by the Director General and make a recommendation on them to the board of directors

(iii) to suggest general guidelines to be followed in determining the strategic planning of the company

(iv) to give its opinion on the approach to be used for the preparation of the annual budget and to propose to the board of directors future improvements

(v) to follow up in relation to the company's performance against its budget strategic plan, and

(vi) to identify risk factors which impact on the company and evaluate policies to manage this risk.

The finance and planning committee of a company should:

(i) give the board of directors its opinion on the viability of the main investments and finance operations of the company, taking into consideration the company's relevant policies

(ii) assist the board in verifying that the investment and financing policies are consistent with the strategic vision of the company, and

(iii) assist the board in reviewing the financial projections of the company and verifying that they are consistent with the strategic objectives of the company.

The strategic position of the company should be reviewed periodically together with its strategic plan.

Conclusions

Mexico has recently evolved a more professional management requirement for the compliance of corporate laws, together with control systems to fulfil corporate governance consistent with international 'known' principles. These changes include introducing and amending the legal framework to regulate board members' obligations in relation to transparency, duty of care, loyalty and confidentiality and emphasising the right structure for an effective board of directors. This transparency is now considered essential by investors and should provide some measure of confidence that appropriate checks and balances are in place and risks are being monitored. The end result is a more sophisticated system of corporate governance in which inward (and domestic) investors can have confidence. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE NETHERLANDS

Aravind Ramanna, Advocaat
Boekel De Nerée

The notion of directors' liability is a statutory tool for allocating risk in the event of losses suffered by the involved company, its stakeholders or third parties such as financiers. The legislator decides that, in certain cases, the directors are to bear the risk and the financial consequences of their actions. In general, it can be said that profits can potentially be greater when the levels of risk increase.

Risk management is a relatively new field and one that is constantly evolving. In this contribution to the 2010 Willis Guide, we will assess, from a Dutch law perspective, the background of directors' liability and how it can be avoided through the creation and enforcement of an effective risk management programme.

Basis of risk management in The Netherlands

In the Dutch legal framework the following sources require effective risk management within a company:

SOX 404

This legislation is applicable to all publicly held companies in the United States that have a market capitalisation of more than US$75m and report to the SEC on a quarterly basis. SOx 404 requires the establishment and maintenance of an adequate internal control structure and procedures for financial reporting. It has a top-down approach.

Tabaksblat Code on Corporate Governance

The Dutch Corporate Governance Code ('the Code') applies to companies that have their statutory seat in the Netherlands and have issued securities listed on a stock exchange recognised by the Dutch Government. The Code requires companies to which the Code applies to implement a risk management system and that management includes in the annual report any significant changes in the risk management system and/or details of significant improvements that are planned. In addition, the annual report must include:

- a description of the major risks relating to the strategy of the company
- a description of risk management and control systems designed to deal with major risks, and
- a description of the identified shortcomings of the risk and control system for the relevant financial year to which the annual report relates.

Section 2:141/251 Dutch Civil Code

Management of Dutch companies is under the statutory obligation to inform the supervisory board in writing of the strategic policy and the general and financial risks of the risk and control system of the company at least once a year.

Section 2:391 Dutch Civil Code

Management of Dutch companies is under the statutory obligation to disclose in the annual report a description of the major risks and uncertainties to which the company is exposed.

The various sources of law do address the risk management issue but do not provide hard and fast rules on what constitutes an effective risk management system and how it is enforced. This is a rather unsatisfactory situation given the far-reaching consequences for management in the event that personal liability arises, or is alleged, for individual members of a company's management.

Case law

Case law provides a good indication of instances in which directors may be held personally liable for lack of suitable or adequate risk management. The most common grounds in the Netherlands are:

- Management opts for too risky a policy
- Management makes decisions without proper regard for risk exposure
- Company lacks a risk and control framework and management takes decisions without having access to a framework that is adequate for associated risks
- Risk exposure is assessed but involved risks are not identified or taken seriously
- Inadequate response to materialisation of risks
- No criteria or guidelines issued with respect to control of identified risks
- No periodic assessment of de facto exposure versus applicable criteria
- Lack of a contingency plan
- No review with respect to incidents
- No correction or enforcement with respect to infringements of applicable criteria or guidelines

- Failure to inform fellow management members or supervisory directors about incidents or material weaknesses in risk and control systems
- False or incorrect public disclosure regarding risk management

In general, the duties of management are a collective liability. The position of management and members of the supervisory board is assessed in light of the specific role of each respective body in the corporate governance structure of the company and the de facto role taken.

The risks associated with a Dutch subsidiary company must be included in the group risk management and control policy.

Effective risk management and enforcement

A risk and control management policy can be created in a number of ways. Statutory law will determine the boundaries of such a policy with respect to criminal law, tort and contractual obligations (eg banking covenants and solvency ratios). The nature of the company's activities, constitutional documents and company guidelines will be crucial for the content of a risk management policy. An effective risk management policy should comprise the following elements:

- Definition of corporate risk appetite
- Definition of corporate objects
- Identification of risk events that have materialised
- Analysis of probability and consequences of risk
- Identification and evaluation of possible responses to risks that materialise
- Control activities: creation and enforcement of guidelines and procedures to ensure that the response to risks is carried out effectively
- Identifying, recording and communicating relevant information
- Monitoring and, where necessary, amending the enterprise risk management system.

It is essential that the risk exposure is brought in line with the risk appetite of the company.

Risk considerations in respect of your Dutch subsidiary

The risks associated with a Dutch subsidiary company must be included in the group risk management and control policy. Below is an outline of issues that must, *inter alia*, be considered from a corporate risk perspective in relation to Dutch group companies:

Constitutional liability

A minimum capital requirement exists that has to be maintained for Dutch N.V. and B.V. companies. If the applicable procedure is not followed at incorporation with respect to bank confirmation and deposit of the funds, this may potentially lead to directors' liability and may expose individual shareholders. Additionally, joint and several liability may apply for incorporators with respect to contributions in kind that have not been assessed by an auditor.

Dividend policy

Dividend that is paid out in breach of capital requirements may lead to the liability of directors and recipients of wrongly paid out dividend in breach of statutory capital requirements. It may be subject to claw-back procedures.

Corporate guarantees

Parent companies often issue operational joint and several liability guarantees, comfort and hold harmless letters, or joint and several liability undertakings for consolidation purposes with respect to obligations owed by the subsidiaries. Such liability may severely limit reorganisation options and care is required when making public disclosures about such assumption of liability as this may limit the possibility of revoking such liability.

Care is also required with regards to liability when the sale of the Dutch subsidiary is envisaged.

Liability for dissolved Dutch group company

A dissolved Dutch company may be re-activated by the courts if debts surface and if there are assets to be distributed. The latter is usually easy to demonstrate based on restitution of liquidation proceeds. For this reason, it is essential that the applicable procedures be followed and notifications are made when dissolving and liquidating a Dutch entity.

Operational liability

When entering into commercial agreements, it is essential that management confirms that the Dutch operational company is capable of fulfilling its obligations under the commercial agreement and/or that sufficient additional comfort can be sought from group companies. Entering into agreements with the knowledge that the company cannot fulfil its obligations constitutes an act of tort and may lead to (personal) civil liability.

It is essential that the risk exposure is brought in line with the risk appetite of the company

This situation may occur where the management of a Dutch operational subsidiary is requested by the parent company to accept joint and several liability for a group financing arrangement that far exceeds the balance sheet total of the Dutch subsidiary. It may also give rise to the ultra vires issue: the transaction is not in line with the objects or interest of the company.

Corporate authority

It is not in line with an effective risk management policy to have just one person with the corporate authority to bind the Dutch subsidiary. This constitutes a major risk and is not in line with market practice. An alternative solution lies in a corporate authority structure where there are two classes of directors: Directors A and Directors B. A director may only bind the company when acting in concert with a director of the opposite class. For day-to-day corporate actions, a revocable continuous power of attorney is issued, excluding material representational issues and including tight monetary caps. Powers of attorney must at all times be limited, as opposed to general and all-inclusive powers of attorney. Directors and proxy holder registrations and information about corporate authority, registered with the Trade Registry, carry third-party effect. It is essential that up-to-date information be maintained at the Trade Registry to limit risk exposure.

Closing remarks

Risk management is not an exact science and the parameters are constantly evolving. In the Netherlands, statute and case law form the basis of the requirement to have an effective risk and control system in place within every company and to ensure its enforcement.

Where the risk management requirements included in statute are of a general and abstract nature, case law shapes the notion of what is considered to be good management practice and adds a certain degree of objectivity.

The creation and enforcement of an effective risk management system will provide a safeguard against directors' liability.

The acceptance of risk is inevitable if one is to create, build and sustain a successful and profitable business. This attracts risk – no risk, no gold. An assumption of risk does not pose an issue nor should it lead to personal liability for management provided that the assumed risk fits within the risk profile and risk appetite of the company. The allowable degree of risk appetite and the related degree of risk exposure depend on the nature of the company, its business, constitutive documents, internal guidelines and statutory limits.

Provided that this is taken into account, the position of the director of a Dutch company will not entail strict liability. ■

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BOEKEL DE NERÉE

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN QATAR

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Demand for D&O insurance in Qatar has historically been fairly limited (as is the case in other jurisdictions in the Middle East), largely as a consequence of the low incidence of claims in Qatar and the fact that many large corporate groups are family owned. However, many companies fail to recognise that the legislation in Qatar does impose duties upon their directors and officers and, consequently, that there are very real, potential legal exposures for the primary assets – their management team.

In addition, companies need to appreciate that as the nature of business in Qatar becomes increasingly international, the potential liabilities for directors and officers is far greater.

A summary of the exposures that companies face when doing business internationally is beyond the scope of this chapter. Instead, we focus on the key duties and liabilities applicable to directors of the two most common forms of corporate vehicle in Qatar – Qatari shareholding company (**'QSC'**) and limited liability company (**'LLC'**) – in an attempt to highlight the potential liabilities under Qatari law. A QSC may be public (listed) or private (unlisted, also referred to as 'closed') in nature and is typically the form adopted for larger ventures due to the higher capital and regulatory requirements (relative to a LLC).

Who is a director?

The primary statutory source of director duties and liabilities is the Commercial Companies Law (Law No. (5) of 2002 as amended) (the 'Companies Law'). It is worth noting at the outset that, as all laws and regulations in Qatar are published in Arabic, all English translations are unofficial by their nature. This is important because the Arabic word used in the Companies Law (and other laws) to describe a director may also be translated (interchangeably) as 'manager'.

In the case of a LLC, it should be noted that a LLC acts through its shareholders in Qatar. It is the shareholders who sign a power of attorney appointing a 'general manager' to run the company on their behalf. Although the position of general manager is not referred to expressly in the Companies Law, it is generally accepted (as a matter of practice) that the general manager has the same duties and responsibilities as a director. The Companies Law does not provide for any board of directors for LLCs but provides that LLCs are managed by a 'manager'. The Companies Law provides that where there are several managers, the company's articles of association may provide for a 'board of managers'. In practice, the general manager becomes empowered with all the powers, duties and obligations of the board. The general manager is identified in the LLC's commercial registration and is granted a high degree of authority to manage and operate the LLC.

To avoid confusion, only the terms 'director' (for QSCs) and, where necessary, 'general manager' (for LLCs) will be used in the remainder of this chapter.

Conveniently, the Companies Law provides that the general manager of a LLC has the same duties and responsibilities as a director of a QSC.

Directors' duties

The main sources of duties and liabilities imposed on directors of a QSC are

- the Companies Law; and
- the Corporate Governance Regulations of companies listed on the Qatar Exchange issued by the board of the Qatar Financial Markets Authority on 27 January, 2009 (the 'Corporate Governance Regulations').

This section only considers some of directors' general duties. It does not discuss whether a specific duty may arise under a particular law or regulation as a consequence of an activity undertaken in the course of a QSC's day-to-day business.

The general duties attaching to QSC directors are summarised below.

Duty to act in the QSC's best interests

The directors must exercise their powers and carry out their duties in such a way as to serve the interest of the QSC and the shareholders.

Duty to avoid conflicts of interest and transactions with directors

No director may participate in any act which may compete with the company, or trade for his own account or the account of a third party in any branch of the activities carried out by the company. The company may otherwise demand compensation from the director and consider the operations carried out as having been done for the company's account.

With the exception of state representatives in QSC and persons owning more than 10% of shares in a company, no person can be a director of more than three companies, or the chairman or deputy chairman of more than two boards of directors.

No director may have a direct or indirect interest in any contract, project or other commitment involving the company, unless a public tender takes place and the company in its general meeting approves of the director's involvement on an annual basis, if applicable. The director concerned must not be present in any board meeting or general assembly at which the director's involvement is being considered.

A company may not make any loans to a director or guarantee a loan made by a third party to a director with the exception

of a bank or other credit providers where the loan or guarantee is given on the same terms and conditions as those applying to members of the general public.

No person may simultaneously hold the office of auditor and be founder of the QSC, be a director thereof, or perform any technical, administrative or advisory work for the company.

Duty to exercise reasonable care, skill and diligence

A director must carry out his duties in a responsible manner, in good faith and with due diligence.

Requirement to own shares in the QSC

A director must own such number of the company shares as the articles of association may specify ('security shares'). The security shares must be deposited within 60 days with one of the accredited banks in Qatar.

The security shares are assigned for the security of the rights of the company, shareholders, creditors and third parties against the responsibilities assumed by the director and remain non-transferable until the end of the director's mandate as a director and the approval of the balance sheet for the last year of his mandate.

Prohibition on use of inside information

No director must use any information obtained by virtue of his position for his benefit or the benefit of his wife, children or one of their relatives up to the fourth degree and/or have a direct or indirect interest in any party carrying out transactions intended to influence the price of financial instruments issued by the company.

Duties arising from the Corporate Governance Regulations

Pursuant to the Corporate Governance Regulations, the board of directors has wide-ranging corporate governance responsibilities, which include but are not limited to:

- drafting a corporate governance code for the company in line with the provisions of the Corporate Governance Regulations, amending it whenever necessary and making it available to the public
- approving the strategic plans and main objectives of the company
- appointing and revoking managers and ensuring succession planning
- ensuring the company's compliance with the laws and regulations and its articles of association.

At least one-third of the board of directors must be independent members. An independent member of the board of directors must be completely independent of the QSC and must not infringe the conditions of the Corporate Governance Regulations, which include but are not limited to the following conditions:

(a) during the preceding three years, must not have been:

(i) a senior executive of the company; or

(ii) an employee, or director, or owner, or partner or shareholder in any company advising the QSC including the QSC's auditors

(b) must not be a relative of any of senior executives of the company

(c) must not have been a board member of the company for more than nine consecutive years.

The majority of the board of directors must be non-executive members. A non-executive member of the board of directors must not have held a full-time management position at the company and must not receive a monthly or yearly salary except the directors' remuneration.

Directors' liabilities and penalties

All directors are jointly responsible for compensating the company, its shareholders and third parties for damages resulting from any fraudulent act, abuse of power, breaches of the Companies Law and the company's articles, and errors of management (except for those made in good faith). Any indemnity by the company against such responsibility is considered invalid.

All directors are jointly responsible for compensation in the above circumstances if the loss was caused by a decision which was unanimously approved. In the case of a resolution passed by a majority, the objecting directors are not liable to pay compensation, provided their objection is recorded in the minutes of the company. Absence from the meeting where the relevant decision was taken will not be a reason to absolve a director from responsibility unless it is proved that the absent director did not know of the decision, or that the director could not object to it on becoming aware of the decision.

A director may be liable to the company for up to five years after the cause of the loss or damage to the company.

The company in general assembly may not absolve a director of responsibility for loss or damage during their time in office.

If the loss or damage was caused by an act which was approved by the company in general assembly, the director's liability would cease five years after the date of the general assembly. However, this does not apply if the loss or damage may be attributed to a criminal offence.

Director's criminal liability

For completeness, directors may also be subject to penalties under Articles 324 and 325 of the Companies Law. Article 324 provides for imprisonment for a period of not more than two years and a fine of no less than QAR10,000 and no more than QAR100,000, or by either punishment for:

- every person who deliberately establishes false statements or statements in violation of the Companies Law in publications for issuing shares, bonds or other securities
- any founding member who, by way of misrepresentation, values shares in kind at prices higher than their true value
- any person who in bad faith resolves or distributes profits, interest or returns in violation of the Companies Law or the company's articles and any auditor who in bad faith approves of the same
- any person who forges company records or intentionally makes false entries, prepares or presents to the company's general assembly a report which includes false or incorrect statements which influences the assembly's resolutions
- any director or employee of the company who reveals any of the company's secrets or intentionally attempts to damage its activity, or has a direct or indirect interest in any business entity carrying out operations that are intended to influence the price of financial instruments issued by the company; or
- any other contravention of the provisions of the Companies Law.

Article 325 of the Companies Law also provides for additional penalties of a fine of no less than QAR5,000 and no more than QAR50,000 for :

- any person who disposes of shares or capital in violation of the provisions of the Companies Law
- any person who intentionally refuses to allow auditors or officers of the Ministry of Business and Trade to review the company's records and documents which they are entitled to under the Companies Law; and
- any director who intentionally hinders or prevents the notification of the convening of the company's general assembly or the holding of the general assembly.

In the case of repeated violations, Article 326 of the Companies Law provides that the fines set out in Articles 324 and 325 are doubled and a court order may be obtained to address any refusal to redress a violation.

As in other jurisdictions in the Middle East, the demand for D&O insurance appears to be increasing in other sectors as the incidence of claims has increased during the global economic recession.

Directors' and officers' liability insurance in Qatar

Notwithstanding the fairly extensive obligations owed by directors as a matter of Qatari law, demand for D&O insurance in Qatar has been limited. This appears to be a consequence of a number of factors including: (i) low awareness of the liabilities and exposures of directors; (ii) low awareness of the insurance products available; (iii) a relatively benign claims culture in Qatar; and (iv) the prevalence of family owned businesses. The main purchasers of such protection have, therefore, historically been international financial institutions. As in other jurisdictions in the Middle East, the demand for D&O insurance appears to be increasing in other sectors as the incidence of claims has increased during the global economic recession. In particular, press

coverage of the claims against the Saad Group and the Ahmad Hamad Al-Gosaibi & Brothers Co (see the Saudi Arabia chapter) has resulted in greater awareness of the potential exposure for directors and officers.

There are 13 insurers licensed to operate in Qatar. A number of these insurers offer D&O insurance, including Qatar Insurance Company and Arabia Insurance Company. As there are no specific regulations in place addressing D&O insurance, the policies on offer tend to resemble London market wordings. This gives rise to a number of key considerations for purchasers of D&O insurance, including:

- **What D&O claims are covered?** D&O policies are typically issued on a 'claims made' basis. That is to say that coverage is triggered upon the occurrence of a claim against the director or officer in question. Careful consideration needs to be given as to what precisely will amount to a claim. For example, will the costs associated in dealing with administrative proceedings such as formal investigations be covered? This is an increasingly important point as regulators in Qatar (and the broader Gulf Cooperation Council, 'GCC') are becoming increasingly proactive in their investigation of breaches of local regulation.
- **When does the insurer require notification?** Many D&O policies in the region specify that timely notification of a claim is a condition precedent to the insurance company's liability. Such provisions can be particularly problematic for companies where they also require immediate notification of circumstances that might give rise to a claim. Whilst Qatari courts have a general discretion whether to deny coverage on the basis of a breach of such notification obligations, companies are best advised to ensure that their management teams are aware of these requirements so as to avoid prejudicing any potential insurance coverage.
- **What losses are covered?** D&O policies in the Middle East often do not provide coverage for fines, penalties, exemplary damages or punitive damages. Whilst awards of non-compensatory damages are rare in the region, companies need to consider the risk of proceedings elsewhere in the world. It is not necessarily the case that a company needs to be operating elsewhere in the world for it to be drawn into proceedings overseas (and thereby exposed to the compensation culture of such overseas jurisdictions).

US exposures

For companies doing business in the United States, or whose securities are sold there, it will be important to ensure that the D&O policy provides coverage for claims made in the United States. Typically, such claims are not covered under standard D&O policies sold in the region and such coverage is provided by way of a policy extension. However, even where the company does not have an obvious connection to the United States, it should be aware that claims have been brought in the United States against companies in the GCC for no better reason than one of the directors being a US national. Even if ultimately the US court can be persuaded to decline jurisdiction over a case, the director will incur costs in challenging the jurisdiction of the US court.

Insured versus insured

Coverage is typically excluded for claims made by one director against another director (or by the company itself). Such exclusions vary from policy to policy but may extend to exclude liability for claims arising from anyone directly or indirectly connected with an insured.

Claims arising out of professional services

Coverage is typically excluded for losses arising out of 'professional services'. Whilst the definition of 'professional services' is often fairly vague, the intention is clearly to exclude losses that would otherwise be covered under a professional indemnity insurance. In determining whether wrongdoing occurred whilst acting as a director/officer or in the course of professional services, the courts will typically enquire whether the individual was undertaking an act that required specialist training or was merely administrative in nature.

In summary, companies need to be aware of the potential liabilities to which their directors and officers are exposed when doing business in the region. Companies should not underestimate the scope of such liabilities and exposures and should ensure that the insurance protection that they purchase is suited to the risks that they face. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE RUSSIAN FEDERATION

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Directors' and officers' ('D&O') liability insurance policy terms vary depending upon the insurer and the risk. However, the basic D&O insurance contract is fundamentally based on US and English law. Despite the differences in legal concepts around the world, the basic D&O insurance contract has been exported out of the US and England and sold in non-US and non-English jurisdictions. The result is an imperfect fit between the basic D&O insurance contract and local law. Russia is one of the many countries that presents a complex set of issues and considerations for directors of local entities and their coverage advisors when it comes to D&O insurance.

It is a well-established principle that coverage under a D&O insurance policy is based on the availability of corporate indemnification. This is evident from the structure of traditional D&O insurance, with 'Side A' providing coverage for non-indemnifiable loss and 'Side B' for indemnifiable loss. While bifurcating coverage in this way works perfectly well in jurisdictions such as the US and England, difficulties arise in other jurisdictions – such as in Russia – where the legality and enforceability of indemnification is not well defined. In such instances, the basic D&O insurance policy must be revised and rewritten to provide appropriate coverage for the insured; coverage that will actually respond to a claim *in Russia*. This requires a combination of Russian law expertise and a sophisticated knowledge of relevant insurance law issues.

