D&O insurance in a global context

Have you got it covered?

Jane Harte-Lovelace and Sarah Turpin consider the current climate for directors' and officers' (D&O) claims in Europe, and the issues of concern for companies when taking out D&O insurance cover in the UK market for the benefit of their global operations.

Illustration: Domonic Li

In today's highly regulated and litigious climate, directors and officers are subject to increasing scrutiny, not only by shareholders but by regulators, government bodies and criminal investigators. The US has witnessed a proliferation of securities class actions in recent years combined with follow-on ERISA (Employee Retirement Income Security Act) lawsuits and shareholder derivative actions. A number of the securities class actions filed in the US have involved European companies, including Parmalat,

The NatWest Three

The "NatWest Three", David Bermingham, Giles Darby and Gary Mulgrew, are three British bankers who worked at NatWest's investment banking arm. The three were extradited to the US in July 2006 on wire fraud charges involving collapsed US energy giant, Enron. It was alleged that the three men had advised NatWest to sell its stake in Swap Sub, an investment company, to a company controlled by the Enron Chief Financial Officer, Andrew Fastow, for less than it was worth. Mr Fastow then sold Swap Sub on to Enron at its true value and paid US$7.3 million (GB£3.5 million or about EUR5.1 million) from the transaction to the three men.

The trio originally faced possible sentences of up to 35 years in prison but, following a recent plea bargain, this has now been reduced to around 37 months. They will also have to pay the GB£3.5 million back to NatWest.

Royal Dutch/Shell, Vivendi and Daimler Chrysler. In 2005, two of the ten largest class action settlements involved foreign issuers: Deutsche Telecom AG (US$125 million (about EUR85 million)) and Royal Ahold NV (US$1.1 billion (about EUR725 million)).

US government regulators and prosecutors, particularly the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ), have become increasingly active, and the long arm of US jurisdiction is such that directors of non-US companies face heightened scrutiny, even where links to the US are tenuous. The NatWest Three is the classic example of US prosecutors exerting jurisdiction over non-US citizens even where the allegedly criminal conduct took place outside the US and against a non-US company (*see box, The NatWest Three*).

It is clear that directors' and officers' (D&O) claims are already an issue in the US, but the extent to which such claims and investigations are underway in Europe is less clear. This article considers:

- The current climate for D&O claims outside the US.
- The issues of concern for companies when taking out D&O insurance in the UK market for the benefit of their global operations.

D&O claims: the current climate

There has been much talk in recent months about the globalisation of class action culture. It is perhaps no coincidence that, while the number of securities class actions filed in the US is on the decline, US law firms are said to be gearing up for class actions in Europe.

Class actions are not currently a feature of the litigation landscape in Europe and there are good reasons for this. In Europe, the procedures available for bringing actions on behalf of a group tend to involve "collective" actions, by named individual plaintiffs or consumer associations, rather than actions by a generic class. Claimants must expressly "opt in" to an action in Europe. In the US, potential claimants must "opt out" of the class as certified by the court; if they do not do this then they will ordinarily be bound by any judgment given in the action.

There has been much debate in some European jurisdictions about whether there should be greater scope for class actions to be brought. At present, for instance:

- In the UK, the Group Litigation Order (GLO), first introduced in 2000, enables a group of common claims to be managed as a single case where there are common issues of fact or law, but any claimant wishing to participate in the group action must "opt in" by a date specified by the court. The GLO procedure is designed mainly as a way of managing group actions rather than specifically promoting the bringing of such claims. The take up of GLOs has been fairly modest since they were first introduced. The procedure appears to have been used mainly for product liability and personal injury claims.
- In Germany, the concept of group actions was only introduced in 2005 when a test case for group actions in capital market cases (Law on the Introduction of Capital Investor Representative Proceedings 2005 (*Kapitalanleger-Musterverfahrengesetz*) (KapMuG)) was enacted which, if accepted as part of the German Civil Procedural Code, will apply to all civil claims.
- In France and Italy, there is no class action procedure at present. However, in Italy there are options available for consumer groups and there have recently been political initiatives in both countries to introduce some form of class action procedure.