In addition, laws stipulating that D&O coverage may only be provided by Russian insurers for Russian risks further complicates policy placement and considerations. There are very few Russian insurers that are experienced enough to underwrite D&O insurance. As a result, the D&O insurance is often underwritten by the London insurance market through a 'fronting arrangement'. In such cases a Russian insurer ('fronting insurer') will issue the D&O policy, but reinsure the risk through the London market ('reinsurer'). When such arrangements are entered into, marrying up fronting and reinsurance policy terms becomes very difficult because most insurers are not aware of the complexity of legal issues under Russian law. As a result, a director is left with unintended gaps in coverage or unenforceable policy terms.

In this chapter we identify some of the unique insurance law issues which challenge directors in Russia and highlight the various factors that should be considered to resolve such complexities.

Directors' liabilities

The Russian law on directors' liability is set out in the Civil Code of the Russian Federation and in the Joint-Stock Company Law. Article 53.3 of the Civil Code sets out the general principles of directors' duties (which are also reflected in Article 71.1 of the Joint-Stock Company Law) as follows:

> 'A person who by virtue of a law or the constitutive documents of a juridical person acts in its name *must operate in the interests of the juridical person represented by him in good faith and reasonably.* He shall be obliged at the demand of the founders (or participants) of the juridical person, unless provided otherwise by a law or contract, to compensate losses caused by him to the juridical person.' (*Russian company and commercial legislation*, W.E. Butler, 2003 [added emphasis].)

Article 71.2 of the Joint-Stock Company Law further stipulates that directors may be held personally liable for any losses caused to the company as a result of their wrongful acts and omissions. The Russian legal concept of 'wrongfulness' or 'fault' (*vina*) is roughly equivalent to a combination of the Western legal notions of negligence and wilful misconduct. Generally, a party will not be found to have acted wrongfully if he acted with a degree of care and caution that would be reasonably expected under the particular circumstances. Liability therefore requires a constituent of fault in the performance of a director's duties, determined by reference to regular business practice and norms.

Liability is joint and several except for those directors that vote against a decision or do not participate in the vote. Directors of a parent company can be held jointly and severally liable with those of the subsidiary for the subsidiary's intentional insolvency and can also be held criminally liable where such insolvency caused significant losses or other serious consequences.

Whilst corporate indemnification is examined more closely below, it is worth noting that Russian law is not positively disposed towards the limitation of director liability. Given that liability is statutory, it cannot normally be limited in the constitutional documents, nor in the service contract between the General Director (akin to a CEO) and the company.

Admitted coverage

Insurance is regulated by the Civil Code and by the Law of the Russian Federation No. 4015I on Insurance Business in the Russian Federation (the 'Insurance Law'). Russian law dictates that the interests of legal entities and natural person residents be insured only by insurance carriers licensed to conduct such business in Russia (Article 4.5 and Article 6 of the Insurance Law). If an insurer under an insurance policy does not have a licence to operate an insurance business, then such insurance policy is deemed invalid in accordance with Article 173 of the Russian Civil Code. Since any operations that are subject to licensing under the law involve the public interest, the law also provides for administrative and/or criminal liability for carrying on a business without a licence. (Article 171, 'Illegal Enterprise', of the Russian Criminal Code.)

Therefore, companies wishing to purchase global insurance policies for their directors are forced to restrict their choice of insurance company to those that are registered pursuant to Russian law and have the appropriate licence. Given the capacity of Russian domestic carriers, this often means that D&O insurance policies are put in place with a local fronting insurer retaining the initial, usually less than 10%, limit of liability and with the majority of the risk reinsured through one of the larger

international insurance markets, such as Lloyd's. Such arrangements must therefore be examined closely to ensure that the policy terms and conditions of both the primary (fronting) insurance and the reinsurance are consistent.

Choice of law

Non-Russian directors are being appointed to the boards of Russian entities with increasing frequency (usually as non-executive directors). The ability to select foreign law is often a question non-Russian directors ask. Many non-Russian directors want their D&O policy to be governed by English law. English law, unlike Russian law, has familiarity and certainty which can provide peace of mind to directors when considering Russian board appointments.

Russian law permits parties discretion to enter into agreements subject to any foreign law, where one of the following circumstances exist:

- the agreement has a 'foreign element' (Article 1186 of the Civil Code)
- the agreement is not subject to an imperative (Articles 1212 and 1213.2 and some other provisions of Chapter 68 of the Civil Code) or supermandatory (Article 1192.1 of the Civil Code) provision under Russian law requiring that it be governed by Russian law, and
- the agreement is not subject to a mandatory provision and is in fact connected only with Russia (Article 1210.5 of the Civil Code).

Russian law does not state what is considered to be a 'foreign element' but provides two examples, where (a) one of the parties to the agreement is a foreign resident or (b) the object of the agreement is situated abroad (Article 1186.1 of the Civil Code). In addition to these, legal references also suggest a third foreign element, where the juridical fact takes place abroad (*Commentaries to the Civil Code,* edited by T E Abova et al, 2005; and *Commentaries to the Civil Code (Part III),* edited by L P Anufrieva, 2004).

A juridical fact is understood to be an event or action which leads to the establishment or termination of, or change in the rights under, an agreement (*Civil law textbook,* edited by E A Sukhanov, 2000). This may be the case where the acts (or omissions) of a director which result in an obligation to compensate losses take place outside Russia. It is also arguable that the proprietary interest being insured under the D&O insurance is the liability to compensate damages to directors which, by extension, means that if the director is a foreign resident, then the obligation to compensate his damages may theoretically be considered a 'foreign object' of the agreement. Such arguments are, however, at best tenuous and where a foreign director is located in Russia, discharging directorial duties on behalf of a Russian domiciliary, it is likely that Russian courts will look unfavourably on the existence of a foreign element. Where the only parties to the agreement are Russian, the Russian courts are highly likely to reach a finding of no foreign element.

In an attempt to preserve an English (or other foreign law) choice of law clause, the policy language could be amended so as to specifically include non-Russian directors which may be sufficient to satisfy the foreign element test.

If a foreign element can be found to exist and the policy is made subject to foreign law, there is still a risk that the insurer, when drafting the policy, will have to adhere to certain mandatory provisions of Russian insurance law (Article 1192 of the Civil Code) which will not always be compliant with English law. For example, Russian law does not permit insurance coverage for administrative or criminal penalties imposed on a director or officer. There may also be supermandatory provisions that apply which arise out of the particular nature of, or special meaning attributed to, a contract. There is no list of such supermandatory provisions and the court decides in each particular case at its discretion whether a provision is supermandatory, leaving much room for uncertainty. As a result, Russian courts may decide that, irrespective of the choice of law provisions in the D&O insurance policy, certain provisions of Russian law will nevertheless prevail.

Even if a court were to rule that a policy may be governed by English law, there is a high degree of probability that where the insured organisation, directors and discharge of duties are located in Russia, the court will find the policy connected only to Russia. In this case, in accordance with Art. 1210.5 of the Russian Civil Code, the imperative provisions of Russian insurance law would apply to the policy and the policy will therefore be subject to Russian governing law (it must be noted that almost all of the provisions of Russian insurance law are imperative and do not provide for the exercise of the discretion of the parties).

The answer to the question of governing law will depend upon the exact nature of the risk insured. It is also an important consideration to address when fronting arrangements are put in place between a Russian insurer and the London market. It is highly likely that the D&O policy issued by the Russian insurer will be subject to Russian law, regardless of the choice of law clause agreed to by the parties. It is also highly likely that the reinsurance agreement with the London market will be governed by English law. The difference in the governing laws within the entire insurance arrangement can cause problems for a director in the event of a claim. While multiple insurers may spend time disputing among themselves as to whether coverage applies, a director may be left waiting for protection.

Tax considerations

Pursuant to the insuring clauses under D&O policies, the carrier undertakes to pay the loss 'on behalf of' an insured person (director), or to directly pay the loss to the director. Thus, the insurance payments for the losses contemplated under such a policy may be made either to the insured or to other persons entitled to receive such payment; eg third parties liable to compensation as a result of an insured's wrongdoing. If a covered claim occurs, any insurance recoveries received by directors under the D&O policy may be deemed to have been received from a source within Russia (given the admitted policy requirements) and could consequently be considered to be taxable income within the jurisdiction. Legal advice should be sought to evaluate what the tax consequences may be.

Legal prohibition and presumptive indemnification

Russian law skirts the issue of indemnity. There is virtually no case law that could provide a legal precedent for either rejecting or acknowledging the concept of indemnity and there is no requirement under Russian law for a company to indemnify its directors. Russian law permits parties to enter into agreements which are not prohibited by the Civil Code. Thus, in order to be valid, indemnification agreements must meet the general requirements pertaining to all contracts as set out in the Civil Code and additional requirements pertaining to insurance set out in the Civil Code and other laws/by-laws and must not be contrary to public policy (Article 1193 of the Civil Code).

Even if a court were to rule that a policy may be governed by English law, there is a high degree of probability that where the insured organisation, directors and discharge of duties are located in Russia, the court will find the policy connected only to Russia.

One example of a potential issue arises under the application of Article 15 of the Russian Civil Code which defines damages as expenses paid or incurred by the party whose rights have been violated for restoration of such rights, loss or damage to his property (actual losses), as well as lost profit. In circumstances where the actions of a director lead to a reduction in the assets of the company, the shareholders can exercise their right of claim to bring about the restoration of the total amount of the 'lost' assets. If the company enters into an indemnity agreement with the director, the above restoration of 'lost' assets will not take place since the company will make available to the director exactly the same amount as he is required to contribute to top up the total assets of the company as a result of the damages he has caused it.

If the indemnity agreement survives the above-described risk, it is possible to argue that, under Russian law, the indemnity agreement should qualify as a donation (gift) agreement. In particular, the company cannot be considered to be compensating the director for damages as the company has not caused such damages to the director (otherwise the company would act as an insurer which it cannot do without an appropriate licence). Therefore, any obligation by the company to make payments to the director should be for proper consideration (unless it is donation or gift), ie provision of services, supply of goods, performance of work etc. As the indemnity agreement is lacking consideration it may therefore qualify as a donation (gift) agreement. Such qualification of the indemnity agreement will not lead to its invalidity per se, but may trigger adverse tax consequences both for the director and the company. Whilst not necessarily eliminating the risk, the indemnity agreement should contain a clear indication that it is not a donation or gift agreement.

The consequences of the foregoing issues arise most crucially in the formulation of D&O policies. Many D&O polices contain 'presumptive indemnification' clauses meaning that, for coverage purposes, it will be assumed that the company will indemnify its directors and officers to the 'fullest extent permitted by law'. In other words, it does not matter what the company actually does: when a claim is made, the insurance only covers claims relating to matters beyond those for which a director could legally have been indemnified, leaving the directors exposed to personal liability in excess of that.

The consequences of this are two-fold. Firstly, in a traditional policy, this could mean that Side A coverage (for non-

indemnifiable loss) is effectively redundant since the absence of legislation means that the amount a company can indemnify is unlimited, so that coverage will not be triggered. Therefore, any reference to 'legislative prohibition' in the definition of 'non-indemnifiable loss' has the effect of moving all loss into 'indemnifiable' loss and therefore into Side B coverage (for indemnifiable loss) since no loss is capable of falling within the former definition.

It is highly likely that the D&O policy issued by the Russian insurer will be subject to Russian law, regardless of the choice of law clause agreed to by the parties.

The effect upon a company and its respective directors is therefore that a premium for coverage under Side A will be paid yet can never be triggered. It is therefore crucial to ensure that the language in the policy addresses the issue and limits indemnifiable claims to those permitted or required by the insured organisation's charter, by-laws, certificate of incorporation or other comparable organisational documents.

A secondary effect of a poorly worded policy is that in the event that a company does not indemnify the director, the insurer is liable only for losses in excess of the retention, which will be the company's retention (as opposed to the usual 'nil' retention applied to Side A). Given that these retentions are often very substantial, the effect may be to eviscerate entirely the intended coverage for the directors. Ideally, it would be best to remove any such provision in the policy and to vest in the insurer the right to pursue the benefit of the indemnity (to the extent of the retention) from the company in the event it was not provided when it should have been.

Until such time when an indemnification agreement is tested in the Russian courts, the enforceability issue remains unresolved.

Conclusion

The issues concerning the enforceability of indemnification agreements and the drafting of D&O insurance policies for application in Russia are fraught with legal uncertainty. The need for sophisticated legal and insurance advisers is therefore vital to modify policy language in order to reflect the legal and commercial realities within the jurisdiction and to provide innovative solutions ensuring broad and appropriate coverage for directors sitting on Russian boards. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE KINGDOM OF SAUDI ARABIA

Abdulaziz Al-Bosaily, Partner
Abdulaziz A. Al-Bosaily in association with Clyde & Co LLP

Corporate governance standards are increasing in the Kingdom of Saudi Arabia ('KSA'). These developments are particularly in respect of public companies and also reflect concerns arising from a number of high-profile cases involving directors of Saudi-owned businesses. It is therefore likely that there will be increased demand for D&O insurance in KSA. Indeed, the non-executive and independent directors now required are increasingly likely to require such insurance protections as condition of their appointment.

This chapter provides a summary of the duties and liabilities applicable to directors of the most common forms of KSA company: unlisted limited liability companies (**'private companies'**) and listed public joint stock companies (**'public companies'**). As in many other jurisdictions, the corporate governance standards for a public company are considerably more onerous than those that apply to a private company. However, the difference between corporate governance standards applying to public companies and private companies is more pronounced in the KSA than in many other jurisdictions. This is due largely to the fact that there is no binding system of judicial precedent (KSA is a civil law jurisdiction). Accordingly, advances in corporate governance are largely dependent upon new laws and regulations being issued by the relevant authorities, rather than as a result of interested parties bringing legal proceedings.

There have been some significant recent developments in respect of public companies but little development in the law and regulations applying to private companies. For example, the Capital Markets Authority (the **'CMA'**) has made several key provisions of the previously voluntary corporate governance code mandatory for public companies since the beginning of 2009. Now the board of directors for a public company must:

- provide enhanced disclosures in their annual report
- be comprised of a majority of non-executive directors
- be comprised of at least two independent members, or one-third of the members, whichever is greater; and
- set up an 'audit committee' with fairly stringent requirements and far-reaching duties and responsibilities.

This increased focus on lifting corporate governance standards for listed companies reflects the growing importance of the Tadawul (the securities market of the KSA) which is easily the largest and most active financial market in the Middle East region.

Directors' duties for a public company

The main sources of duties and liabilities imposed on directors of a public company are:

- Regulations for Companies, issued by Royal Decree No. M6 of 22 Rabi'I 1385 (20/07/1965G) (**'Companies Regulations'**)
- The Capital Market Law, issued by Royal Decree No. M/30 dated 2/6/1424H (01/08/2006G) (**'Capital Market Law'**)
- The Listing Rules, issued by the Board of the CMA pursuant to Resolution No. 3/11/2004 dated 20/8/1425H (4/10/2004G) (**'Listing Rules'**); and
- The Corporate Governance Regulations, issued by the Board of the CMA pursuant to Resolution No. 1.212.2006 dated 21/10/1427H (12/11/2006G) (**'Corporate Governance Regulations'**).

The general duties attaching to public company directors arising under the above laws and regulations are summarised below:

Duty to act in the public company's best interests

The directors must exercise their powers and carry out their duties in such a way as to serve the interest of the public company.

Duty to avoid conflicts of interest

A director shall not participate in any business that might compete with the public company's business, unless such participation is approved, on an annual basis, by the shareholders of the public company at an ordinary general assembly.

A director may not hold an interest in any contract entered into by the public company unless such interest is approved in advance by the ordinary general assembly and such approval is renewed on an annual basis by the shareholders of the public company at an ordinary general assembly. The director in question may not participate in any voting undertaken in relation to the contract in question. Further, the chairman of the board is required to report to the ordinary general assembly the operations and contracts in which any member of the board has a personal interest and this is to be accompanied by a special report from the auditor.

A director shall not be entitled to a cash loan from the public company or to any guarantee from the public company in respect of any loan he may enter into with third parties, excluding banks and other credit companies.

Duty to exercise reasonable care, skill and diligence

A director must carry out his duties in a responsible manner, in good faith and with due diligence.

Duty to act honestly

There are broad duties on directors of public companies to act honestly. These duties include obligations to maintain confidentiality of company matters, not to receive or distribute profits that have not actually been earned and not to knowingly include false information, or omit essential information in the balance sheet, the profit and loss statement or in the reports prepared by them for the partners or the general meeting.

Requirement to own shares in the public company

A director must own not less than SR10,000 worth of shares in the public company (**'security shares'**). The security shares must be deposited within 30 days with one of the banks designated for this purpose by the Minister of Commerce and Industry for the purpose of securing the director's liability.

Every shareholder shall have the right to initiate an action in liability against directors on behalf of the public company if the wrongful act committed by such director(s) was personally prejudicial to the shareholder(s).

Duty to comply with the regulations and with government ministry instructions

There are general duties to comply with the regulations issued by government ministries. These duties include obligations to comply with the instructions issued by the Ministry of Commerce and Industry or to show the ministry's representatives such documents and records, or submit such statements and information, as may be required by the ministry. Similar duties arise in relation to compliance with the instructions of the CMA.

Duty to pay damages to the company for misconduct

Directors are jointly responsible for damages to the public company, or the shareholders, or third parties, arising from their wrongful act or misconduct of the affairs of the public company, or their violation of the provisions of the Companies Regulations or of the public company's bylaws. Any stipulation contrary to this provision shall be considered invalid.

Directors' liability to shareholders

Every shareholder shall have the right to initiate an action against directors on behalf of the public company if the wrongful act committed by such director(s) was personally prejudicial to the shareholder(s).

Duty to consider timing for resignation

A director may only resign at a proper time; otherwise, the director shall be responsible to the public company for any damages as a result of resignation at an improper time.

Duties arising from the Corporate Governance Regulations

Most of the Corporate Governance Regulations are 'voluntary'. However, if a public company does not implement any of the 'voluntary' Corporate Governance Regulations it must disclose in the directors' annual report the provisions not complied with and the reasons for not complying. Pursuant to the Corporate Governance Regulations, the board of directors have wide-ranging corporate governance responsibilities, which include:

- approving the strategic plans and main objectives of the company and supervising their implementation
- laying down rules for internal control systems and supervising them
- drafting a corporate governance code for the company that does not contradict the provisions of the Corporate Governance Regulations, supervising and monitoring the effectiveness of the code and amending it whenever necessary

- laying down specific and explicit policies, standards and procedures for the membership of the board of directors and implementing them after they have been approved by the ordinary general assembly
- outlining a written policy that regulates the relationship with shareholders with a view to protecting their respective rights; and
- deciding policies and procedures to ensure the public company's compliance with the laws and regulations and the public company's obligation to disclose material information to shareholders, creditors and other stakeholders.

The ultimate responsibility for the public company rests with the board of directors. This responsibility applies even if the board sets up committees or delegates some of its powers to third parties.

An independent member of the board of directors must be completely independent of the public company and must meet the following conditions:

- the director must not hold a controlling interest in the public company or in any other company within that public company's group
- during the preceding two years, the director must not have been a senior executive of the public company or of any other company within that public company's group
- the director must not be a first-degree relative of any board member of the public company or of any other company within that public company's group
- the director must not be a first-degree relative of any of senior executives of the public company or of any other company within that public company's group
- the director must not be a board member of any company within the group of the public company to which he/she is nominated to be a member of its board; or
- during the preceding two years, the director must not have been an employee of an affiliate of the public company or an affiliate of any company of its group, such as external auditors or main suppliers.

A non-executive member of the board of directors must not have held a full-time management position at the public company and must not receive a monthly or yearly salary.

A non-executive member of the board of directors must not have held a full-time management position at the public company and must not receive a monthly or yearly salary.

Duties in relation to insider trading and disclosure

The duties imposed in relation to insider trading and disclosure are broad and include obligations:

- not intentionally to create a false or misleading impression as to the market, the prices or the value of any security
- not to exploit non-public information about the public company or disclose such information to another person, and
- to notify the public company and the CMA at the end of the trading day upon becoming an owner of, or becoming interested in, any rights in the shares or debt instruments of the public company (or any of its affiliates) or increasing or decreasing such ownership or interest by 1%.

Directors and their associates may not deal in any securities of the public company during the ten days preceding the end of the financial quarter and until the date of the announcement and publication of the interim results of the public company, nor during the 20 days preceding the end of the financial year and until the date of the preliminary announcement of the public company's annual results, or until the final announcement of the public company's annual results, whichever is shorter.

Public companies have an ongoing duty to provide the CMA and the public with details of any major developments in activities

which are not public knowledge and which may impact on the public company's assets and liabilities or financial position or on the general course of its business. Such developments could include significant losses, legal proceedings, changes in the value of net assets or changes in the management of the company. Although this obligation is expressed to be on the public company, the board of directors has responsibility to comply.

The board of directors must approve, and a director authorised by the board of directors and the CEO and CFO must sign, the interim and annual accounts of a public company prior to their issuance and circulation to shareholders and third parties.

Duties of disclosure

A public company must provide the CMA, and announce to the shareholders, its annual accounts as soon as they have been approved by the directors and within a period not exceeding 40 days after the end of the annual financial period to which they relate. Although this obligation is expressed to be on the public company, the board of directors has responsibility to comply.

The board of directors shall, at least 60 days prior to the date set for the holding of the annual general meeting, prepare for every financial year of the public company a balance sheet, a profit and loss statement, and a report on the public company's operations and financial position and on the method which it proposes for the distribution of net profits.

The board of directors must issue a report which the public company must include with its annual accounts. The report must include a review of the operations of the public company during the previous financial year and detail all relevant factors affecting the public company's business which an investor requires to assess the assets, liabilities and financial position of the public company. The directors' report must also contain statements that (i) proper books of account have been maintained; (ii) the system of internal control is sound in design and has been effectively implemented; and (iii) there are no significant doubts concerning the issuer's ability to continue as a going concern.