The European Commission has also voiced its support for the use of group actions as a means of enforcing EC competition laws.

The question being asked by many is whether Europe is about to see securities class actions on the scale of those seen in the US. In practice, it seems likely that most European jurisdictions will seek to avoid the excesses seen in the US by imposing restrictions on the procedure for bringing class actions and on the type of action that can be brought. In any case, there are a number of factors present in the US legal system that have facilitated the widespread use of class actions which are not matched in Europe. These US features include:

- The existence of contingency fees.
- The absence of the "loser pays" principle.
- The prospect of punitive damages.

As matters stand at present, if there is any connection with the US, shareholders are likely to face greater prospects of recovery by joining securities class actions in the US than by pursuing claims within their own jurisdiction. This is despite the apparent jurisdictional hurdles.

In recent years, some US courts have allowed non-US shareholders to participate in securities class actions against foreign issuers: examples include Vivendi, Royal Ahold and Royal Dutch/Shell. In the latter case, which arose out of the restatement by Shell of its oil reserves, the company filed a motion to dismiss claims by non-US shareholders on the grounds of lack of subject matter jurisdiction. The court allowed the non-US investors to remain part of the class on the basis that misstatements by Shell to analysts and investors in the US affected both domestic and foreign issuers, US market activity having become "an example for foreign investors and exchanges". The court dismissed as "speculative" the argument that there was no guarantee any judgment given in the US would be enforceable in the home coun-

Claims against directors in the UK: recent developments

The Companies Act 2006 has, with effect from October 2007, removed some of the restrictions under the current law to enable shareholder derivative actions to be brought against both present and former directors on the grounds of negligence, default, breach of trust or breach of duty. There has been much speculation as to whether the new legislation will result in a proliferation of derivative actions. However, there are two factors that are regarded as something of a safeguard:

- The permission of the court is needed to continue a derivative action. Permission will be refused if the company has already ratified the alleged wrongdoing or if the court is satisfied that a person seeking to promote the success of the company would not pursue the claim.

- Derivative claims are brought for the benefit of the company and the claimant cannot recover damages for any losses alleged to have been suffered by him personally. This factor in particular seems likely to discourage the majority of shareholders but shareholder activists or special interest groups, whose main aim is to achieve publicity, may not be deterred even if they are unlikely to make it beyond the permissions stage.

The duties owed by directors have been codified by the Companies Act 2006 as follows:

- Duty to act within powers (in force on 1 October 2007).

- Duty to promote the success of the company (in force on 1 October 2007). The directors must have regard to the following factors with regard to this duty:

  - the likely consequences of any decision in the long term;

  - the interests of the company's employees;

  - the need to foster the company's business relationships with suppliers, customers and others;

  - the impact of the company's operations on the community and the environment;

  - the desirability of the company maintaining a reputation for high standards of business conduct; and

  - the need to act fairly as between members of the company.

- Duty to exercise independent judgment (in force on 1 October 2007).

- Duty to exercise reasonable care, skill and diligence (in force on 1 October 2007).

- Duty to avoid conflicts of interest (in force on 1 October 2008).

- Duty not to accept benefits from third parties (in force on 1 October 2008).

- Duty to declare interest in proposed transaction or arrangement (in force on 1 October 2008).

These duties are intended to reflect the existing common law duties with one notable addition: the duty to promote the success of the company. It is this particular duty, combined with the factors that the director is required to take into account, which has prompted the most debate. The concern is that the requirement for directors to take into account factors such as the impact of the company's operations on the community and the environment will result in claims by shareholder activists making use of the new derivative procedure.

tries of foreign investors and would therefore result in duplicative litigation.