Duties in the event of bankruptcy

The powers of the board of directors shall cease upon the dissolution of the public company. However, the directors shall continue to manage the public company and shall be deemed, as regards third parties, as liquidators until a liquidator has been appointed.

Liability for breach of duties by a director of a public company

Under the Companies Regulations:

- **Criminal liability** A director who fails to observe the mandatory rules issued under the Companies Regulations is liable to imprisonment for a period of not less than three months and not more than one year and/or to a fine of not less than SAR5,000 and not more than SAR20,000.

- **Civil liability** The public company may institute an action in liability against (its) directors for wrongful acts that cause prejudice to the body of stockholders. The resolution to institute this action shall be made by the ordinary general assembly, which shall appoint a person (or persons) to pursue the case on behalf of the public company.

If a director intentionally manipulates the price of a security, the directors will be liable for damages to any person who purchases or sells the security whose price has been significantly adversely affected by such manipulation.

Under the Capital Market Law

If a director intentionally manipulates the price of a security, the directors will be liable for damages to any person who purchases or sells the security whose price has been significantly adversely affected by such manipulation. In addition to the

penalties and financial compensation provided for under the Capital Market Law, the Committee for the Resolution of Securities Disputes may punish the persons who violate the market misconduct provisions of the Capital Market Law with an imprisonment term not exceeding five years.

Directors' duties for a private company

The main source of duties and liabilities imposed on directors of private companies is the Companies Regulations. The general duties attaching to directors of a private company are summarised below:

Duty to act honestly

A director must not receive or distribute profits that have not actually been earned by the private company (ie fictitious profits).

A director must not knowingly include false information in the balance sheet or the profit and loss statement, or in the reports prepared by him for the partners or the general meeting; or omit essential facts from such reports with the intention of concealing the financial position of the private company from the partners or third parties.

Directors have the duty to publish the articles of association for the private company and any amendments to it.

Duty to comply with the regulations and with government ministry instructions

A director must not wilfully insert in the memorandum of association, bylaws or other documents of a private company, or in the application for authorisation to incorporate it, particulars which are false or contrary to the provisions of the Companies Regulations, and must not knowingly sign or distribute such documents.

A director must observe and implement all of the mandatory rules issued under the Companies Regulations or decisions.

A director must not, without any justifiable cause, fail to comply with the instructions issued by the Ministry of Commerce & Industry (the 'Ministry') regarding the obligations of such private companies or to show the Ministry's representatives such documents and records, or submit such statements and information, as may be required by the Ministry.

Directors have the duty to publish the articles of association for the private company and any amendments to it. This is considered an important duty by the KSA authorities, as the publication of the articles of association provides third parties with important information about the private company.

Article 175 of the Companies Regulations imposes obligations on the directors to provide to the Ministry certain documents. An advice issued by the Ministry considers the breach of this obligation a criminal offence.

Duties in the event of bankruptcy

The powers of the board of directors or managers shall cease upon the dissolution of a private company. However, the directors shall continue to manage the private company and shall be deemed, as regards third parties, as liquidators until a liquidator has been appointed.

Liability for breach of directors' duties under the Companies Regulations

- **Criminal liability** A director who fails to observe the mandatory rules issued under the Companies Regulations is liable to imprisonment for a period of not less than three months and not more than one year and/or to a fine of not less than SAR5,000 and not more than SAR20,000.

- **Civil liability** The managers shall be jointly responsible for damages sustained by the private company, or the partners, or third parties as a result of the managers violating the provisions of the Companies Regulations or of the private company's memorandum of association, or of wrongful acts committed by the managers in the performance of their duties.

D&O insurance in KSA

The insurance industry in KSA is still relatively young. Until the introduction of the Law on the Supervision of Cooperative Insurance Companies in 2003 (the 'Insurance Law'), companies could only purchase insurance from the state monopoly provider, NCCI (now known as Tawuniya) or from outside of KSA. Following the enactment of the Insurance Law, all Saudi risks are required to be underwritten by a licensed Saudi insurance company (although the Saudi Arabian Monetary Agency, the insurance regulator, has the discretion to permit insurance to be placed outside of KSA in certain cases). There are presently 29 licensed insurers in KSA, of whom a number offer D&O coverage in KSA, including: Ace Arabia Insurance Company, Allianz Saudi Fransi and Chartis.

Policy wordings used in KSA are often based upon Lloyd's standard forms and therefore are subject to similar terms and conditions to other jurisdictions. The fact that there are no specific regulations in respect of D&O insurance, coupled with the historically low incidence of D&O claims, means that the products remain largely untested by the KSA courts. The issue to which such wordings give rise are the same across the Middle East.

Although, historically, demand for D&O insurance in KSA has largely been limited to financial institutions in KSA, this is now starting to change as a result of a number of recent high-profile cases which have highlighted the need for D&O insurance. In particular, allegations of wrongdoing against two prominent Saudi entities, the Saad Group and Ahmad Hamad Al-Gosaibi & Brothers Co, and their affiliates, that included two Bahraini banks, Awal and The International Banking Corporation, have resulted in proceedings against individual directors of these entities in several jurisdictions around the world. The claims against these entities and their directors are reported to exceed US$10bn. ■

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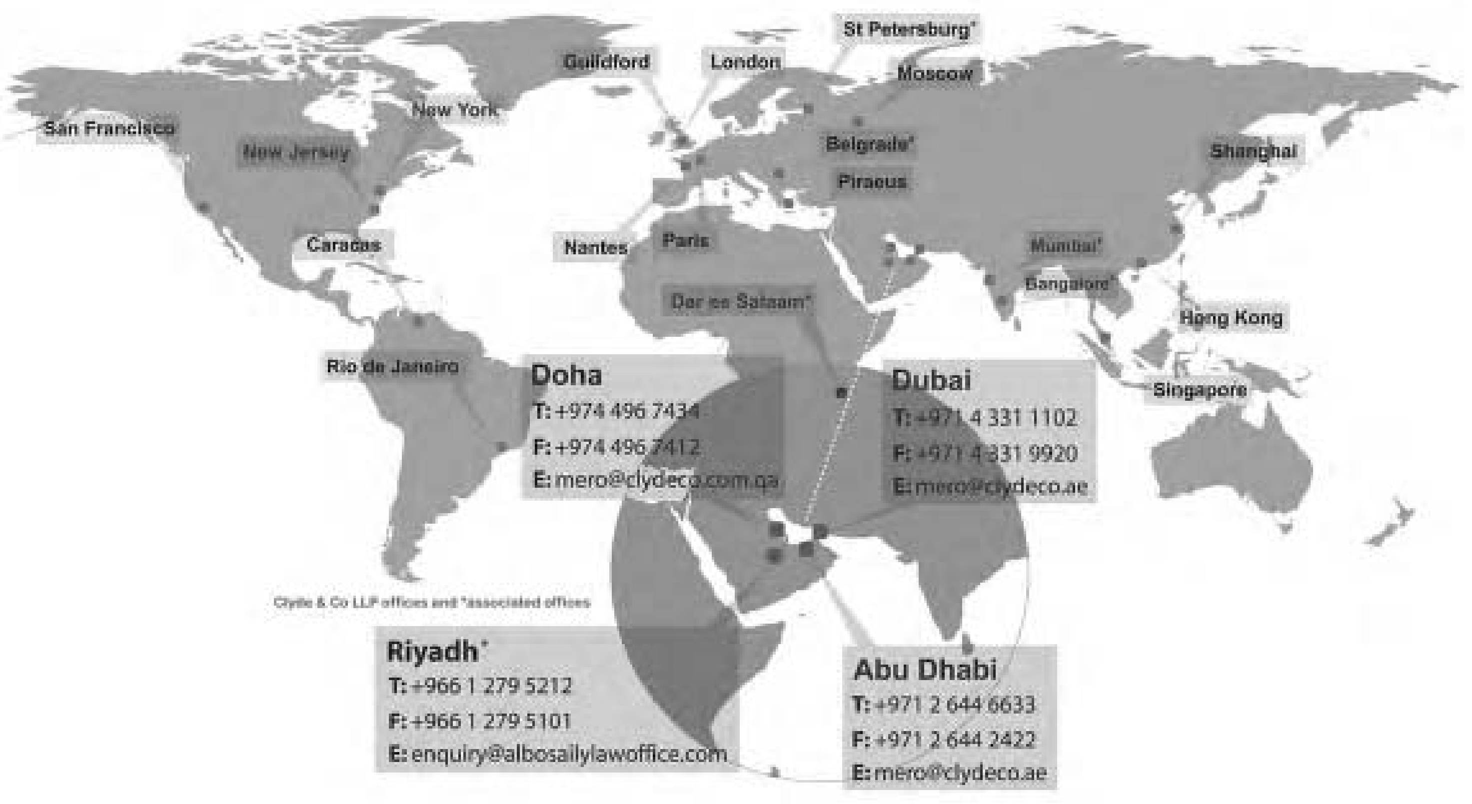

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN SINGAPORE

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In the wake of the 2008/2009 international financial crisis, Singapore (like many other countries) is in the process of reviewing its corporate governance regime and is expected to implement reforms shortly. One such reform under consideration is the codification of directors' duties currently embedded in common law and equitable principles so as to create greater certainty for directors of, and investors in, Singaporean companies.

In this chapter, we provide an overview of significant directors' duties applicable in Singapore and matters relevant to the enforcement of those duties. We also address restrictions imposed on Singaporean companies in respect of the indemnification of directors and officers, and identify reforms to Singapore's corporate governance regime now being considered.

Legal context

Singapore's laws and legal institutions are largely a product of the country's history as a British colony between 1819 and 1965. Over that period, Singapore was governed by English common law and legislation passed by the British parliament. Upon obtaining independence in 1965, Singapore retained those laws and legal institutions (with certain modifications to reflect its independence) and has since continued to align significant legislative developments with those of other Commonwealth common law jurisdictions, such as England, Australia and Canada.

In addition, although Singapore abolished the right of appeal to the Privy Council in England in 1994, Singaporean courts (including Singapore's court of final appeal, the Court of Appeal) continue to give considerable weight to decisions of higher courts in those other Commonwealth jurisdictions – whether decisions concerned with common law or equitable principles, or with statutory provisions similar to those contained in Singaporean legislation.

This is the background against which directors' duties were first introduced and have been subsequently developed in Singapore. However, developments in corporate governance in Singapore have also become increasingly directed at ensuring Singapore retains its position as a leading global centre for trade and finance.

Common law and fiduciary duties

Directors' duties in Singapore are embedded in common law and equitable principles (referred to hereunder as 'general law') inherited as part of the English common law system. Those principles are recorded in case law and are interpreted and applied by Singaporean courts. In addition, certain duties have been codified in Singapore's Companies Act but are expressed to apply in addition to (and not in place of) duties imposed under general law. As such, there is considerable crossover between relevant principles. Litigants concerned with a director's potential breach of duties often plead alternative causes of action to reflect the position under the Companies Act and at general law.

By way of a brief summary, significant directors' duties imposed at general law in Singapore include the following:

Duty to act in a company's interests

First, directors are under a duty to act in a company's interests. This requires directors to exercise their discretion *bona fide* in such a manner as they consider is in the company's interests. The duty should, in theory, require a court to determine whether, on a subjective basis, a director honestly believed that his or her conduct was in the company's interests. In practice, courts have applied an objective test – namely, whether an intelligent and honest person in the position of the director could in the circumstances have believed that the transaction was for the benefit of the company.

Duty to avoid conflicts of interest

Secondly, as a director occupies a fiduciary office, he or she is under an obligation not to place into conflict, on the one hand, his or her duty of loyalty to the company and, on the other hand, his or her personal interests or the interests of a third party for whom he or she acts.

Case law indicates that where directors act to further their own interests they will not be able to assert that they have exercised their discretion *bona fide* for a company. Accordingly, the duty to avoid conflicts of interest is closely connected to the duty to act in a company's interests.

Nevertheless, in circumstances where they have disclosed their interests to the company and obtained the company's approval, directors may, on behalf of a company, enter into a transaction in which they have personal interests or as a result of which they obtain benefits.

Duty to act for a proper purpose

A third duty is the duty to act for a proper purpose which prevents directors from using their powers for purposes outside the scope of the purposes for which they were conferred, and from misapplying company funds.

In determining whether a director has breached this duty, a court will first seek to define the limits within which a relevant power may be exercised and will then examine the substantial purpose for which the director exercised the power.

A director will be in breach of this duty even in circumstances where he or she has acted in what he or she honestly considered were the company's interests.

Statutory duties

Certain directors' duties have also been included in provisions of the Companies Act. Case law suggests that certain of those provisions (discussed below) indirectly cover matters that are the subject of the general law duties identified above. Other provisions deal with separate matters.

By way of a brief summary, significant relevant provisions in the *Companies Act* include the following:

Section 157 duties

Section 157 is considered by courts and commentators to be a statement of directors' duties in Singapore. The duties imposed by s157 apply in addition to (and not in place of) duties under general law. Furthermore, unlike general law duties, s157 duties cannot be excluded by agreement between a director and a company (for instance, in provisions of the company's articles of association).

Relevantly, s157(1) provides that a director '*shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office*'. This comprises two primary elements: a duty to act honestly, and a duty to use reasonable diligence.

Case law concerned with the 'duty to act honestly' in s157(1) suggests that the duty is the statutory equivalent of the duty to act *bona fides* in a company's interests under general law (discussed above) and that, together, the duties impose a unitary obligation to '*act bona fide in the interests of the company in the performance of the functions attaching to the office of director*': see *Townsing Henry George v Jenton Overseas Investment Pte Ltd* [2007] SGCA 13. Case law and commentary also suggest that the requirement in s157(1) to 'act honestly' covers a multitude of additional obligations imposed under general law, including the duties to avoid conflicts of interest and to act for a proper purpose (discussed above).

As concerns the 'duty to use reasonable diligence' in s157(1), this is essentially a component of a broader duty imposed on directors not to act negligently in the discharge of the powers conferred on them by a company. In this respect, case law indicates that the applicable standard of care and diligence is objective – that is, it is directed at whether a person has exercised the same degree of care and diligence as a reasonable director in his or her position – and that the standard is not fixed but a 'continuum' depending on factors such as the size and type of company and the person's role in the company: see *Lim Weng Kee v PP* [2002] 4 SLR 327.

Finally, s157(2) provides that a director '*shall not make improper use of any information acquired by virtue of his position as [a director of a company] … to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the company*'. This duty also reflects and reinforces the duty to act for the proper purpose imposed at general law.

Section 156 duties

As noted above, a director may avoid breaching the duty to avoid conflicts of interest at general law by making disclosure to the company of his or her personal interests in a transaction and obtaining the company's approval. Section 156 of the Companies Act reinforces this duty.

In particular, ss156(1) and (5) provide that a director who is interested in a transaction or proposed transaction with the company, or holds an office or possesses any property whereby duties or interests might be created in conflict with his or her duties or interests as a director of the company, must make appropriate declarations at a meeting of the company's directors.

Other subsections in s156 provide details of how and when declarations must be made and related matters, and confirm that duties imposed under s156 are in addition to (and not in place of) duties imposed at general law.

Other duties

In addition to the duties referred to above, the Companies Act imposes on directors various additional obligations primarily concerned with disclosure, accounting, reporting and general management of a company.

For example, pursuant to the Companies Act, directors must:

- ensure that their company keeps accounting and other records necessary to explain transactions engaged in by, and the financial position of, the company (s199)
- ensure that dividends are paid only out of the company's profits (s403)
- ensure that information about their share holdings are kept on a register maintained by the company (s164); and
- produce to shareholders each year a profit and loss statement which is compliant with accounting requirements, provides a true and fair view of the company's position and attaches a report of the directors (s201).

Enforcement – who can sue?

The Companies Act provides both criminal and civil liability for breaches of directors' statutory duties. Criminal prosecutions are initiated and conducted by the Monetary Authority of Singapore (the ***MAS***), and sanctions include fines and prison terms (generally up to 12 months).

Companies may also bring civil suits against their directors or former directors for breaches of the various statutory and general law duties referred to in this chapter. Typically, such actions are brought in the name of the company by a liquidator appointed following the company's collapse. Shareholders may also initiate such civil actions – however, this is relatively uncommon because of the relatively high costs of bringing proceedings in Singapore and restrictions imposed on third parties under Singapore's champerty and maintenance laws (see, in respect of champerty laws, *Otech Pakistan Pvt Ltd v Clough Engineering Ltd* [2006] SGCA 46).

In civil actions, various remedies are available in respect of a director's breach of his or her duties. A plaintiff may sue for damages suffered as a result of a director's conduct or, where property has been misappropriated or misapplied, may obtain orders for return of the property. Furthermore, where a director has breached a fiduciary duty, a plaintiff may seek payment by the director of any related profits made by him or her. A plaintiff may also seek a declaration from the court that the director's exercise of his or her discretion was invalid on the basis of a breach of a director's duty.

In addition, s157(3) of the Companies Act specifically provides that, where a director has breached s157, he or she will be liable to the company for any profit made by the director or any damages suffered by the company – at the discretion of the company.

By way of defence, a director may seek to take issue with all or certain of the allegations made against him or her. Furthermore, pursuant to s391, a director may apply to the court for relief against a civil claim for breach of directors' duties on the basis that he or she acted honestly and reasonably and that, having regard to the circumstances of the case, it would be fair to excuse his or her breach. Such relief is not available in respect of criminal claims under the *Companies Act*.

In addition to employing s391 as a defence to an actual claim, directors may also apply to the court to obtain protection under that provision in anticipation of a claim that might be brought against them in future.

Case law indicates that where directors act to further their own interests, they will not be able to assert that they have exercised their discretion *bona fide* for a company.

Indemnification and insurance

Restrictions imposed by s172

Section 172 of the Companies Act restricts the circumstances in which a Singaporean company may release or indemnify a director, officer or auditor in respect of certain liabilities. In particular, s172(1) provides that any provision (in a contract, a company's articles of association or otherwise) which purports to release a director, officer or auditor from, or indemnify them against, any liability to the company based on '*negligence, default, breach of duty or breach of trust*' shall be void.

Section s172(2) clarifies that s172(1) does not prevent a company from purchasing and maintaining insurance for a director or officer in respect of any such liabilities, or from indemnifying a director or officer against any liability incurred in defending any proceedings in which judgment is given in his or her favour. Section 172(2) also indicates that the company may purchase and maintain such insurance for liabilities incurred by directors or officers in connection with an application under s391 (discussed above) or any other provision in the Companies Act pursuant to which relief is ultimately granted by the court.

Accordingly, where a potential liability to a company arises against a director or officer as a result of '*negligence, default, breach of duty or breach of trust*', a company may only lawfully indemnify the director or officer where a court has exonerated him or her or has granted relief pursuant to s391.

What directors' and officers' insurance cover is available?

The market for directors' and officers' insurance in Singapore is developing and a broader range of cover is becoming available for purchase directly in the Singaporean market. Until recently, most Singaporean companies' D&O cover requirements had to be met in London or other well-developed markets. More recently, however, Lloyd's has set up an operation in Singapore and a significant number of syndicates and managing agents are now operating directly out of offices there. In addition, the large company insurers who extend cover in the D&O market have set up or expanded their operations in Singapore.

Singapore has essentially become a hub for the insurance industry in Asia and its importance as an insurance centre is growing.

For the full range of insurance cover that is available for directors and officers in Singapore, and in order to assess the level and nature of any cover that should be purchased, we suggest that you contact your insurance broker.

Reform

Although ranked first in corporate governance standards in Asia by the World Economic Forum's *Global Competitiveness Report* in 2009, Singapore's government and regulators are currently in the process of reviewing the country's corporate governance regime with a view to implementing reforms in 2010. This is motivated in part by the experience of Singapore and other countries during the recent international financial crisis, but also reflects Singapore's desire to remain a flexible, transparent and competitive centre for finance and trade.

One significant reform being considered is the codification of directors' duties now embedded in the general law. To this end, Singapore's Ministry of Finance has set up a steering committee, chaired by Attorney General Professor Walter Woon, to consider, among other things, the merits of extensively codifying directors' duties in Singapore. It will also consider corporate governance practice directions and guidance notes.

Such codification, if recommended and implemented, is likely to cover directors' duties now embedded in general law and may also include the restatement of duties contained in the Companies Act. Based on experiences in the United Kingdom, Australia and other jurisdictions, after any such codification of directors' duties, there will likely follow a period of uncertainty during which the scope and meaning of new statutory provisions are tested before the courts.

In addition, Mr Heng Swee Keat, managing director of the MAS, announced in November 2009 that the MAS will shortly establish a Corporate Governance Council comprising members from industry and government with the objective of promoting a higher standard of corporate governance in listed companies in Singapore. The MAS has indicated that it will announce members of the council in early 2010.

An immediate task for the council will be the review of Singapore's 'Code of Corporate Governance', a code issued by Singapore's Council on Corporate Disclosure and Governance in 2001, setting out principles and guidelines for the operation, composition, conduct and performance of boards of listed companies in Singapore. Following an initial review process, the code was reissued with amendments in 2005. Pursuant to the code, listed companies are required to disclose their corporate governance practices and explain deviations from the code in their annual reports. Since late 2007, the code has been administered by the MAS and the Singapore Exchange. ■

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CLEAR THINKING

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN SOUTH AFRICA

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Introduction

The recent global financial crisis, which many attribute to a failure of corporate governance and oversight of directors, has placed the spotlight on directors. Directors are under intense public and political scrutiny of their basic role and functions at the helm of companies, especially public companies.

In addition, the South African regulatory environment has seen a number of changes during recent times with the introduction of significant legislation and codes of good practice, namely, the new Companies Act, the Competition Amendment Act, amendments to the Mine Health and Safety Act (MHSA) and the third edition of the King Code. These new standards are expected to have a significant impact on the composition and conduct of boards of directors.

This chapter summarises these significant legislative developments and certain relevant recent cases.

The Companies Act

Introduction

The most significant recent development for directors and officers has, undoubtedly, been the promulgation in 2008 of the new Companies Act. The new Companies Act will come into operation on a date yet to be fixed by the President by proclamation in the *Government Gazette*, which is expected to be in July 2010.

The new Companies Act completely rewrites South African company law legislation, and contains the first statutory codification of South Africa's directors' duties, which have historically only been embodied in the common law. The new Companies Act also regulates the liability of directors and provides much-needed clarity in respect of the ability of companies to indemnify their directors and purchase D&O insurance.

Prescribed officers

A significant feature of the new Companies Act is the extension of the application of 'directors' duties' to persons other than directors. This is achieved through the introduction of the concept of a 'prescribed officer'. The definition of 'director' is defined to include prescribed officers so that prescribed officers are subject to the same duties and liabilities as directors. In the draft regulations which were published on 22 December 2009, it is provided that persons who are not directors but who have general executive authority over various aspects of the company's business (eg finance, operations), regardless of whatever title such office is designated, are to be regarded as prescribed officers.

Standards of directors' conduct

The new Companies Act sets out certain standards of directors' conduct, which contain elements of the traditional common law fiduciary duties and the duty to act with care and skill.

A director of a company must (a) not use the position of director, or any information obtained while acting in the capacity of a director (i) to gain an advantage for the director, or for another person other than the company or a wholly-owned subsidiary of the company; or (ii) to knowingly cause harm to the company or a subsidiary of the company; and (b) communicate to the board at the earliest practicable opportunity any information that comes to the director's attention, unless the director (i) reasonably believes that the information is (aa) immaterial to the company; or (bb) generally available to the public, or known to the other directors; or (ii) is bound not to disclose that information by a legal or ethical obligation of confidentiality.

In addition, a director must exercise the powers and perform the functions of director:

- in good faith and for a proper purpose
- in the best interests of the company; and
- with the degree of care, skill and diligence that may reasonably be expected of a person (i) carrying out the same functions in relation to the company as those carried out by that director; and (ii) having the general knowledge, skill and experience of that director.

These duties are not materially different from the common law duties.

The new Companies Act provides some comfort to directors through the introduction of a presumption of compliance if certain factors are met. This provision is akin to the business judgment rule that has been adopted in the United States. The provision provides that a director will have satisfied the obligations regarding acting in the best interests of the company and with the necessary degree of care, skill and experience if:

- the director has taken reasonably diligent steps to become informed about the matter
- either (i) the director had no material personal financial interest in the subject matter of the decision, and had no reasonable basis to know that any related person had a personal financial interest in the matter; or (ii) the director complied with the requirements regarding the disclosure of such interests; and

- the director made a decision, or supported the decision of a committee or the board, with regard to that matter, and the director had a rational basis for believing, and did believe, that the decision was in the best interests of the company.

As a further comfort to directors, the new Companies Act specifically provides that the directors are, in certain circumstances, entitled to rely on the advice of employees, professional advisors and other committees of the board.

Enhanced rights of shareholders

In addition to changes to the duties and liabilities of directors, the new Companies Act increases the burden on the office of director by enhancing the rights of shareholders and other stakeholders, with perhaps the single most significant enhancement being the introduction of appraisal rights for dissenting shareholders. The appraisal rights will be available wherever the company proposes to enter into certain fundamental transactions or to alter its memorandum of incorporation in a manner adverse to the rights of any class of shares. Shareholders who unsuccessfully oppose such actions in the prescribed manner will thereafter be able to compel the company to repurchase all of their shares for their fair value, unless a court orders otherwise. However, apart from a situation in which the company would be plunged into illiquidity as a result of that repurchase, the grounds on which the court may order otherwise are not clear.

Liability of directors

The new Companies Act sets out in detail the bases upon which a director may be held liable for his conduct. These are:

- liability in accordance with the principles of the common law relating to breach of a fiduciary duty for any loss, damages or costs sustained by the company as a consequence of any breach by the director of a duty relating to (i) disclosure of a director's financial interests; (ii) the duty not to use information of the company to gain an advantage; and (iii) the duty to act in good faith and for a proper purpose and in the best interests of the company; and

- in accordance with the principles of the common law relating to delict (ie tort) for any loss, damages or costs sustained by the company as a consequence of any breach by the director of (ii) the duty to act with care, skill and diligence; (ii) any other provision of the new Companies Act; and (iii) any provisions of the company's memorandum of incorporation.

The new Companies Act also sets out certain specific acts that will give rise to director liability, such as (i) acting in the name of the company despite knowing that the director lacked the authority to do so; and (ii) signing, consenting or authorising the publication of any financial statements that were false or misleading in any material respect. Importantly, the test for knowledge is both subjective and objective, and includes, in addition to actual knowledge, knowledge which the director ought to have had.

If directors are liable, their liability is joint and several. Proceedings to recover any loss may not be commenced more than three years after the act or omission that gave rise to that liability.

Criminal penalties

One of the stated objectives of the new Companies Act was to decriminalise company law. The current Companies Act has numerous provisions providing for criminal liability. The new Companies Act provides for far fewer offences and the main offences provided in the new Companies Act are the following:

- falsification of accounting records

- fraudulently providing false or misleading information; and

- knowingly (which, as noted above, is defined as wider than actual knowledge) being a party to reckless trading or trading in insolvent circumstances.

Civil actions

There are two potentially far-reaching provisions in the new Companies Act which may give rise to civil claims against directors. Section 20(6) of the new Companies Act provides that each shareholder has a claim for damages against any person (not only a director) who fraudulently, or due to gross negligence, causes the company to do anything inconsistent with the new Companies Act or the memorandum of incorporation of the company. Moreover, section 218(2) provides that any person (not only a director) who contravenes any provision of the new Companies Act is liable to any other person for any loss or damage suffered by that person as a result of that contravention.

Indemnification of directors

The new Companies Act introduces certain significant changes to the law regarding indemnification of directors. The new Companies Act provides that any provision in a company's memorandum of incorporation is void to the extent that it directly or indirectly purports to

- relieve a director from a duty set out in new Companies Act or of liability provided for in the new Companies Act; or

- negate, limit or restrict any legal consequences arising from an act or omission that constitutes wilful misconduct or wilful breach of trust on the part of the director.

A company may, however, indemnify a director against any liability other than:

- liability arising (i) out of the director (a) acting in the name of the company knowing that the director lacked authority; (b) acquiescing in the carrying on of the company's business despite knowing that it was being conducted recklessly; and (c) being party to an act or omission despite knowing that the act was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose; and (ii) wilful misconduct or wilful breach of trust; and

- a fine imposed on the director who has been convicted of an offence.

A company may advance expenses to a director to defend litigation in any proceedings arising out of the director's service to the company (or directly or indirectly indemnify a director for such expenses), if the proceedings (a) are abandoned or exculpate the director; or (b) arise in respect of any liability for which the company may indemnify the director.

Moreover, a company may, unless its memorandum of incorporation provides otherwise, (i) purchase insurance to protect (a) a director against any liability or expenses for which the director is permitted to indemnify the directors, and (b) the company against expenses and/or liability which it is permitted to advance to a director or for which it is permitted to indemnify a director. This provision clears up the uncertainty in the current Companies Act regarding the ability of a company to purchase insurance to protect its directors.

Remedies

The new Companies Act introduces a number of new remedies that could increase claims against directors. The first is a new statutory derivative action, which explicitly substitutes the common law rights in this regard. The new provision provides that certain categories of persons may serve a demand upon the company to commence or continue legal proceedings to protect the legal interests of the company, which would include a claim against the directors. In addition to shareholders and directors, the categories of persons who are entitled to serve such notice include (i) trades unions and (ii) any other person, provided that such person must be granted leave of the court, which may be granted only if the court is satisfied that it is necessary or expedient to do so to protect a legal right of that person.

A company which receives such a demand must either apply to a court to set aside the demand on the basis that it is frivolous, vexatious or without merit or must take steps to investigate the demand, and, thereafter, within 60 days, initiate legal proceedings or serve a notice on the individual making the demand, refusing to comply with it. If the company does so refuse, the person making the demand may apply to a court for leave to bring proceedings in the name and on behalf of the company. The court will, however, only grant such leave if certain criteria are met, including that it must be in the best interests of the company that the applicant be granted leave to commence the proposed proceedings. A rebuttable presumption is created that it is not in the best interests of the company to initiate proceedings against a third party if it established that all of the directors participating in the decision not to initiate proceedings, acting in good faith, without personal financial interest, after having informed themselves as to the matter, reasonably believed that the decision was in the best interests of the company.

The Competition Amendment Act

The Competition Amendment Act, was assented to by the President on 26 August 2009. This is despite persistent calls for the President to refer it to the Constitutional Court. The Amendment Act brings with it the most far-reaching amendments to South African competition law since the Competition Act became effective ten years ago. The amendments will introduce the following noteworthy provisions:

- criminal liability for a director or a person having 'management authority' where he/she either caused a firm to engage in a prohibited practice in terms of section 4(1)(b) of the Competition Act or knowingly acquiesced in the firm engaging in such conduct. A sentence of up to ten years' imprisonment or a fine not exceeding R500,000 can be imposed against each person convicted

- the creation of a prohibited practice of 'complex monopoly' conduct by two or more sizeable firms in a concentrated market which conduct their affairs in a conscious parallel or co-ordinated manner without agreement between or among themselves; and

- the ability of the Competition Commission to conduct a formal enquiry into the general state of competition within particular markets. The Commission will have the power to summon any person believed to be able to furnish any information in respect of the enquiry to appear before the Commission for interrogation or to deliver any documents.

The exact date on which the Amendment Act will come into operation is not, as at the date of writing, known; it is still to be fixed by proclamation by the president. The date will be an important one for directors and managers because from that date

they become vulnerable to criminal prosecution if their companies are found to be involved in price fixing, market division or bid rigging.

King Code on Corporate Governance

The third King Code and Report on Corporate Governance was released on 1 September 2009 ('King III'). The review of the second King Code was prompted by a number of developments that had occurred in South Africa since the release of the second King Code in 2001 ('King II'), including the new Companies Act and changes in international governance trends. The Code sets out a number of governance principles that should be read together with the Report, which contains best practice recommendations on each principle. The Institute of Directors has also issued a number of practice notes to assist companies in implementing the Code.

King III addresses many of the same areas as those addressed in King II. In addition there is an increased focus on sustainability, risk management, information technology, internal audit, alternative dispute resolution, business rescue and fundamental and affected transactions. King III introduces new requirements regarding the independence and remuneration of directors.

In a change of approach, King III moves from a 'comply or explain' approach to an 'apply or explain' approach. This allows directors to conclude that if following a recommended practice in King III is not necessarily in the best interests of the company, they may apply a different practice as long as it is explained together with the reasons for doing so. Significantly, King III will apply to all legal entities irrespective of their manner or form of incorporation or establishment and whether or not they are listed. All entities are encouraged to apply King III's principles to the extent that best suits their size and complexity. The drafters intend that entities will aspire to apply King III on the basis that if its principles are adhered to, then the entity will have practised good governance. It is expected that the listings requirements of the Johannesburg Stock Exchange ('JSE') will mandate compliance with certain provisions of King III as was the case with King II. King III came into effect on 1 March 2010.

King III is not law and failure to comply therewith will not result in direct liability for directors, save to the extent that compliance is made mandatory by the JSE. That being said, it is likely that the principles set out in King III will constitute a base for determining whether directors have performed their duties with reasonable care, skill and diligence as required by the new Companies Act.

Mine Health and Safety Act

In 2008, Parliament passed an amendment to the Mine Health and Safety Act ('MHSA'), which introduces a provision providing that an employer, chief executive officer, manager, agent or employee commits an offence if he or she contravenes or fails to comply with the provisions of the MHSA thereby causing (a) a person's death; or (b) serious injury or illness to a person. The provision specifically provides that issuing instructions is not in itself sufficient proof that all reasonable steps were taken and that the defence of ignorance or mistake cannot be admitted. The exact date on which the provision will come into operation is, as at the date of writing, still to be fixed by proclamation by the president.

Recent case law – cases involving s424 of the Companies Act

In the 2007 case of *Strut Ahead Natal (Pty) Ltd v Burns*, the court concluded that the defendant's conduct revealed a disregard for the success of the company, an attitude which ultimately prejudiced the creditors of the company. Accordingly, the defendant, who, while not a director, was effectively responsible for running the business of the company, was declared personally liable in terms of section 424(1) for knowingly carrying on the business of the company recklessly.

In another 2007 case, *Heneways Freight Services (Pty) Ltd v Grogor*, the court held that even if the respondent's conduct of furnishing creditors with cheques when he knew or reasonably should have foreseen the possibility that there may not be funds in the company's bank account to meet the cheques was negligent, it was not of such an order as to constitute recklessness within the meaning of section 424(1).

In a recent 2009 case, *Saincic and Others v Industro-Clean (Pty) Ltd*, the court held that, while it was not necessary to prove a causal link between the reckless conduct and the debts or liabilities for which the creditor sought a declaration of personal liability in terms of s424, the absence of such a proven link was a factor to be taken into consideration by the court in the exercise of its discretion and in order to decide whether such a declaration was, in all the circumstances, just and equitable.

Conclusion/risk exposure

There is no doubt that the new legislation in South Africa poses certain new risks for directors, although steps have been taken to protect non-conflicted directors who act in good faith. It remains to be seen whether shareholders will use this new legislation to apply a higher level of scrutiny to the conduct of directors. Regardless, it is clear that the introduction of this new legislation and the increased focus on executive behaviour means that there should be an increased emphasis by directors on the proper role and functioning of boards. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN SPAIN

Ignacio Figuerol, Partner
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In the current economic climate, directors' and officers' liability continues to be a hot issue, with increased numbers of claims being brought, particularly in the context of the insolvency of companies in the construction and related sectors, key areas of the Spanish economy. The construction and real estate sectors have been clearly affected by the credit crunch, with most companies unable to continue borrowing money and raising capital. According to information provided by the National Statistics Institute, the number of companies that ran into financial difficulties and ended up in insolvency proceedings during 2009 was 4,984 (72.2% more than in 2008), 75% of which were in the construction, real estate, industry and trade sectors. These were, to a great extent, small and medium-sized companies, although some large companies, including listed ones, have also been affected.

The Insolvency Act 2003 provides a specific directors' liability to indemnify the financial deficit of the company. However, the Act does not set out guidelines for determining what percentage of the financial deficit should be paid by the directors in question, and now the commercial courts have come to an understanding in this respect.

In terms of legislation, the last major reform of the Companies Act took place in 2003. The most recent corporate governance report, the 'Conthe Report' (the 'Report', 19 May 2006), urged the government to tighten up and toughen the civil liability regime for breach of trust by directors. The measures suggested in the Report are as follows:

(a) A better description of the duties of loyalty and the procedures to follow in the event of conflicts of interest

(b) The extension of duties of loyalty, and the associated liability, to controlling shareholders

(c) Granting a direct course of action to shareholders to file a derivative suit for breach of trust

(d) Establishment of a leave-to-proceed filter so that a judge can reject any cases constituting abuse of process

(e) Imposing heavier penalties, to include at least the repayment of the sums corresponding to unfair enrichment.

The Report emphasises that these recommendations refer solely to breach of trust, and not to actions taken for negligence or breach of care. As the Spanish Government has amended the Companies Act in the past to accommodate corporate governance recommendations, we expect further reform as per the Report's recommendations.

Other legislation, such as the new Competition Act 2007 and the Environmental Act 2007, have established further specific liabilities of directors. This confirms the trend to enhance the scope of liability of those who run companies in Spain.

The Companies Act: overview

Under the Companies Act 1989, directors (including *de facto* directors) shall be jointly and severally liable to the company, the shareholders and the company's creditors for any damage they may cause, for any action or omission that is contrary to the law or the articles of association, or for those actions carried out in breach of their duties.

The Companies Act does not make any distinction between executive and non-executive directors for liability purposes. They are thus liable on an equal footing.

Directors can only avoid liability if they prove that they did not participate in the adoption or implementation of the relevant resolution and had no knowledge of it or, being aware of the resolution, they took such steps as were practicable to avoid the damage being suffered, or, at least, they expressly opposed the relevant resolution. The Companies Act expressly provides that the fact that an agreement is subsequently ratified in a general shareholders' meeting does not release directors from liability.

The following actions against directors may be brought under the Companies Act:

- **Corporate liability action**
  Section 134 of the Companies Act provides that where damage is allegedly caused to the company, the company can bring an action against its directors. In order to bring the action, a resolution to this effect by the majority of shareholders at a general shareholders' meeting is required. In limited circumstances, minority shareholders holding more than 5% of the capital will be entitled to bring such an action. Additionally, the company's creditors can also bring a corporate liability action, but only if the shareholders or the company have failed to bring a corporate liability action and the assets of the company are insufficient to meet its liabilities.

- **Individual liability action**
  Under Section 135 of the Companies Act, any shareholder is entitled to bring an action against the directors who caused direct damage to him. For this type of action to succeed, it is essential that the claimant is able to provide evidence that the alleged damage directly resulted from a specific wrongful act by the defendant directors.

- **Company's debts action**
  The Companies Act also establishes an action against directors for the company's debts where any of the following causes of dissolution take place:

  (i) it is manifestly impossible to carry out the company's corporate purpose

(ii) losses reduce its net equity to less than half of its stock capital, unless the stock capital is then increased or reduced in a sufficient manner and it is not appropriate to request a declaration of insolvency proceedings

(iii) the corporate capital is reduced below the legal minimum

(iv) any dissolution cause established in the articles of association takes place.

In respect of paragraph (ii) above, it should be noted that by means of Legislative Royal Decree 10/2008 (12 December 2008), financial losses suffered as a consequence of the reduction in value of properties and other fixed assets will not be taken into consideration for a period of two years. This is an exceptional measure adopted in order to minimise the consequences of the current economic crisis.

If any of the above dissolution causes do occur, the dissolution of the company will require a resolution of the general shareholders' meeting. To this end, and within two months, the directors must call the general shareholders' meeting for the adoption of a resolution to dissolve the company or take steps in order to remove or negate the dissolution cause. Alternatively, if the company is in an insolvency situation, the directors may apply for a declaration of insolvency. Where the resolution is against dissolution or where no resolution is adopted, the directors are required to apply within two months for the judicial dissolution of the company.

The directors shall become jointly and severally liable for the company's debts which are subsequent to the dissolution cause if they fail to comply with the requirement (i) to call the general shareholders meeting within two months, (ii) to pass a resolution to dissolve the company, or (iii) if they either do not apply for the judicial dissolution of the company or, if appropriate, for the commencement of insolvency proceedings, within two months of the date set for a meeting that was not held or from the date of the meeting that passed a resolution against dissolution. The Act provides that debts are presumed to be subsequent to the dissolution cause unless the directors provide evidence that they precede the dissolution cause.

The Insolvency Act: new guidelines of the commercial courts to allocate liability

Under the Insolvency Act 2003, directors may only be found liable if the insolvency is classified as 'guilty' as opposed to 'innocent'. In this respect, an insolvency is classified as 'guilty' where there has been bad faith or gross negligence on the part of the directors of the company in generating or aggravating the insolvency.

Pursuant to Section 164 of the Act, an insolvency will be considered 'guilty' in any of the following situations:

- Where the company is legally obliged to keep accounts but substantially fails to fulfil this obligation, keeps double accounts or commits an irregularity relevant to the understanding of the financial situation for which it is supposed to keep account
- Where the company commits a serious inaccuracy in any of the documents accompanying the documentation for the declaration of insolvency or presented during the proceedings, or where it submits or presents false documents
- Where the liquidation commences as a consequence of the breach of the arrangement with the creditors for a reason attributable to the company
- Where the company absconds with the whole or part of its assets, causing harm to its creditors, or commits an act which delays, causes difficulty to, or impedes the effectiveness of a seizure of property in any class of execution initiated or in potential causes of action
- Where, during the two years prior to the date of the declaration of insolvency, rights or assets from the company are fraudulently transferred elsewhere
- Where, before the date of the declaration of insolvency, the company realises any legal act directed to feign a financially fictitious situation.

Pursuant to Section 165 of the Act, it is presumed, unless the contrary is proven, that the directors of the company acted in bad faith or were guilty of gross negligence where they:

- Failed to apply for a declaration of insolvency within the required time frame (two months)
- Failed to comply with the duty to cooperate with the judge dealing with the insolvency proceedings or with the administrators; where they did not make available the information necessary or convenient in investigating the insolvency; or where they did not attend a meeting of creditors, either personally or through an agent
- Did not produce the annual accounts or subject them to auditing or did not deposit them in Companies House in any of the last three financial years before the declaration of insolvency, when legally obliged to.

Where the insolvency is classified as 'guilty', the judge may order any directors who held this position within the two years prior to the date of the declaration of insolvency, to pay, in whole or in part, the financial deficit of the company, ie the

shortfall between the amount of their credit and the sum they receive in the liquidation of the rights and assets, and also may order the same to indemnify any specific damage caused.

The Insolvency Act does not provide any guidelines for determining what part of the shortfall should be indemnified by those directors. The commercial courts' judgments tend now to follow the following criteria:

- in cases of very serious conduct (double accounting, fraudulent transfer of assets, etc), between 75% and 100% of the financial deficit of the company
- in cases of serious conduct (substantial failure to keep accounts, failure to audit accounts, etc), between 30% and 75% of the financial deficit of the company
- in cases of minor conduct (failure to apply for insolvency proceedings within the required timeframe), not exceeding 30% of the financial deficit.

The judge may order the seizure of the assets and rights of the directors if there are indications that the insolvency could be classified as negligent and that the assets of the company would not be sufficient to cover all of the debts. Such a seizure order may be substituted by a guarantee of a credit institution.

The Competition Act 2007

In 2007, a new Competition Act (Act 15/2007 of 3 July) came into force. The Act provides for disciplinary proceedings in cases of infringement of antitrust rules and incorporates a new list of infringements according to their seriousness. Fines for infringement of the rules may range from 1% to 10% of the previous business year's turnover of the infringing company. The specific amount of the fine will depend on the seriousness of the infringement; please note that the Competition Act establishes that the conduct of the company is considered to extend to that of the natural persons and legal entities controlling the company.

In addition, fines for individuals (directors of the company having participated in the infringement), ranging from €30,000 to €60,000, may be imposed. Finally, higher periodic penalties (up to €12,000 per day) are provided by the Competition Act for failure to comply with the Competition Regulator's decisions on mergers, restrictive practices or interim measures. The Competition Act does not refer to criminal sanctions in cases of infringement of antitrust rules. In Section 40.2.a, the Act provides that the staff of the Competition Regulator, when conducting an investigation, shall have access to the private dwellings of the directors of the company being investigated.

Environmental Liability Act 2007

New environmental liability legislation came into force in 2007 (Act 26/2007 of 23 October). The Act (which implemented the Environmental Directive 2004/35/CE) aims to establish a framework to prevent and remedy environmental damage, where polluting companies are required to pay for the consequences of environmental damage and also to take action to prevent it from taking place again. Whenever environmental damage occurs, the company is bound to adopt all necessary measures as required by the circumstances to immediately repair, restore or replace the natural resources (and the services attached to natural resources) affected by the damage. When the damage entails loss of natural resources, the company shall compensate for the damage by way of investments to improve the flora, fauna, habitat and water resources of the damaged site.

Generally, the Act provides strict liability criteria based on the 'polluter pays' principle, by means of which, and despite the possibility of seeking a later recovery from third parties and/or the public administration, the polluting company is primarily called to pay the remedial costs for the environmental damage caused.

The Act establishes a vicarious liability of the directors of the company in respect of the company's environmental liability under the Act.

Class actions: no win no fee agreements now valid

The current Civil Procedures Act allows for class actions (collective actions) to facilitate the provision of compensation for damage suffered by consumers and end-users of products and services. Under these provisions, groups of victims, consumers and end-user associations, and bodies which are legally incorporated for the protection of consumers and end-users, are entitled to bring these types of actions.

No win no fee agreements were not previously permitted under the relevant Law Society provisions. However, the Supreme Court, by means of a judgment of 4 November 2008, declared that 'no win no fee' agreements are valid. This may well be an incentive for further class actions being brought in Spain.

Criminal Code reform

The Criminal Code 1995 lists the so-called 'corporate crimes'. It is primarily aimed at protecting the interests of the marketplace and of minority shareholders, through the following measures:

- Under Section 290, directors (including *de facto* directors) who falsify the annual accounts or any of the documents that should present the legal or economic situation of the company are convicted

- Under Section 291, those who, taking advantage of a majority in the shareholders meeting or on the board, impose abusive agreements with the purpose of obtaining a benefit and thereby prejudicing other shareholders are convicted
- Under Section 292, those who, in prejudice of the company or its shareholders and for their own benefit or for the benefit of a third party, impose or take advantage of any harmful agreement adopted on the basis of a fictitious majority are convicted
- Under Section 293, directors (including *de facto* directors) who, without legal justification, prevent any shareholder from exercising his/her rights, or deny shareholders information to which they are entitled, are convicted
- Under Section 294, directors (including *de facto* directors) of any company doing business in any regulated market who fail to cooperate with the competent regulatory authorities are convicted
- Section 295 punishes directors (including *de facto* directors) who, for their own benefit or for the benefit of a third party fraudulently dispose of assets of the company.

The Spanish Criminal Code has just been reformed by means of Act No 5/2010, dated 22 June 2010. The reform includes the establishment of a criminal liability for legal entities for acts carried out in the interests of the company by its directors and officers; and/or 'for not having exercised proper control' of the employees of the company; and for acts carried out in the interests of the company by the company's employees 'for not having exercised proper control of them'. The proposed reforms also contemplate mitigating factors (confession to the authorities, co-operation with the investigation, restitution of losses, setting up effective prevention measures) and a range of penalties that could be imposed on companies which are declared criminally liable, including:

- Monetary fines
- Liquidation of the company
- Disqualification from conducting business for a period of up to five years
- Closure of premises for a period of up to five years
- Disqualification from carrying out specific activities
- Disqualification from obtaining public subsidies, government contracts or tax or social security benefits for a period of up to 15 years.
- Intervention by the courts to safeguard the rights of employees and workers or creditors for a period of up to five years.

Indemnification

The Spanish Companies Act does not regulate the indemnification of directors. In the absence of specific regulation, the Companies Act provides that a company's articles of association may include any agreement which is neither contrary to the Act nor to the legal principles which shape limited companies.

On this general basis, some experts are of the opinion that indemnification agreements are not legal since they would amount to an exemption of liability for directors beyond that permitted in the Companies Act; they would render the regulation of liability of directors void; or they would be detrimental to companies, being for the exclusive benefit of directors. Other experts, however, conclude that indemnification agreements are legal. Such proponents rely on an analogical application of certain Civil Code provisions which establish the obligation to indemnify the manager the necessary and useful expenses incurred and the prejudicial consequences resulting from the performance of the task.

On these grounds, it is argued that provided the claimant is not the company itself, indemnities and defence costs could or even should be indemnified by companies where the defendant directors have not acted in bad faith nor breached any of their duties.

D&O insurance in Spain: peculiar covers

The policies available in the Spanish market are similar to those available in any jurisdiction. Having said this, due to the peculiarities of the Spanish procedural and legal system, some specific covers have been developed, including: cost of, or provision of, civil bonds and bail bonds in criminal proceedings; cost of bank guarantees to replace freezing orders in insolvency proceedings; disciplinary fines; vicarious tax liability; subsidy in case of disqualification under the Insolvency Act 2003; and defence costs for so-called 'related persons'. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN SWITZERLAND

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In Switzerland, the basis upon which the personal liability of members (the 'directors') of the board of a Swiss joint company (*Aktiengesellschaft*, herein a 'company') could be invoked is rather broad but court cases outside of the bankruptcy of a company are rather rare. However, directors' liability has become an increasingly sensitive topic. Although no legal changes have as yet been introduced, the global focus on corporate governance has resulted in a more rigorous standard for directors (through rules enacted by the SIX Swiss Exchange and by soft law, such as the Swiss Code of Best Practice for Corporate Governance, 'SCBP'), which increases the risk of claims against them.

This chapter offers a brief description of the company's organisation before dealing with the main duties of directors. The principles governing civil liability and indemnification of directors will then be outlined as will the criminal liability of directors.

Organisation and competence of the board

The board consists of one or more directors who need no longer be shareholders. Earlier rules on nationality and residency of directors have also been abolished but at least **one board member or one member of management** who is entitled to represent the company **must be resident in Switzerland**.

In principle, Swiss corporate law provides for a **one-tier board structure**. However, the board has considerable organisational discretion. It may delegate some or most of its powers (save for the non-transferable duties set out below) to one director, to a board committee, or to non-members of the board, such as a CEO or to an executive management team (in banks and insurance companies, directors have to delegate most of their duties to management). Such a delegation requires an authorisation by the shareholders in the articles of association and must be specified by the board in organisational regulations. Thus, it is possible to create a two-tier structure, which is what listed companies typically do and which the SCBP recommends by asking for a majority of non-executive directors.

The board is authorised to **decide on all matters that are not reserved to the shareholders' meeting or to the auditors** by Swiss law or the articles of association. Meetings of the board should **take place as often as business so requires**. As a rule of thumb, at least four meetings should be held each year. If fewer meetings are held, there is a risk of a Swiss court assuming that the board has not complied with its duties.

Main duties of the board

Non-transferable duties of a board

Swiss corporate law stipulates certain **non-transferable duties of a board**:

- **Strategy**: The directors must develop a business strategy and determine the appropriate means to pursue it (eg establishment of a long-term and a medium-term business plan, issuance of appropriate directives and instructions). The aim must be to increase the long-term company value, considering the shareholders' interest.
- **Determination of the organisation**: The board has to decide on the governance structure of the company and of the board itself by enacting organisational regulations. As seen above, the board may delegate management, appoint board committees (eg audit, nomination, compensation and risk committee) and, unless this is reserved to the shareholders' meeting by the articles of association, the board appoints its chairman. If the board chairman and the CEO are identical, the board should, pursuant to the SCBP, provide for adequate control mechanisms (eg by appointing an experienced non-executive director as lead director).
- **Structuring of the accounting system, financial control and planning**: This duty covers not only financial accounting and the preparation of financial statements, where the board retains the ultimate responsibility (eg for determining the accounting standard, the reporting currency and decisions in those areas, where there is discretion) but also the necessity to establish a financial control system, including the monitoring of the liquidity of the company.
- **Appointment and removal of the persons entrusted with management and representation**: Whereas the power to appoint the top executive management must remain with the board, appointments to lower levels may be delegated. Appointments (and succession planning) have to be prepared with all due care and persons who fail to carry out their task properly have ultimately to be dismissed.
- **Supervision**: The board has to supervise management, in particular with respect to compliance with the law, the articles of association, organisational regulations and other internal directives. To fulfil this continuous task, the board has to define clear reporting lines and implement an adequate control system.
- **Preparation of the annual report as well as preparation of the shareholders' meetings and the implementation of the latter's resolutions**: The annual shareholders' meeting has to be held within six months of the end of each business year. The board has to call for the meeting in due time, set the agenda and submit motions for every agenda item.

Special duties **arise in the case of financial difficulties of the company**:

- **Loss of capital**: If the stand-alone statutory balance sheet of the company shows that the net assets no longer fully cover half of the share capital and the legal reserves, the board must call a shareholders' meeting without delay and propose restructuring measures to the shareholders.
- **Over-indebtedness**: If there is concern that the company's net assets are negative, an interim balance sheet must be prepared and submitted to the auditors for examination. If the interim balance sheet shows that the claims of the company's creditors are neither covered by its assets on a going concern nor on a liquidation value basis, the board must file for bankruptcy. The board may only refrain from doing so if it takes immediate steps to reorganise the business (both operationally and financially) and/or improve the balance sheet such that a sustainable recovery of the company is highly probable; often, certain classes of creditors must in this context be convinced to subordinate their claims to cure the over-indebtedness.

Further duties

Besides these core duties, **other duties** can be relevant in connection with personal liability:

- **Duty to carry out a risk assessment and risk management,** eg define the company's risk appetite and tolerance and monitor possible risks
- **Duty to communicate and engage with shareholders while maintaining confidentiality of non-public information** and ensure that the board is aware of any material changes in the share register and, thus, the shareholder base
- **Duties according to SIX Swiss Exchange Regulation for listed companies**: rules on ad hoc publicity, disclosure of management transactions, corporate governance disclosure (eg on tasks and responsibility within the board and for each committee, work methods, compensation)
- **Duties contained in various other legislation** such as the Merger Act, Criminal Code (eg with respect to insider dealing, price manipulation) or the Old Age Insurance Act.

Standard of care

The directors and the management team must carry out their duties with **due care**, ie a judge would ask what kind of behaviour could be expected in the given situation from someone in the same situation who acts properly. Insufficient skills or 'no time' are no excuses. Directors must always act in the interest of the company (**duty of loyalty**) and must not compete with the company (eg lure away customers or grasp corporate opportunities). Furthermore, directors and persons related to them must conduct business with the company on an **arm's length** basis.

With regard to the **area where the board has delegated** its duties to management, the liability of non-executive directors is limited to the proper selection, instruction and supervision of the managers. Supervision requires an adequate reporting system, and directors must read and analyse the information provided, ask for further information if needed, and take the necessary actions.

In addition, the board must ensure that under like circumstances **shareholders are treated equally.** However, the board may also have regard to the interests of a specific shareholder if other shareholders are not disadvantaged and the decision taken is in the interest of the company. For listed companies, the principle of equal treatment is relevant with regard to the registration in the share register, share buy-back programmes and most importantly the information of shareholders.

Civil liability

Qualification as corporate body and breach of duties

In Switzerland, **directors as well as other persons managing a company** (ie everybody involved in the decision-making process including *de facto* directors such as potentially major shareholders or banks) **are personally liable** if (i) a damage is suffered by the company or the claimant, (ii) they have violated a duty set out by law, the articles of association, organisational regulations or other internal directives by (iii) an intentional or negligent act and (iv) this violation of a duty has caused the damage.

Depending on who is damaged, a successful liability claim can lead to payments to **the company, shareholders or creditors** of the company. Whilst the company and the shareholders may bring a claim at any time, creditors can, in general, only do so once the company has become insolvent and is declared bankrupt. In other words, creditors may not bring claims against a solvent company based on directors' liability, unless they have suffered a direct damage, in which case ordinary tort law principles apply.

With regard to the **burden of proof**, it is the practice of Swiss courts that once a violation of duties is established, the defendant must exonerate himself.

If several directors are liable for a damage, any one of them is **jointly and severally liable** with the other directors to the extent the damage is attributable to each one of them based on their own fault and the circumstances. **Claims are barred after five years**, calculated from the day the injured party has knowledge of the damage and the person liable.

Risk of personal directors' liability in practice

In practice, **shareholders' actions against directors are rare** outside bankruptcy but rather frequent if a company becomes insolvent. Recently, directors' liability claims have also been brought in the context of unfriendly takeovers to put pressure on the board.

Measures to mitigate the risk of liability

Boards can mitigate the risk of personal liability by:

- following a **decision-making process** which leads to unbiased and informed business decisions (eg by taking decisions on the basis of appropriate and timely information after due discussion of the pros and cons, by considering alternatives and their respective risks, by consulting experts in areas where the board does not have sufficient expertise) and carefully drafting the **board minutes** so that they reflect the discussions or at least the fact that an in-depth discussion has taken place
- ensuring an **adequate organisation** of the board and the company
- **delegating** all tasks that can be delegated to management and applying due care in the selection, instruction, and supervision of the managers
- ensuring **compliance** with the financial reporting obligations; closely following the financial situation of the company based on internal reporting; and, in the event of financial distress, taking immediate action.

Even though the business judgment rule as applied by US courts has not been formally recognised by the Swiss legislator, it is widely agreed that adhering to the formal criteria provided by this rule significantly reduces liability risk. Consequently, Swiss courts are likely not to review a business decision which is based on (i) proper and meaningful documentation and taken (ii) without any conflict of interest interfering into the decision making process. However, boards must not only focus on formal and procedural requirements but also ensure that they comply with their non-transferable duties in substance.

Insurance and indemnification of directors

Swiss law does not explicitly address the question whether insurance and indemnification of directors is permitted. In a nutshell, the legal situation presents itself as follows:

Advance of legal costs to directors: Such advances by the company are widely accepted. Although successful liability claims against directors are rare, and the legal costs are often shifted to the losing party, directors may encounter a significant expense burden for many years until the proceedings are closed. Several legal authors state as a precondition for such advances, that the company is not the claimant itself and that the claim is not based on a substantial or wilful breach of duties.

Assumption of legal costs by the company: Usually, only part of the costs (ie attorneys' and other advisors' fees) will be covered by the losing claimant in the case of a positive outcome for a director; additionally, most of the law suits end up being settled, in which case no costs are reimbursed. In these cases, the assumption of costs by the company is generally allowed. However, a number of legal authors consider this unlawful if the director is held liable, particularly in cases of wilful or substantial breaches of duties; most authors allow, however, an assumption of cost in case the director has breached his duties only negligently.

Indemnification clauses in articles of association or individual agreements: Such clauses or agreements are in general regarded as unlawful to the extent they also cover wilful or substantial breaches. An indemnification for mere negligence is generally accepted with the argument that forcing directors to be too careful will make them totally risk averse.

Directors' and officers' insurance: There is wide consensus that directors may be held harmless by D&O liability insurance purchased by the company. Normally, intentionally wrongful acts are excluded in such insurance.

Hold harmless clause by the major shareholder (eg the parent company): Such clauses are considered lawful. The parent company then usually also undertakes not to bring any claims against directors in subsidiaries – this of course does not bind shareholders who have not consented to such an agreement nor creditors of the subsidiary. In any case, it is not possible to indemnify directors from criminal liability.

Criminal liability

Directors can become subject to criminal liability if they do not comply with their corporate duties. Apart from fraud, misappropriation, general mismanagement or insider dealing, crimes or offences arising in connection with bankruptcy and debt collection are of particular relevance. In general, as opposed to claims for civil liability, mere negligence will not be sufficient grounds for a criminal liability. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE UNITED ARAB EMIRATES

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Financial institutions operating in the United Arab Emirates (**UAE**) have been consistent buyers of D&O insurance over the years. However, there is less demand from government-owned and private entities. In the case of family owned businesses, this appears to be due to a perception that they do not have any real shareholder-type claims exposure. Government-owned entities, which include many of the larger companies in the UAE, also appear not to believe that they have a large claims exposure. As a consequence, the D&O coverage purchased (to the extent that it is purchased at all) has not been commensurate with the size of the operations. This situation has arisen notwithstanding the fact that premium rates for D&O products are low in comparison to other regions of the world. To some degree, this is a reflection of the fact that, until recently, there has been little or no claims activity in the region.

Whether this position will continue unabated is a question for debate. Experience elsewhere in the world has demonstrated the impact of the economic situation on the growth in demand for D&O products. After spectacular economic growth in recent years, the UAE has experienced significant financial failures for the first time during the recent global economic crisis. The Dubai World saga continues and with other prominent regional conglomerates on the brink of financial failure, estimates of the potential liabilities vary. It seems inevitable that claims will emerge against the directors and senior management of the companies concerned – if only as an attempt to improve recoveries and, potentially, to circumvent or pre-empt any arrangements with creditors.

It is clear that the current financial situation has led to moves to reinforce corporate regulation, increasing enforcement of the existing regulations and corporate governance standards. In addition, the crisis has created an environment where there is greater awareness of the potential liabilities for directors and senior management. The litigation risks for companies are no less real than elsewhere in the world and this chapter seeks to highlight some of the areas where directors and senior officers can fall foul.

Corporate entities

By way of background, it is worth briefly reviewing the forms of corporate organisation in the UAE to give some context to the issues of directors' and officers' duties and liabilities under the law. In this regard, it is important to note that companies may be established 'onshore' or in one of the 30 or so free zones established in the UAE (which are typically subject to the rules and regulations of the free zone). For the purposes of this chapter, we have focused upon onshore companies and companies established in the Dubai International Financial Centre ('**DIFC**').

The main corporate entities used onshore in the UAE are:

i ited liability co pany

A LLC (i) has limited liability, (ii) must have between two and 50 shareholders and (iii) cannot offer its shares to the general public.

At least 51% of a LLC's shares must be held by a UAE national or by a company wholly owned by UAE nationals (although some business activities can only be undertaken by UAE nationals). Nationals of other Gulf Cooperation Council ('**GCC**') states can normally own 100% of a LLC's share capital. However, if any shareholders are from outside the GCC states, the requirement for 51% of the shareholders to be UAE nationals applies.

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These can be either a:

- **Private joint stock company ('PRJSC').** A PRJSC is a company with at least three founder shareholders and whose shares are not offered for public subscription. A PRJSC must have at least AED2m (about US$544,600) in share capital
- **Public joint stock company ('PUJSC').** A PUJSC is a company that offers its shares for public subscription. A PUJSC must have at least AED10m (about US$2.7m) in share capital.

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The Dubai International Financial Centre ('DIFC') is a free zone in the UAE, focusing on financial services. Different types of companies can be incorporated in the DIFC, including companies limited by shares and limited liability companies. This chapter only considers companies limited by shares.

Other legal entities operating in the UAE include: (i) branches of a foreign company; (ii) partnerships; and (iii) civil business companies (incorporated under Civil Code No. 5 of 1985). The management of such entities have their own exposures and liabilities which are beyond the scope of this chapter.

Legal framework

Directors' and officers' liabilities and exposures typically arise out of the following:

onstit tional doc ents

These form a major part of the regulatory framework in accordance with which management is required to operate. LLCs and JSCs are generally incorporated by a memorandum of association (sometimes referred to as an agreement for

incorporation), while Free Zone Companies ('**FZCOs**') and DIFCOs are generally incorporated with a memorandum and articles of association. Some FZCOs (notably, one-shareholder free zone establishments) do not have any constitutional documents and are governed only by the applicable free zone regulations.

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This applies to all companies incorporated within the UAE. However, it does not apply to FZCOs to the extent that a free zone has its own specific rules and regulations. In particular, DIFCOs are entirely exempt from the provisions of the Companies Law. Other than in relation to the public subscription of shares, the provisions in the Companies Law concerning PUJSCs also apply to PRJSCs.

Code of Commercial Practice (Federal Law No. 18 of 1993) ('Commercial Code')

The Commercial Code regulates many aspects of business in the UAE, other than business conducted in the DIFC.

Civil Code (UAE Law No. 5 of 1985) ('Civil Code') and Penal Code (UAE Law No. 3 of 1987) ('Penal Code')

These are relevant to a director's potential liabilities and in the case of the Penal Code will also apply to DIFCOs.

Commercial licence

The activities of a company incorporated in the UAE are generally restricted by the terms of its commercial licence.

In addition to the foregoing, PUJSCs listed on the Dubai Financial Market ('**DFM**') or the Abu Dhabi Securities Exchange ('**ADX**') are regulated by:

- Securities and Commodities Authority ('**ESCA**')
- Federal Law No. 4 of 2000 concerning The Emirates Securities & Commodities Authority and Market ('ESCA Law')
- Chairperson Decision No. (R/32) of 2007 on Governance Controls of Joint Stock Companies, issued by ESCA ('ESCA Decision').

DIFCOs established within the DIFC are not subject to federal civil and commercial laws (Federal Law No. 8 of 2004). DIFCOs are subject to the DIFC Companies Law No. 2of 2009 ('DIFC Companies Law'). The Dubai Financial Services Authority ('DFSA') regulates financial services conducted through the DIFC. The DFSA has issued the DFSA Offered Securities Rules ('OSR') (which set out binding rules for corporate governance) for DIFCOs listed on NASDAQ Dubai, or which have made a public offer of securities. The NASDAQ Dubai listing rules also apply to listed DIFCOs.

Board composition

Companies in the UAE generally adopt a unitary board structure, although this is not mandatory. In a LLC where there are more than seven shareholders, at least three shareholders must form a supervisory board with the role of, among other things, inspecting the company books and financial position and reporting to the other shareholders.

With regard to management:

LLC A LLC's shareholders are known as partners and the directors are known as managers. A LLC also has a general manager (who need not be a director) who is usually responsible for the day-to-day management of the company. The position of general manager is not referred to in the Companies Law. However, the general manager's name appears on the company's commercial licence and, in practice, this provides him with a degree of authority to bind the company. In addition, due to the form of language used, some governance provisions in the Companies Law relating to LLC directors are also likely to extend to a LLC general manager. A LLC should have between one and five directors.

JSC A JSC's board of directors manages the company. A JSC must appoint a chairman responsible for leading the board of directors. The board normally delegates the day-to-day operation of the business to its executives. A JSC should have between three and 12 directors.

DIFCO DIFCOs are managed by their directors, who may delegate the management of the company to the company's officers. As with a LLC, a DIFCO must have a general manager named on its commercial licence. A DIFCO should have at least two directors, with a maximum number generally set by the DIFCO's articles of association.

Management rules and authority

LLC A LLC's internal management is regulated by its constitutional documents, which may specify the board's operation and the required majority for adopting resolutions (Companies Law).

JSC Meetings of the board of directors must be convened by the chairman at least once every two months or when two-thirds of the board of directors request it. The minimum notice period before convening a board meeting is one week. A

quorum requires the presence of a majority of the directors. For resolutions to be passed, they must be supported by a majority of directors present or represented. In the event of a tie, the chairman has a casting vote.

DIFCO In listed DIFCOs, the board must meet on a regular basis throughout the year in order to discharge its duties with respect to corporate governance requirements, among other things (OSR). There are no statutory provisions governing voting requirements for board resolutions.

Directors of companies in the UAE generally have full authority to manage the business of the company, subject to any statutory restrictions, the constitutional documents, or any applicable listing rules. The constitutional documents often expressly contain the powers of the directors and the general manager and/or these powers are contained in a separate power of attorney granted by the company.

In addition to any express restrictions set out in the constitutional documents, typical matters requiring shareholder approval under company laws (eg the alteration of constitutional documents and share capital) and matters to be determined by shareholders at an AGM, other matters exist which require shareholder approval. Of note is that for a JSC, shareholder approval is expressly required for:

- entering into loan agreements for periods in excess of three years
- the sale or mortgage of the company's real property or its place of business
- absolving company debtors of their liabilities.

Under the company's constitutional documents, the board is generally able to delegate its powers to an individual director or a committee of directors. In addition:

LLC The responsibilities of the director(s) and general manager are often set out in the company's constitutional documents.

JSC A JSC's chairman represents the company before the courts and third parties. Third parties are entitled to rely on the chairman's signature as being that of the board of directors.

PUJSC A PUJSC's board of directors should implement an audit committee and a remuneration committee (ESCA Decision).

DIFCO Listed DIFCOs should consider establishing a nominations committee and a remuneration committee, depending on the size and nature of its operations (OSR). However, the board must establish an audit committee to monitor and review the company's internal audit function and make recommendations to the board on the appointment, removal and terms of engagement of external auditors.

Duties and liabilities of directors

Directors' duties and personal liability to the company, its shareholders and third parties can be broadly categorised under the following headings:

eneral d ties

LLC A LLC director's responsibilities are the same as those of a director of a JSC (Companies Law) (see below, JSC). In certain cases, these could extend to a general manager who is not a director (see above).

JSC The directors of a JSC are liable to the company, its shareholders and third parties for (i) all acts of fraud or abuses of power, (ii) violations of the Companies Law or the company articles and (iii) mismanagement (Article 111, Companies Law).

DIFCO A director must exercise his powers (i) honestly, (ii) in good faith and (iii) lawfully, (iv) with a view to the best interests of the company, and (v) with reasonable care, diligence and skill (DIFC Companies Law).

eft and fra d

Under the Companies Law, directors (and potentially general managers) of a LLC or JSC are subject to a prison sentence or a fine if, among other things, they:

- Sign in the company's name documents containing false information
- Insert false information in company documents and sign or distribute those documents knowing them to contain false information
- Disclose the company's confidential information or use such information for their, or a third party's, benefit.

Under the Penal Code, all directors and officers of entities in the UAE may be criminally liable for (i) fraud or embezzlement in respect of property or a legal right, (ii) disclosure of confidential information to obtain a personal benefit, and (iii) writing a

cheque on behalf of the company when the company does not have sufficient funds to honour that cheque.

ec rities la

Under the Companies Law, a prison sentence of up to two years and a fine of up to AED100,000 (about US$27,235) can be imposed on:

- A director who makes a public offer of shares in a LLC
- Someone who evaluates shares in bad faith at more than their real value.

A director can also be liable for a fine of up to AED100,000 for issuing shares in breach of the Companies Law.

PUJSC A PUJSC director who deals in securities of his company in breach of the ESCA Law, or on the basis of inside information, can be liable to imprisonment for a period of up to three years and a fine of up to AED1m (about US$272,350). Transactions made in contravention of the ESCA Law may also be invalid.

DIFCO There are extensive regulations in the OSR on offers of securities by a DIFCO. The DFSA has the power to make wide-ranging orders, including restitution orders, banning orders and civil penalty orders where a director has breached any of the rules in the OSR.

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Directors of a bankrupt LLC or JSC can be criminally liable for (Commercial Code):

- Concealing, destroying or altering some or all of the company's books
- Misappropriating or concealing part of the company's assets
- Knowingly declaring debts not owed by the company or failing to submit papers in their possession
- Fraudulently obtaining an arrangement with the company's creditors
- Making untrue statements about the capital of the company
- Distributing fictitious profits
- Receiving remuneration or bonuses in excess of the amounts stipulated by law or by the company's constitutional documents.

If a worker suffers injury, the directors must report the matter immediately to the police and to the relevant labour department.

Directors of an insolvent company may also face imprisonment and/or a fine if it is proved that they committed one of the following acts:

- failing to keep commercial books of the company that are sufficient to arrive at a true picture of the company's financial position
- failing to submit the information required of them by the judge supervising the winding-up of the company or the trustee in bankruptcy or willfully submitting false information;
- disposing of assets of the company with the intention of removing them from the reach of creditors after the company has ceased to be able to pay its debts;
- paying the debt of one creditor to the detriment of others or resolving to give sureties or advantages to one creditor in preference to the company, even with the intention of obtaining an arrangement, after the company has ceased to be able to pay its debts;

- disposing of the company's goods at an undervalue with the intention of delaying the time at which the company would be unable to pay its debts, delaying the declaration of bankruptcy or the cancellation of an arrangement with creditors or resorting to illegal means to obtain money;
- spending large sums on reckless ventures or speculation not required for the business of the company; or
- participating in or consenting to actions contrary to law or to the memorandum of association of the company.

ealt and safety

All company directors have general obligations to ensure the health and safety of their employees (Federal Labour Law No. 8 of 1980). Company representatives must inform workers on recruitment of any occupational hazards. If a worker suffers injury, the directors must report the matter immediately to the police and to the relevant labour department. It is illegal for directors, or employee representatives in a position of control, to bring alcoholic beverages into the workplace.

Directors can be subject to civil liability for any act carried out in the course of their duties that harms another person.

n iron ent

Breaches of Environment Law (UAE Law No. 24 of 1999) (the 'Environment Law') are punishable by imprisonment and/or fines. Fines vary between AED2,000 (about US$545) and AED10m (about US$2.7m), depending on the offence committed. The Environment Law also imposes liability for acts or omissions that result in pollution affecting third parties. The liability imposed by the Environment Law is potentially very large.

nti-tr st

The Commercial Code contains a number of provisions dealing with unlawful competition. In particular, companies must not:

- Approach a competitor's employees to acquire its customers, clients or trade secrets
- Resort to any methods involving untruthfulness to acquire a competitor's customers or clients
- Use deceptive and fraudulent methods in the distribution of its goods
- Disseminate or publish false information damaging to a competitor.

A director who is found to have breached these provisions can be liable for damages or compensation.

Other

Directors can be subject to civil liability for any act carried out in the course of their duties that harms another person (Civil Code).

an a director's liability be restricted or li ited s it possible for t e co pany to inde nify a director a ainst liabilities

A LLC or JSC may indemnify a director against liabilities arising from the performance of their duties. There are also no laws or regulations preventing directors of LLCs or JSCs from obtaining liability insurance coverage. Directors of LLCs or JSCs are collectively liable for all actions prohibited by law where they were carried out as a result of a unanimously adopted resolution. However, if the majority of the board adopted the resolution causing the liability, any dissenting directors (who had their objections properly recorded in the minutes of the meeting) are not liable (Companies Law). If shareholders ratify by resolution any acts of directors causing liability, there is a time bar of one year from the date of the sharholder meeting on proceedings for liabilities.

With regards to a DIFCO, a company can indemnify an officer for liability caused by his negligence, default, breach of duty or trust and a director of a DIFCO can obtain his own liability insurance (see below).

Can a third party (such as a parent company or controlling shareholder) be liable as a de facto director (even though such person has not been formally appointed as a director)?

There is no formal concept of a *de facto* director in the UAE. However, some of the penalty provisions in the Companies Law, Commercial Code, Civil Code and Penal Code can apply to a person who has not been officially appointed as a director.

Transactions with directors and conflicts

Are there general rules relating to conflicts of interest between a director and the company?

LLC A LLC's constitutional documents may contain general rules relating to conflicts of interest between a director and the company. The responsibilities of a director of a LLC are the same as those for a JSC (*see below*).

JSC: Any director who has an interest that conflicts with those of the company in a transaction must present that conflict to the board for consideration and approval. The conflicted director cannot participate in voting on the decision concerning the transaction.

DIFCO: A director of a DIFCO must disclose to the company any direct or indirect interest he has in a transaction that may conflict with the company's interests. If the director fails to do this, he can be liable to account to the company for any profit, gain or benefit he obtains.

The Civil Code in the UAE provides that any clause that addresses the invalidity of a contract, or lapse of the right of an insured, must be conspicuous.

Are there restrictions on particular transactions between a company and its directors?

LLC The responsibilities of a director of a LLC are the same as those for a JSC (see below)

JSC A director cannot conduct business for his own account in competition with the company's business without the shareholders' prior approval. If the director's actions are not approved, the company may claim an indemnity or consider the business as conducted on its behalf. A JSC may not grant cash loans of any kind to a director or guarantee any loan agreement entered into by a director.

DIFCO Financial assistance from a DIFCO to its directors is prohibited, unless one of the express exceptions apply, including where the shareholders' prior approval has been obtained (DIFC Companies Law).

re t ere restrictions on t e p rc ase or sale by a director of t e s ares and ot er sec rities of t e co pany e is a director of

PUJSC A PUJSC director can deal in securities issued by his company, subject to disclosure of the details of the transaction to the stock exchange and the prior approval of the board of directors, without which the transaction is void (ESCA Law).

DIFCO The directors of a listed DIFCO must not deal in securities of the company:

- During a close period lasting for one month before the announcement of the financial statements for a financial period, until the disclosure of the financial statements for that period
- When they hold undisclosed material information.

Directors must not deal in securities of the company without receiving prior written clearance from the chairman.

Directors' duties of disclosure

o directors a e to disclose infor ation abo t t e co pany to s are olders t e p blic or re latory bodies

LLC Each year, the directors must provide shareholders the company's annual report and financial statements. The directors must also lodge the financial statements and particulars of the company's share register with the Ministry of Economy and the 'relevant authority' for the Emirate in which the company is established.

Members of a LLC's supervisory board are entitled to access to all of the company's books and documents.

JSC Each year, a JSC must provide the Ministry of Economy and the relevant authority with a detailed list of the names of each director, their capacities and nationalities. A JSC must also notify both the Ministry of Economy and the relevant authority of any changes to this list.

A JSC must also provide to its shareholders:

- A directors' report on the company's activities and its financial position
- The company's financial statements
- The auditor's report.

In addition, both the ADX and DFM have material, price-sensitive information disclosure requirements.

DIFCO The OSR establishes a continuous disclosure regime for listed DIFCOs that requires timely disclosure of material price-sensitive information about the company. DIFCOs must also prepare and file an annual report with the DFSA.

Some of the penalty provisions in the Companies Law, Commercial Code, Civil Code and Penal Code can apply to a person who has not been officially appointed as a director.

Internal controls, accounts and audit

re t ere any for al re ire ents or idelines relatin to t e internal control of b siness risks

PUJSC The board of a PUJSC must establish an internal control system to evaluate procedures for risk management and the implementation of corporate governance controls. The board is also required to conduct a yearly review of the internal control system and report its findings to shareholders (ESCA Decision, effective April 2010).

DIFCO: The OSR states that a listed DIFCO should have appropriate systems and controls in place to ensure that it, its directors and its employees cannot breach the rules.

at are t e responsibilities and potential liabilities of directors in relation to t e co pany's acco nts

LLC and JSC Company directors must prepare and approve the company's balance sheet and profit and loss statement as well as an annual report of the company's activities and its financial position. ESCA requires a PUJSC's accounts to comply with international accounting standards issued by the International Accounting Standards Committee.

A director who intentionally omits material facts or inserts false particulars in the balance sheet or the profit or loss statement with intent to conceal the real financial position of the company is subject to a prison sentence of up to two years and/or a fine of up to AED100,000 (about US$27,235) (Companies Law).

FZCO Directors must keep sufficient accounting records to show the company's transactions and to disclose the company's financial position.

DIFCO Directors' failure to approve and sign the financial accounts can attract a fine of up to AED36,720 (about US$10,000).

D&O insurance in the UAE

Insurance legislation in the UAE requires that insurance be placed with a locally licensed insurance company (although DIFCOs can purchase D&O insurance directly from an insurance company licensed in the DIFC). However, any insurance placed in respect of onshore risks with an unlicensed insurer is null and void and the insured is entitled to damages as a consequence of such nullification (article 24 of UAE Federal Law no. 6 of 2007). This can cause issues for multinational groups who have a single D&O policy covering the entire group, in which case a local insurer will need to be introduced to front the coverage in the UAE.

There are currently 59 licensed insurance companies onshore in the UAE and 19 in the DIFC (excluding captive insurance entities). A number of these, including Chartis, ACE and Zurich (in the DIFC), offer D&O coverage.

At the time of writing, there are no specific regulations governing D&O insurance (as distinct from other types of insurance). However, the UAE Insurance Authority is expected to issue a number of new regulations during the course of 2010 and this situation may change. In the absence of express regulations, D&O policies in the UAE (as elsewhere in the GCC) tend to be based on Lloyd's standard forms and are subject to the same types of issues highlighted in the Qatar chapter.

There are some specific features of UAE insurance law that are important when considering a D&O policy issued by an onshore insurer:

rabic lan a e

Policies, including D&O insurances, are required to be in the Arabic language. This often means that the policy is produced in both English and Arabic. It is important to understand the Arabic version as this will take precedence in the event of a dispute.

nforceability of e cl sions

The Civil Code in the UAE provides (at Article 1028) that any clause that addresses the invalidity of a contract, or lapse of the right of an insured, must be conspicuous. A breach of this requirement will result in the condition being deemed void and unenforceable by the insurer. At least one judge has recently refused to enforce a warranty that was not separately initialled by the insured.

-side' co era e

As noted above, the shareholders of LLCs and JSCs are required under the Companies Law to consider absolving their directors of liability or initiating proceedings against them at each annual general meeting. Where this involves a director being indemnified in respect of claims against him, it will be necessary to ensure that the D&O policy will reimburse such indemnity payments. This so-called 'B-side' coverage is typically offered as an extension (the basic D&O coverage will protect the directors and officers as distinct from the company).

isp te resol tion

Whilst it can be slow and costly to resolve disputes via the courts, many insurers are reluctant to include arbitration clauses in insurance policies. This is because in the UAE an arbitration clause must be set out in a separate agreement or, at the minimum, be signed separately by the parties, in order to be enforceable. ■

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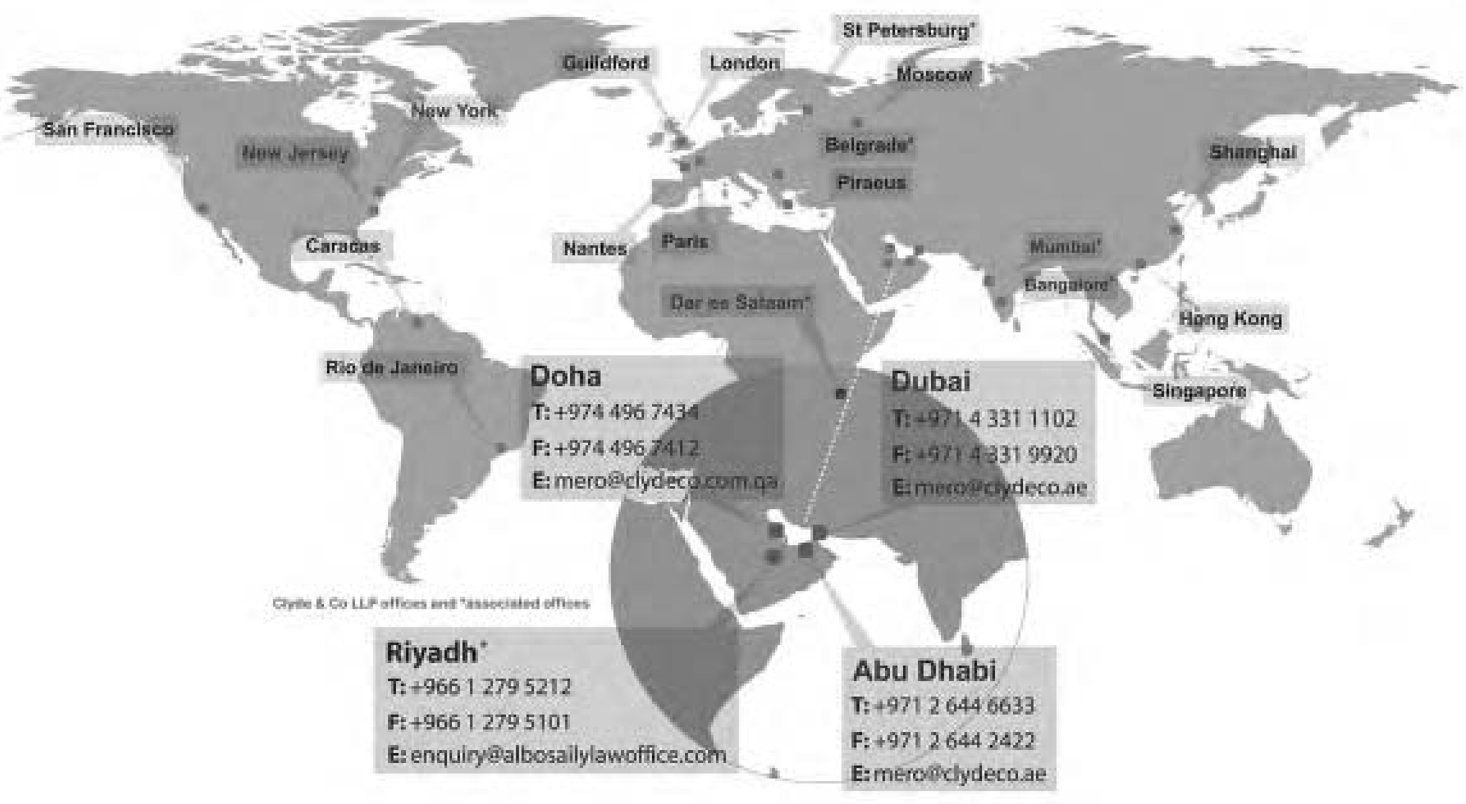

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE UNITED KINGDOM

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Recent amendments to the legislative architecture and turbulent economic conditions have given rise to changes in the risk landscape for UK companies and their directors.

We will first examine the aftermath of the significant changes to UK company law introduced by the Companies Act 2006 and consider what the legislation has meant for companies and their directors in practice. We will look at the statutory rules governing the scope of indemnities that companies are able to give to their directors and the inter-relationship with companies' D&O insurance arrangements (and also look at the less well understood extra-territorial consequences of this for UK-listed companies with non-UK subsidiaries).

We will then discuss recent developments in the risk landscape for directors and officers, particularly in light of the global financial crisis and increased insolvency risk. We will look at directors' exposures upon insolvency and highlight the important role that D&O insurance plays for directors when a company is in financial difficulty. We will also comment on how the UK D&O market has responded to the global financial crisis.

Lastly, we will comment on some other interesting developments that have focused boardroom minds, including the implications of the lower threshold test for bringing shareholder derivative claims and the impact of the Corporate Manslaughter and Corporate Homicide Act 2007 (the 'Corporate Manslaughter Act') which came into force in April 2008, as well as discuss the insurability of fines and penalties.

The aftermath of the Companies Act 2006

Directors' duties

The final provisions of the Companies Act 2006 came into effect during 2009. One of the most significant changes introduced by the Companies Act 2006 was a partial codification of directors' duties. The seven codified duties are:

(i) a duty to act within powers;

(ii) a duty to promote the success of the company;

(iii) a duty to exercise independent judgement;

(iv) a duty to exercise reasonable care, skill and diligence;

(v) an expanded duty to avoid conflicts;

(vi) a duty not to accept benefits from third parties; and

(vii) a duty to declare an interest in a proposed transaction or arrangement.

There were concerns that the new statutory duties and the old principles would not always correspond, particularly with respect to the new duty to promote the success of the company (section 172 of the Companies Act 2006) which replaced the previous duty to act in the best interests of the company. There was uncertainty as to how the courts would interpret the statutory wording, in particular the meaning of the word 'success'. However, the UK Government has maintained that the statutory duty to promote the success of the company merely codifies the previous law and, to date, this seems to have been borne out in practice, with no significant extension or modification of what is expected of directors being evident in case law.

The Companies Act 2006 prescribes a list of six factors (including, for example, the likely consequences of any decision in the long term and the need to act fairly between members of the company) to which a director must give proper consideration when exercising the duty to promote the success of the company. There have been concerns regarding what directors need to do in practice to demonstrate that they have properly taken into account the relevant factors. Such uncertainty has been particularly acute in the case of companies in financial difficulty.

It is clear that paying due regard to the list of factors should not be a box-ticking exercise. There is little to be gained by a company creating a paper trail or including standard wording in board minutes simply stating that the directors have considered the statutory factors without the proper consideration having been given. However, in circumstances where one or more of the factors are particularly relevant to a significant decision, it would usually be appropriate to record the board's considerations. Evidencing consideration of the factors (eg in board minutes) may be of particular benefit in circumstances where the directors anticipate a problem or wish to have on record that they have complied with their duties. One reason to have such a record, particularly for major decisions, relates to the preparation of the company's business review. Part of the purpose of the business review involves demonstrating to shareholders how the directors have performed their duty to promote the success of the company (and hence how they have had regard to the relevant factors).

Another contentious topic flowing from the codification of directors' duties was the new statutory duty to avoid conflicts of interest (section 175 of the Companies Act 2006). There was concern that the expanded duty to avoid conflicts and possible conflicts would make multiple directorships, or combining directorships with the trusteeship of a group pension scheme, more difficult to manage. Under the previous law, there was scope for directors to manage conflicts, for example, by absenting themselves from meetings at which particular matters were discussed. Such a course of action in itself is unlikely to satisfy the

new statutory duty. It is possible for a company's articles to contain provisions to facilitate dealing with conflicts, and situational conflicts can be authorised either by the (non-conflicted) directors or by shareholders. For public companies (where shares are widely held), authorisation by shareholders will be impractical and it is therefore advisable for such companies to amend their articles of association to provide for authorisation of conflicts by non-conflicted directors. Many listed companies have already made arrangements to deal with this.

Director indemnities

Companies are able to loan directors an amount equal to the cost of funding the defence of any civil, regulatory or criminal actions brought against them. In the case of claims brought by the company (or an associated company) and criminal proceedings, the loan must be repaid immediately if the director is not ultimately exonerated. In all other cases, the company may indemnify the director against his defence costs. Where the director is sued by third parties directly, the company is also allowed to indemnify the director against any liability to the third party as well as for the director's defence costs. Companies should check that their constitutional documents permit the provision of loans and indemnities in this form. Directors need to be aware that the indemnity provisions within a company's articles of association are not in themselves enforceable by directors but must be supported by a contractual arrangement between the company and each director in order to be enforceable by such director. The existence of any indemnity granted to directors must be disclosed in the company's directors report.

The scope of a permissible director indemnity under the Companies Act 2006 remains narrower than the scope of available D&O insurance cover and being granted a wide indemnity by the company does not remove a director's need to be covered by D&O insurance.

UK-listed companies are required by the Listing Rules to ensure that the scope of any director indemnity arrangement entered into by their non-UK subsidiaries is no broader than it would be if those subsidiaries were regulated by the Companies Act 2006. This is because the exemption in the Listing Rules for related party transactions applicable to director indemnities requires UK-listed companies to comply with the Companies Act 2006, even where the indemnity is granted by overseas group subsidiaries. This means that if a non-UK subsidiary of a UK listed company wishes to grant an indemnity to directors that is broader than allowable under English law, approval from the UK listed company's shareholders would be required. Obtaining shareholder approval is, in most cases, likely to be impractical and, in reality, non-UK subsidiaries are likely to need to stay within the confines of what English law allows. As a result, UK restrictions on indemnification have *de facto* extraterritorial effect in those circumstances.

Allen & Overy's experience is that the majority of UK public companies have agreed to fund the defence of claims against their directors and other related expenses and some have expressly agreed to fund extradition defence costs and bail arrangements. With limited exceptions, we have seen that directors of subsidiary companies (whose risk profile is different from that of plc directors) are not offered equivalent indemnities.

The issue of whether or when it is in a company's interest to indemnify a director against his liability to a third party has understandably caused much boardroom debate. In our experience, no standard response has emerged. Each company has to consider its own boardroom risk profile and circumstances. In any event, shareholders who bring direct claims against directors are unlikely to take kindly to the company funding the cost of a director's settlement if their complaint is that a director's actions have caused a diminution in their investment.

In general, the scope of a permissible director indemnity under the Companies Act 2006 remains narrower than the scope of available D&O insurance cover, and being granted a wide indemnity by the company certainly does not remove a director' s need to be covered by D&O insurance. Furthermore, just because the Companies Act 2006 does not prohibit a company from indemnifying a director, this does not mean that it will or is able to do so. Furthermore, when a company is insolvent or in financial difficulty, a contractual indemnity may be practically worthless.

A comprehensive D&O policy should provide for repayment of a defence costs loan (where required) if the director opts to borrow his defence costs under an indemnity rather than claiming directly under the company's D&O insurance cover. Directors and companies are encouraged to check that their D&O policies respond accordingly.

The recession, directors' exposure on insolvency and risk management

The past couple of years have been tumultuous for many companies and their directors. Market volatility and increased insolvency risks have amplified directors' concerns over personal exposure. The global financial crisis has resulted in an increase in corporate insolvencies and instances of directors being sued by insolvent entities. When a company is in financial difficulty (either approaching insolvency or actually insolvent), the duties of the directors to act in the interest of shareholders are displaced by duties to act in the interests of the company's creditors. The majority of duties imposed on the directors of companies facing insolvency arise under the Insolvency Act 1986 and not under the Companies Act 2006.

The key questions that arise in this context are:

(i) exactly when does a director need to consider the additional duties that arise when a company is facing insolvency?

(ii) what are those additional duties? and

(iii) to whom are they owed?

Directors are encouraged to seek legal advice on these issues as soon as they become aware or suspect that the company is facing financial difficulty.

The risk of a director being sued is significantly increased when a company is in financial distress. A key part of a company's overall risk-management strategy to manage the risks that flow from financial distress should be to ensure that the company has adequate D&O insurance arrangements in place. D&O insurance will be a particularly valuable asset for the directors of an insolvent company, as a director's contractual indemnity from the company will be of little practical worth.

Directors should check that their D&O insurance policy provides cover for claims that arise from acts or omissions after the company has become insolvent and when reviewing a company's D&O policies it is important to be on the look-out for insolvency-sensitive terms. A good D&O insurance policy should provide that, if the company is legally permitted to indemnify a director or other individual but cannot do so because of financial distress or insolvency, the insurer will provide coverage to the individual directors directly, without the need for them to pay the deductible that would usually apply to the company with respect to an indemnifiable claim. Even better is a provision that says that, if the company is legally permitted to indemnify a director or other individual but refuses to do so for whatever reason, the insurer will provide coverage to the individual directly and pursue the company for the deductible. Insureds should also ensure that a claim instigated by a liquidator or other insolvency official in the name of the company is carved out from any 'insured versus insured' exclusion. It is also important to review key definitions such as the definition of 'claim' and 'loss', to ensure that they are sufficiently broad to cover the types of claims, investigations and losses that flow from claims against directors instigated by insolvency practitioners. The definition of 'loss' in D&O policies varies widely, and insureds should ensure their definitions are broad enough to cover loss characterised as compensatory in nature and cover, for example, recompense payable by directors who have been held liable for 'wrongful trading' under the Insolvency Act 1986.

Lastly, it is worth remembering that, although D&O insurance is a valuable asset for directors, putting D&O insurance in place can also increase the likelihood of a claim being made against them. Insolvency practitioners regard D&O insurance as an asset, and the existence of a D&O insurance policy means possible access to the deep pockets of the insurer. Insolvency practitioners generally adopt a commercial approach when deciding whether or not to instigate claims against directors, and they often see little or no point in instigating a claim against a director unless the director is covered by D&O insurance.

How has the UK D&O market responded to the global financial crisis?

After a number of years of a softening market prior to the financial crisis, there has been a general stabilisation of the UK D&O insurance market in recent times. However, the picture is not uniform and whether affordable D&O insurance cover is available will, to a large extent, depend on the nature of the entity seeking cover for its directors. For financial institutions and those firms facing the toughest financial challenges in the recession, it has been difficult to find the D&O insurance capacity that they have sought at an affordable price. The market may harden further if we continue to witness increased claims in the aftermath of the recession.

Shareholder derivative claims

English law only allows shareholders to bring claims on behalf of the company and for the company's benefit (so-called shareholder derivative claims) in the narrowest of circumstances. This is because directors owe their duties to the company as a whole, and not to individual members, employees, creditors or other outsiders. As a general rule, any breach of a duty owed by a director which causes loss is actionable by the company that suffered the loss and not by its shareholders. One key

exception to this rule relates to directors' personal liability to investors for the accuracy of circulars and prospectuses promoting the sale of company securities.

Prior to 1 October 2007, a shareholder's ability to bring a derivative action was not contained in statute but was a matter of common law. The Companies Act 2006 introduced a new codified derivative claim regime and with it a wider range of circumstances in which a derivative action can be brought by shareholders, which includes cases of pure negligence.

The Companies Act 2006 understandably caused unease amongst directors. Uncertainties created by the codification of directors' duties, together with the expanded types of conduct in respect of which a shareholder can complain under the codified derivative claim regime (eg negligence), had the potential to lead to an increase in the volume of claims. However, to date, we have not witnessed any noticeable increase in the volume of claims. This may be because, unlike for US securities class actions, any damages recovered will be payable to the company rather than the litigious shareholder. In addition, the filtering process under the Companies Act 2006, which requires a shareholder to establish a prima facie case for permission, has enabled the court to weed out frivolous claims at an early stage.

A company cannot legally indemnify its directors in respect of any damages awarded against them in a successful derivative action and can only indemnify for their defence costs where the claim against them is dismissed or they are exonerated. While the company could fund a director's defence, this can only be done by way of a loan, which would have to be repaid immediately if the director loses the claim.

D&O insurance policies will normally operate to fund a director's defence costs in a derivative claim. Whether they would also cover any damages awarded against the director will depend on the policy terms.

Corporate manslaughter and fines

A new offence of corporate manslaughter was introduced when the Corporate Manslaughter Act came into force in April 2008. The Corporate Manslaughter Act replaced the common law offence of manslaughter by gross negligence for companies and other organisations. As this Act does not apply to individuals, such as directors and other managers, directors are not directly exposed to personal prosecution under the legislation. However, directors should be aware that they can still be prosecuted under the common law offence of manslaughter by gross negligence.

It is possible that the new corporate manslaughter regime will result in increased directors' exposure to claims. In the first prosecution of corporate manslaughter under the new legislation in 2009, simultaneous proceedings were also brought against one of the company's directors for manslaughter by gross negligence under the common law and for an offence under health and safety legislation for failure to look after the health and safety of the company's employees. (The trial has been adjourned and press reports suggest that the hearing will not commence until autumn 2010.) Moreover, the way in which a company's activities are managed or organised by its senior management will form a substantial element in establishing a breach of the Corporate Manslaughter Act. It is therefore possible that claims could be made, eg by way of shareholder derivative action, against individual directors or senior managers whose breach of the duty of care caused or contributed to the prosecution of a company under the Corporate Manslaughter Act, to recover the cost of fines paid by that company. To date, we are not aware of any claims of this nature being made against directors in this context but the risk of such claims arising in the future cannot be dismissed. The eventual outcome of the trial in *Safeway Stores Limited and others v Simon John Twigger and others (2010)* will also have significant implications for where the liability for corporate fines will ultimately lie. In that case, claimant companies in the Safeway group issued proceedings against eight former directors and employees alleging breach of employment contract, breach of fiduciary duty and negligence as a result of the executives' participation in dairy pricing initiatives in breach of competition law, and their failure to report their involvement in such conduct to superiors or the board of directors. The Safeway group companies are seeking damages of an amount equal to the penalty paid by the companies and related costs.

A D&O insurance policy may provide some cover for a director's or senior manager's defence costs for claims alleging manslaughter by gross negligence or breach of statutes in relation to health and safety. For public policy reasons, D&O insurance will not cover liabilities resulting from a successful prosecution for a manslaughter offence. Similarly, as public policy precludes insuring against the risk or consequences of an insured being found liable for a deliberate wrongdoing, criminal fines are uninsurable. The position in relation to the status of insurance against civil fines is less clear. Many D&O policies completely exclude cover for fines and penalties; however, we have witnessed an increase in insurers willing to provide coverage for fines and penalties to the extent insurable at law.

It will depend on the terms of the D&O insurance policy whether a liability owed to the company seeking an indemnity for a fine will be covered. In the *Safeway* scenario, had the fines been levied directly against individual directors, it is likely that no cover would be available under the most standard D&O policies due to the fines and penalties exclusion. However, because the fine was levied against the company, which sought to pass liability across to its directors and employees by alleging a breach of duty and negligence, the D&O policy is likely to be very much in play. In *Safeway*, the court acknowledged that the real target of the claim was the relevant executives' D&O insurance. It will be worth monitoring the outcome of this case and how the D&O market responds. ■

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LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE USA

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Sophisticated directors and officers of public corporations, and their liability insurers, recognise that the cost of defending a claim may be a greater economic concern than the exposure to a judgment awarding damages. Although percentages vary between state and federal courts and from jurisdiction to jurisdiction, the overwhelming majority of lawsuits filed in the United States do not proceed to trial and to verdict. All of them, however, require defence and the cost of defence may be significant to the defendant and its insurer.

As a consequence, obtaining a judicial determination of the merits of an asserted claim early in the litigation process is a goal of most defendants. In particular, a determination of the merits of a claim prior to the commencement of discovery proceedings may avoid hundreds of thousands or millions of dollars in defence costs in a complex commercial case, such as one involving claimed violations of the federal securities laws.

Insurance coverage for the defence of securities law claims is generally available under most public companies' directors' and officers' ('D&O') liability insurance. The goal of the insured defendants is to obtain insurance coverage for as much of the defence costs as possible, as early in the process as possible. To that end, the insurance policy's definition of 'claim', the availability of defence costs for claims alleging fraud, and the policy's allocation provision are of significant import. These terms can vary significantly from policy to policy and can often be negotiated to provide maximum coverage to the policyholders.

Plausibility: *Twombly* and *Iqbal*

Although the Supreme Court has focused previously upon the concerns raised by the cost of defending groundless claims, its holding in *Bell Atlantic Corporation v. Twombly*, 550 U.S. 544 (2007), an antitrust case, and its recent extension of that holding, in *Ashcroft v. Iqbal*, 129 S.Ct. 1937 (2009), to all civil actions, are the most significant and consequential from the defence perspective. Both *Twombly* and *Iqbal* interpret the requirement, within Rule 8(a)(2) of the Federal Rules of Civil Procedure, that a complaint include a short and plain statement of the claim showing that the pleader is entitled to relief, to equate with a finding of plausibility, rather than mere possibility.

For more than half a century, the requirement of Rule 8(a)(2), as interpreted by the Supreme Court in *Conley v. Gibson*, 355 U.S. 41 (1957), was 'the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief'. (355 U.S. at 45-46.) In *Twombly*, the Supreme Court stated that 'after puzzling the profession for 50 years, this famous observation has earned its retirement. The phrase is best forgotten as an incomplete, negative gloss on an accepted pleading standard.' (550 U.S. at 563.) Instead, 'plausibility' has become the keyword for meeting the requirement of Rule 8(a)(2). Under *Twombly*, a complaint must allege enough facts to state a claim for relief that is 'plausible on its face'. (550 U.S. at 570.)

In reaching this holding, the Supreme Court pointed to its decisions in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), and *Dura Pharmaceuticals, Inc. v. Broudo*, 554 U.S. 336 (2005), both federal securities law cases, as precursors of its current analysis.

In *Blue Chip Stamps*, the Supreme Court held that only purchasers or sellers of securities may assert private claims under Section 10(b) and Rule 10b-5. (421 U.S. at 749.) One of the factors considered by the Supreme Court for limiting the class of potential plaintiffs was the impact on settlement value of the threat of extensive discovery, particularly as it may accompany a groundless lawsuit. The Supreme Court explained that:

> The potential for possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure may likewise exist in this type of case to a greater extent than they do in other litigation. The prospect of extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents, is a common occurrence in this and similar types of litigation. To the extent that this process eventually produces relevant evidence which is useful in determining the merits of the claims asserted by the parties, it bears the imprimatur of those rules and of the many cases liberally interpreting them. But to the extent that it permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit.' (421 U.S. at 741)

In *Dura*, the Supreme Court held that proximate causation and economic loss must be plead and proven to sustain a claimed violation of Section 10(b) and Rule 10b-5, and allegations that a purchase price was inflated are insufficient to meet the required burden. (544 U.S. at 338.) As the Supreme Court explained:

> 'Our holding about plaintiffs' need to *prove* proximate causation and economic loss leads us also to conclude that the plaintiffs' complaint here failed adequately to *allege* these requirements. We concede that the Federal Rules of Civil Procedure require only 'a short and plain statement of the claim showing that the pleader is entitled to relief'. (Fed. Rule Civ. Proc. 8(a)(2).) And we assume, at least for argument's sake, that neither the Rules nor the securities statutes impose any special further requirement in respect to the pleading of proximate causation or economic loss. But, even so, the "short and plain statement" must provide the defendant with "fair notice of what the plaintiff's claim is and the grounds upon which it rests".' (*Conley v. Gibson*, 355 U.S. 41, 47, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). (544 U.S. at 346.)

Holding otherwise, according to the Supreme Court, would permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the (discovery) process will reveal relevant evidence. (*Id*. at 347.)

The question of whether *Twombly's* holding should be narrowly read to apply only to claimed violations of the antitrust laws involving conspiracy allegations was first addressed by the Second Circuit in its decision in the *Iqbal* case, *Iqbal v. Hasty*, 490 F.3d 143, 158 (2d Cir. 2007): 'Some of [*Twombly's*] language relating generally to Rule 8 pleading standards seems to be so integral to the rationale of the Court's parallel conduct holding as to constitute a necessary part of that holding.' The Second Circuit thereafter applied the *Twombly* rationale in a federal securities law case, *ATSI Communications, Inc. v. Shaar Fund, Ltd*, 493 F.3d 87, 98 (2d Cir. 2007).

In its 2009 decision in *Iqbal*, the Supreme Court extended its 'plausibility' standard to 'all civil actions and proceedings in the United States district courts'.

In its 2009 decision in *Iqbal*, the Supreme Court extended its 'plausibility' standard to 'all civil actions and proceedings in the United States district courts'. (129 S.Ct. at 1953.) In doing so, the Supreme Court elaborated on the appropriate considerations, under Rule 8(a)(2), of a complaint for evaluating the sufficiency: 'To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to "state a claim to relief that is plausible on its face". [citation omitted] A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.' (129 S.Ct. at 1949.)

The Supreme Court went on to explain that '[t]wo working principles underlie our decision in *Twombly*'. (*Id*.) The first is that although the court must accept as true all of the allegations in the complaint, that tenet is inapplicable to legal conclusions. Thus, '[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice'. (*Id*.) The second is that 'only a complaint that states a plausible claim for relief survives a motion to dismiss'. (*Id*. at 1950.)

The Supreme Court also explained the interplay between Rule 8(a)(2) and Rule 9(b) of the Federal Rules of Civil Procedure, which requires particularity when pleading special matters, such as fraud, but permits intent, knowledge and other conditions of mind to be alleged 'generally', as follows:

> 'But "[G]enerally" is a relative term. In the context of Rule 9, it is to be compared to the particularity requirement applicable to fraud and mistake. Rule 9 merely excuses a party from pleading discriminatory intent (the issue in *Iqbal)* under an elevated pleading standard. It does not give him license to evade the less rigid – though still operative – strictures of Rule 8.' (*Id*. at 1954.)

Although it has only been a matter of months since *Iqbal* extended *Twombly's* plausibility standard to all civil actions, there have been hundreds of district court decisions applying that standard to challenged complaints. Within the Southern District of New York alone, there have been dozens of decisions applying the plausibility standard to claims of federal securities law violations, either in isolation (for claimed violations of the Securities Act of 1933 and the Investment Company Act of 1940) or in conjunction with Rule 9(b) of the Federal Rules of Civil Procedure and the strict pleading provisions of the Private Securities Litigation Reform Act (for violation of the anti-fraud provisions of the Securities Exchange Act of 1934). See, eg: *Landmen Partners Inc. v. Blackstone Group*, 2009 WL 3029002 (S.D.N.Y. Sept. 22, 2009) ('33 Act); *In re Novagold Resources Inc. Securities Litigation*, 629 F. Supp. 2d 272 (S.D.N.Y. 2009) ('33 Act); *DeBlasio v. Merrill Lynch & Co., Inc*., 2009 WL 2242605 (S.D.N.Y. July 27, 2009) ('40 Act); *In re Dynex Capital, Inc. Securities Litigation*, 2009 WL 3380621 (S.D.N.Y. Oct. 19, 2009) ('34 Act); *S.E.C. v. Kelly*, 2009 WL 3241548 (S.D.N.Y. Sept. 30, 2009) ('34 Act); *Owens v. Gaffken & Barriger Fund, LLC*, 2009 WL 3073338 (S.D.N.Y. Sept. 21, 2009) ('34 Act); and *Police and Fire Retirement System v. Safenet, Inc*., 2009 WL 2391849 (S.D.N.Y. Aug. 5, 2009) ('34 Act).

Since the Supreme Court decision in *Iqbal*, there have been relatively few appellate decisions in the federal securities law context. The Second Circuit's decision in *South Cherry Street, LLC v. Hennessee Group LLC*, 573 F.3d 98 (2d Cir. 2009) is illustrative of what may be expected at the appellate level. In affirming the district court's dismissal of the complaint, the

Second Circuit addressed the plaintiff's argument that it was not obligated to make certain allegations because 'such facts would be peculiarly within the knowledge of the defendants'. (*Id.* at 113-14.) The plaintiff intimated 'that it might hope to develop some such evidence in discovery'. (*Id.* at 114.) That argument was rejected by the Second Circuit, as follows:

> 'To be sure, South Cherry should not include such an allegation in its pleading without having a "factual basis or justification", [citation omitted]. But "before proceeding to discovery, a complaint must allege facts suggestive of illegal conduct," [citation omitted]; and a plaintiff whose "**complaint is deficient under Rule 8 . . . is not entitled to discovery,**" [citation omitted]. South Cherry's confessed inability to offer more than speculation that there may have been such unlawful conduct underscores, rather than cures, the deficiency in the Complaint." (Emphasis in original.)

From the perspective of potential defendants and their insurers, *South Cherry* is a welcome sign that there will be no lingering reticence to determine that a plaintiff with a seemingly groundless claim should not be permitted to proceed to discovery and trial, despite five decades of contrary jurisprudence. Although there will continue to be claims that require defence on their merits, the threshold has been raised.

Whether this more stringent interpretation of Rule 8 will translate into lower insurance costs is yet to be seen. In the meantime, policyholders faced with securities claims or other lawsuits or investigations will wish to maximise the extent to which insurance coverage is available for defence costs. Many of the key terms are negotiable, and can significantly increase the breadth of coverage. In particular, the definition of 'claim', the conduct exclusions, and the allocation provision are discussed below.

Since most D&O policies are written on a 'claims-made' basis, covering 'claims' made against the insureds during the policy period, the definition of what constitutes a 'claim' is important.

Since most D&O policies are written on a 'claims-made' basis, covering 'claims' made against the insureds during the policy period, the definition of what constitutes a 'claim' is important. Although all policies will include actual lawsuits and written demands for money damages, many insurers now also agree to cover costs incurred as a result of regulatory and administrative proceedings, certain civil and criminal investigations, demands for non-monetary relief, and even Wells Notices or other preliminary actions taken by the SEC or other regulatory bodies. In addition, since many D&O policies only cover the company for 'securities claims', this definition, too, should be reviewed. Broader definitions will include not only claims based upon alleged violations of the federal securities laws (such as Section 10(b) and Rule 10b-5), but state statutory equivalents and common law claims.

Conduct exclusions generally provide that no coverage is available for any loss arising out of fraud, dishonesty, criminal conduct, personal profit or other advantage to which the insured was not entitled. Most federal securities law claims necessarily include allegations of fraud. Therefore, in order to ensure that defence cost coverage is available for claims alleging fraud, conduct exclusions should apply only after final adjudication or criminal conviction. The most limited exclusions apply only if such an adjudication occurs in the underlying case, thus not allowing the insurance company to file its own lawsuit to establish fraud. These and other exclusions should also contain a 'severability' clause ensuring that the bad acts of one individual insured will not bar coverage for other 'innocent' insureds.

Finally, since securities lawsuits often include non-covered individuals as defendants, the D&O policy's allocation provision dealing with covered and non-covered claims or parties can have a significant impact on the amount of coverage available for defence costs and settlements. For example, where a single claim includes insured directors and officers and uninsured employees, some policies may allocate based on the 'relative financial and legal exposures' of the defendants. This standard was adopted in *PepsiCo, Inc. v. Continental Cas. Co.*, 640 F. Supp. 656 (S.D.N.Y. 1986), but remains the minority rule in the United States, and often benefits the insurer. Policyholders can seek to delete this language from the policy. In the absence of such a provision, many courts would instead impose the 'larger settlement rule', requiring the insurer to prove that the inclusion of the uninsured employees as defendants made any settlement more expensive. *See Caterpillar, Inc. v. Great American Ins. Co.*, 62

F.3d 955 (7th Cir. 1995)(larger settlement rule); *Nordstrom v. Chubb & Son, Inc.,* 54 F.3d 1424 (9th Cir. 1995)(same) and *Safeway Stores, Inc. v. National Union Fire Ins. Co.*, 64 F.3d 1282 (9th Cir. 1995)(defence costs covered if 'reasonably related' to covered claim); *Raychem Corp. v. Federal Ins. Co.,* 853 F. Supp. 1170 (N.D.Cal. 1994). The 'larger settlement' standard presents a more difficult burden for the insurer, and therefore often results in full coverage of defence costs and settlement.

Conclusion

United States courts have made great strides in reducing the costs of defending and settling United States securities cases. By instituting strict pleading standards and early determination of the viability of claims, the courts have sought to reduce the *in terrorem* effect caused by the mere filing of securities class actions. Corporations, and their officers and directors, need to keep pace, ensuring that their policies properly cover early stage resolution of such actions. ■

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Simon also acts in a range of commercial disputes, including representing corporations which are the subject of class actions and group proceedings by shareholders, customers and other claimants. This includes a range of product liability issues.

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Abdulaziz advises on ground-breaking Islamic finance structures and major project finance deals with clients ranging from significant global financial institutions to petrochemical companies.

In addition to advising on some of the largest Islamic financing deals in the Kingdom of Saudi Arabia, Abdulaziz has, through his work in the public and private sector, extensive experience advising multinational and Saudi corporations in relation to foreign direct investments, incorporations, privatizations, compliance and regulatory regimes.

Previously Abdulaziz held the role of General Counsel of the Saudi Arabian General Investment Authority (SAGIA), he has also held roles as a senior projects team member for a prominent Saudi Arabian law firm and as co-head of the Saudi Practice Group of an international law firm. In mid 2008 he established an independent Saudi law office in Riyadh, prior to partnering with Clyde & Co in early 2009.

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Michael is an experienced corporate and financial services lawyer based in our Riyadh office, in Saudi Arabia. He has been working in the Middle East region for over three years and previously worked for a top tier Australian law firm.

In particular, Michael has an in-depth experience and understanding of financial services businesses. He has worked as a financial services regulator, as in-house counsel for a multi-national financial services company and as a specialist financial services lawyer in Australia. In addition, Michael's time in the region has allowed him to appreciate the particular legal, commercial and practical issues that any business will experience in successfully establishing and operating in the region.

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Peter has advised on a range of corporate transactions, including major IPOs, M&A and joint

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Peter is also a specialist in Islamic Insurance (takaful) and routinely advises takaful operators on the establishment and day-to-day regulation of their operations, compliance (including Shari'a compliance) and product development. He has extensive experience in the development of new insurance and reinsurance products and distribution arrangements. He has advised in relation to bancassurance arrangements across the MENA region.

Prior to joining Clyde & Co in January 2009, Peter was involved in the establishment of an international law firm's office in Riyadh. He has broad experience of Saudi Arabian laws and regulations and continues to advise clients establishing and operating in the Kingdom.

David Holiday

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David joined Clyde & Co in 2007, having previously worked as a corporate mergers and acquisitions lawyer at an international law firm based in the UK. Since arriving in the region David has focused on foreign direct investments by insurance interests both onshore and in the DIFC as well as on corporate and insurance related acquisitions around the Middle East region.

David recently advised a significant global corporation on the restructuring of its operations in the Middle East involving 23 companies and branches in 15 jurisdictions. This work, carried out over a 15-month timeframe, involved highly-complex ownership, regulatory, governance and operational issues.

David has also recently been involved with the acquisition by a large insurance entity of a GCC-based insurance company and is currently advising vendors on their disposal of a 20% shareholding in a Kuwaiti joint stock company to an internationally renowned private equity house.

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Prior to joining Clyde & Co in 2007, he worked for the law firm that advised the Government of Lebanon in relation to re-establishing the Beirut Stock Exchange (BSE). During that period he was part of the team responsible for drafting the new legislation for the BSE, as well as advising the government in relation to regulatory issues. He also worked over 5 years as an in-house general counsel.

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Elizabeth is a consultant for Clyde & Co's Latin American and Insurance/Reinsurance departments. She is admitted as a solicitor in England and Wales since 2002 and admitted as a Brazilian lawyer at the Brazilian Bar Association since 1992.

Elizabeth has a wide variety of experience in the areas of commercial litigation, arbitration and alternative dispute resolution.

Elizabeth specialises in international disputes with an emphasis on trade & commodities, energy, shipping, insurance and reinsurance and with a particular focus in Latin America. She has handled some of the largest reinsurance industrial, mining and energy losses in the London market in Latin America. Other types of claims often handled by Elizabeth in Latin America include BBBs, PFI and D&O claims. Given her Brazilian law qualification, she has also developed an expertise in Brazilian insurance and reinsurance law and the Brazilian insurance market practice generally.

Elizabeth is an active member of the Marine and Insurance Committees of the IBA (International Bar Association) and of the AIDA, International Association of Insurance Law. She is co-chair of the Insurance/Reinsurance Legal Service Group of the JETCO Group (Joint Economic Trade Committee). She often contributes articles to the specialist press such as the Lloyd's List and the Insurance Day and attends conference and seminars in the insurance and reinsurance sectors as a speaker.

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Hermes is a well-known international insurance and reinsurance lawyer. He has qualified both as a barrister and solicitor and he has over 20 years' experience working for leading insurers and reinsurers on high value disputes, particularly in Latin America, the Mediterranean basin, Asia and West Africa.

Within Latin America, he has led teams on major litigation relating to financial institutions, directors and officers claims, liability, construction / engineering and energy. He also advises clients on regulatory and corporate matters as well as on the formation and wordings for major projects.

Hermes is fluent in seven languages, including Spanish and Portuguese. He is a co-author of a leading textbook on Reinsurance Law, a co-author of the book, 'War Risks and Terrorism', a contributor to a textbook on Property risks and a vice president of the Insurance Institute of London. He lectures and writes extensively worldwide on key reinsurance matters and specialist risks and legal and forensic investigations.

Hermes is recommended by *Chambers and Partners* and *Legal 500*: "Hermes Marangos has impressed clients as a highly analytical lawyer with particular experience in Latin American , Middle Eastern and Far eastern issues" Chambers and Partners

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Richard is a senior partner specialising in disputes related to banking, insurance and financial institutions, and accountants' liability. He deals with large commercial disputes, international litigation and substantial professional negligence actions. He specialises in insurance law. He has also advised on claims relating to banking fraud and on UK litigation and regulatory issues.

Richard is the English legal advisor for the captive of a large international bank, and advises the captive on claims issues arising with the insured and insurers. He is trained as a mediator. He has written numerous articles and has given talks on subjects including the impact of the Human Rights Act on commercial litigation, insurance coverage issues and accountants' liability.

Richard is recommended by the *Legal 500* and *Chambers Guide to the Legal Profession*: "Richard Highley, specialising in insurance disputes related to banking, financial institutions and accountants' liability, is singled out as 'bright, flexible and supportive'." (*Chambers 2008*).

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Karen has a broad general insurance/reinsurance background. She is an experienced insurance litigator with a particular focus on insurance and reinsurance policy advice and claims, including directors and officers claims and financial institutions risks including Bankers' Blanket Bond, civil liability claims and regulatory investigations. Karen also has experience in professional liability defence work. She has advised on claims against professionals such as solicitors, accountants and project managers for their negligent advice

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Katia is dual qualified, being a member of the Brazilian and Portuguese Bars and admitted in England and Wales as a Registered European Lawyer. She was Head of Legal at one of the Brazil's leading insurance groups before coming to the UK to pursue an international career.

Katia is involved in insurance and reinsurance disputes involving both the London and Latin American markets, with a particular focus on directors and officers claims and financial institutions risks.

Katia advises on other non-contentious and regulatory issues concerning Brazil and Latin America and have worked extensively on analysis of wordings for financial institutions and directors and officers risks.

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Ignacio has extensive experience of

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Fluent in English and Catalan, he has written a number of insurance-related articles and has spoken at seminars and addressed conferences on the subject of directors and officers and professional indemnity insurance both in Spain and in the London market.

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His core practice areas are environmental liability, professional liability, fraud, fidelity bonds, construction liability and defending professional negligence claims on behalf of insurers.

Francisco has spent time working in our Spanish and London firms. He acts regularly as a speaker on subjects including insurance law and practice, civil liability, liability of directors and class actions. He has also written publications regarding claims made policies.

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Jose Luis' experience includes international transactions in Mexico and the United States. He has given legal assistance drafting, reviewing, negotiating and advising on the terms of contracts for architects, contractors, subcontractors, developers and financial groups.

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Mr Hershman's expertise includes accounting, auditing, financial investigations, M&A, and complex financial matters involving financial reporting and application of GAAP and statutory accounting principles. He has led his team in providing litigation consulting, expert testimony, and transactional consulting to successfully assist insurers, reinsurers, brokers and their counsel on dozens of high-stakes matters, including providing expert testimony before the SEC and state legislators and regulators.

Mr Hershman's insurance management experience includes responsibility for all financial, administrative and operational functions. He has provided advice and factual testimony through written and oral presentations at arbitrations, depositions and settlement conferences, and has written and served as panelist regarding arbitration and litigation support. His consulting and advisory support often involves cross-disciplinary collaboration with clients, their counsel and other practice areas within FTI Consulting, including Economic Consulting, Corporate Finance, and Technology.

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Brent received his J.D. degree in 1993 from the University of California, Hastings College of the Law in San Francisco, where he was a member of the Hastings Law Journal. He received his Bachelor of Arts in 1990 from the University of California at Los Angeles. Before joining Kilpatrick Stockton in 2003, Brent was a partner resident in San Francisco with a national firm. He is AV® rated by Martindale-Hubbell.

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Ed graduated from Duke University in 1968 and served as a supply officer in the United Stated Navy before entering law school. He received his J.D. degree, cum laude, from the University of Georgia School of Law in 1974, where he was Managing Editor of the Georgia Law Review. After law school and before joining Kilpatrick Stockton, he served as a law clerk in the United States District Court for the Northern District of Georgia.

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In addition to acting as defense or coverage counsel, Mr Rose also provides strategic advice and acts as monitoring counsel in complex matters which often involve multiple jurisdictions. He has been involved as well in the drafting, adaptation and interpretation of specialty risk insurance policies including those designed for directors and officers and financial institutions.

Mr Rose has also been involved in arbitrations and mediations in various fields, including insurance, products liability, construction and intellectual property matters.

Mr. Rose is listed in *The Canadian Legal LEXPERT® Directory* and in *The Best Lawyers in Canada* in the areas of product liability and insurance.

He received his BCL from McGill University in 1971, and is a member of the Quebec, Canadian, American and International Bar Associations, the Professional Liability Underwriting Society (PLUS), and the Defense Research Institute.

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In her insurance and litigation practice, Mrs Raphaël defends professionals such as investment advisors, insurance brokers, architects and trademark agents. She also specializes in the area of compliance and breach of the rules of ethics of investment advisors and of directors' and officers' liability. She has been involved in matters dealing with misrepresentation and fraud.

She also acts on behalf of manufacturers and vendors in defence of claims involving their products, and represents the interests of manufacturers regarding the implementation and management of product recalls.

She has argued cases before the Quebec Court of Appeal and the Superior Court.

Mrs Raphaël has given numerous training courses and is a regular guest speaker at conferences. She has been a guest lecturer for the Institut d'assurance de dommages du Québec and the Canadian Institute.

Mrs Raphaël is a member of the Young Leaders Circle of the Sainte-Justine UHC Foundation and a member of the Montreal Bar-Superior Court Liaison Committee of the Montreal Bar. She has been a lecturer at the Faculty of Law of the University of Montreal since 2006. She was actively involved for several years in the Young Bar Association and was a member of the board of directors.

She received her LLB from Université de Montréal in 1998, and is a member of the Canadian Bar Association, the Professional Liability Underwriting Society (PLUS), the Risk Management Association and the Montreal Association of Insurance Women.

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A relentless advocate for his clients' efforts to obtain coverage from their insurers, Bob was a leading participant in the early 1980s' birth of modern insurance law, when environmental and asbestos liability unleashed new strict and retroactive liabilities on corporate America. Bob continues to successfully navigate the firestorms of coverage litigation that ensue and has emerged as a leader in new areas such as cyber-insurance, D&O, IP, privacy and 'green' insurance.

Bob has served as the attorney of record in more than 30 reported insurance decisions. He co-authored *Insurance Coverage for Intellectual Property and Cyber Insurance Claims* and is co-editor in chief of the *Environmental Claims Journal*. Listed among *The Best Lawyers in America* and in *Chambers USA: America's Leading Lawyers for Business*, Bob earned his J.D. from Harvard Law School, c la de and his Ph.D from Princeton University.

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Sarah has represented clients including large public companies, officers, directors and boards in securities matters for 25 years including defending class action and derivative lawsuits in securities fraud and breach of fiduciary duty cases and in multijurisdictional litigation arising from change of control issues. She has represented clients in internal investigations and in SEC and other regulatory, and federal criminal investigations and lawsuits. She also represents clients in a wide variety of other civil and criminal matters, including complex commercial litigations for large public companies.

Sarah served as an Assistant US Attorney in the Criminal Division of the US Attorney's Office for the Southern District of New York for six years including in the securities frauds unit, and clerked for a federal judge for two years, prior to entering private practice.

Sarah has authored numerous articles on securities law, authors a column on securities law for *The New York Law Journal* and serves on several not-for-profit boards. She has been listed in *New York Super Lawyers* for securities litigation for many years. She is admitted to practice in New York and Florida as well as in several federal courts and the US Supreme Court.

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Marc E. Rosenthal is a partner in the Litigation & Dispute Resolution Department and the Insurance Recovery & Counseling Group and is resident in the Chicago office. He has significant experience as a litigator and corporate adviser and focuses on issues of insurance and reinsurance. Marc is listed in *Chambers USA*, and is described as 'key to bringing closure to many important negotiated settlements. He is quick to understand the positions and to recommend innovative ways to achieve resolution, and he follows this up with prompt and effective agreement preparation.'

Marc represents clients in insurance coverage matters involving first party, third party, D&O, environmental, toxic tort, business interruption, advertising injury, general liability and professional E&O coverage; reinsurance arbitration; commercial litigation; mediation; negotiation; coverage analysis; and claims counsel.

In addition, Marc advises and represents boards of directors concerning corporate governance; negotiation, placement and terms of D&O insurance and corporate indemnification; coverage analysis; liaison with insurance brokers, carriers and counsel; and bankruptcy issues.

Marc represents and counsels clients in matters involving formation and regulation of captive insurance companies; insurance company and insurance agency regulation, compensation and compliance; regulation, financing, and securitisation of viatical settlements and life settlements for providers, brokers and investors; and design and implementation of insurance-related products and programs for equipment manufacturers, financing companies, captives, real estate trusts, charitable organisations and service providers.

Lastly, Marc represents and counsels corporate clients concerning insurance company acquisitions and restructuring; insurance regulatory advice; risk management and insurance programme placement and negotiation; and insurance and reinsurance contract drafting and negotiation.

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Richard L. Spinogatti is a senior counsel in the Litigation & Dispute Resolution Department. Rich has more than 38 years of experience in federal and state courts in New York and other jurisdictions across the nation. In addition to litigating, trying cases, and arguing appeals at all levels, he has represented national and international clients in civil and criminal investigations, in administrative proceedings before federal, state and local government agencies, and before industry regulatory organisations. Rich also has consulted with clients on a wide variety of risk management issues.

Rich has tried numerous civil and criminal cases involving complex commercial transactions, including a broad spectrum of alleged violations of federal and state securities laws, state antitrust law, ERISA, OSHA, the Internal Revenue Code, consumer protection statutes, and common law claims. He has represented publicly-traded and privately-held corporations, audit committees and individual directors and officers. Rich also has represented general and limited partnerships, limited liability companies and limited liability partnerships.

Through his extensive representation of international, national, regional and local accounting firms, Rich has developed a broad knowledge of accounting, auditing and related professional services, and the complex regulatory structure governing the accounting profession. As a result, Rich is frequently called upon to consult with accountants and other professionals in pre-litigation contexts to avoid or minimise exposure risks. He has lectured and taught seminars for partners and employees of accounting firms on subjects ranging from accountants' liability to litigation support. Rich also has advised and represented accounting firms in mergers and acquisitions and in structuring cutting-edge strategic alliances with financial service organisations.

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Wolfgang is a graduate of the University of Munich and between 1988 and 1993 worked for the central legal department of Bayerische Beamten Lebensversicherung (becoming the head of legal in 1991).

Wolfgang is a member of the German Insurance Law Association and has been regularly quoted in *Legal 500* and *European Legal Experts*.

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He studied law in Munich and Paris and took his doctor of laws degree in international commercial law with Prof. Bruno Simma. Dirk joined Taylor Wessing in 1999.

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Steven A Rosenblum joined the law firm of Wachtell, Lipton, Rosen & Katz in 1983 and became a partner in the corporate department in 1989. He specialises in mergers and acquisitions, buyouts, takeover defence, corporate governance, risk management, shareholder and hedge fund activism, proxy fights, joint ventures, restructurings and securities law. Mr Rosenblum has extensive experience representing major companies in each of these areas. He has been recognised by *Chambers Global* as one of the world's leading transactional lawyers.

Mr Rosenblum received his J.D. from Yale Law School in 1982 and his B.A. from Harvard College magna cum laude and Phi Beta Kappa in 1978. Prior to joining the firm, he was a law clerk to the Honorable Joseph L. Tauro, United States District Court Judge for the District of Massachusetts.

Mr Rosenblum also has written and participated in panels on a number of topics, including mergers and acquisitions, shareholder and hedge fund activism, proxy reform, corporate governance, risk management and corporate disclosure.

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Gareth is a director and head of Werksmans' Commercial department. He specialises in mergers and acquisitions (M&A), corporate finance and structuring; corporate governance; exchange control; financial services regulation; international transactions; listings/flotations; leveraged and management buy-outs; mining transactions; private equity, public offerings and private placements, and black economic empowerment transactions.

Under Gareth's leadership, Werksmans' M&A practice has, for a number of years, headed the league tables and been recognised as the most active South African law firm in M&A transactions by a number of credible local and international ranking organisations, including DealMakers and Ernst & Young.

Gareth obtained his BA, LLB and LLM with distinction from the University of the Witwatersrand. He joined Werksmans in 1994 and became a director of the firm in 1997. Gareth has headed up the firm's Commercial department since 2003.

Shaun Teichner

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Shaun is a director in Werksmans' Commercial department. He specialises in mergers and acquisitions, securities and equity capital markets, advising on black economic empowerment transactions, leveraged and management buy-outs, private equity transactions, trade deals, public offerings and private placements. Shaun joined Werksmans in 2003 and became a director in 2008. Shaun obtained a BCom and LLB with distinction from the University of the Witwatersrand and an LLM from Harvard University.

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Eoin is a partner in William Fry's Insurance department. He joined the firm in 1995 having worked with J P Morgan Chase and Bank of Ireland International Banking. His practice involves a combination of insurance and reinsurance work, both on the non-life and life side, together with a general corporate and financial services client base.

Eoin is a member of the Insurance Institute of Ireland; the British Insurance Law Association; and the Dublin Solicitors Bar Association. He lectures on the commercial and business law courses at the Law Society of Ireland and at the Institute of Chartered Accountants. In addition to his legal qualifications he holds an MBS (Financial Services) and affiliations to the Association of Corporate Treasurers (UK) and the Society of Actuaries of Ireland.