The securities class action relating to Royal Dutch/Shell, like many such actions in the US, was accompanied by a derivative action on behalf of investors seeking changes to the management of the company. This type of shareholder derivative action is rarely seen in Europe. However, this may change in the future, particularly in the UK, which has recently removed some of the restrictions under the current law to facilitate shareholder derivative actions against both present and former directors (*see box, Claims against directors in the UK: recent developments*).

Another source of claims against directors, apart from claims by shareholders, is claims by the company itself. In many European jurisdictions, the duties imposed on directors are owed mainly to the company, which makes the company the most obvious source of claims. In practice, however, such claims are more likely to be brought where the company is insolvent or where the directors in question have resigned. In the UK, in the case of Equitable Life, the company sued 15 former directors for the sum of GB£1.7 billion (about EUR2.4 billion or US$3.5 billion) in a claim that ultimately collapsed but only after the directors in question were subjected to costly, protracted and stressful litigation. There is concern that the codification of directors' duties under the Companies Act 2006 will result in claims like Equitable Life becoming more commonplace (*see also box, Claims against directors in the UK: recent developments*).

The duties owed by directors have also received attention elsewhere in Europe. In Spain, for example, a voluntary corporate code of governance (the Unified Good Governance Code, also known as the Conthe Code) was introduced in May 2006. The Code recommends a stricter definition of a director's duties of loyalty to the company and extends that duty to shadow directors and controlling shareholders. While the code remains voluntary, all listed companies will have to explain any failure to comply with its provisions in their annual general reports from 2007. In Italy, more stringent measures regarding directors' duties and liabilities were introduced during 2003 as part of an overall reform of Italian corporate law. Of particular importance was the change from the "reasonable man" to the "professional man" standard used when assessing the performance of a director in regard to duties owed.

Recently introduced criminal offences in the UK

Recent legislative changes that introduced additional criminal offences in the UK include:

- The Environmental Protection Act 1990, notably Part IIA, which came into force in April 2000 and imposed personal responsibility on individuals who cause or knowingly permit contaminating substances to be present in, on or under land. This could result in such individuals being liable for remediation costs as well as compensation claims.

- The Enterprise Act 2002, which made cartel activity a criminal offence for which individuals can be punished with up to five years' imprisonment and unlimited fines. In May 2007, eight executives from the UK, France, Italy and Japan were arrested in the US in connection with investigations being undertaken jointly by the UK Office of Fair Trading, the European Commission and the US Department of Justice into alleged cartel activity relating to marine hose.

- The Corporate Manslaughter and Homicide Act 2007, which introduced a new statutory offence of corporate manslaughter. While directors cannot themselves be convicted of this offence, a company can now be found guilty of manslaughter if the way in which its activities are organised by senior management is a substantial element of the breach of duty of care that caused a person's death. This increases the burden on directors to ensure that there are stringent health and safety procedures in place. It could also result in claims against directors, possibly in the form of derivative actions, on the basis that the conviction and resulting fine occurred because of failings of senior management.

Only time will tell whether claims against directors will increase in Europe but, in the UK, the increased focus on directors' duties coupled with the new found ability of company auditors to limit their liability for breach of duty may well have a knock-on effect. Up until recently, company auditors were the main target in the event of any financial scandal but increased awareness of the existence of D&O insurance, combined with greater focus on the role and responsibility of directors, may make directors a more obvious target.

Directors are also facing increased scrutiny from regulators and criminal investigators. In the UK, for instance, regulators including the Financial Services Authority (FSA), the Office of Fair Trading (OFT) and the Health and Safety Executive (HSE) are focusing increasingly on the conduct of senior management. Directors face exposure in a number of different areas including health and safety, pollution and the environment, competition and cartel activity. This is partly the result of recent changes in UK legislation that have resulted in the introduction of new criminal offences (*see box, Recently introduced criminal offences in the UK*). Directors may be unaware of these new offences but still find themselves at the centre of an investigation or prosecution.

It remains to be seen whether the future climate for D&O claims is as bleak as some suggest. Much may depend on the future economic climate and the proliferation of market scandals, which inevitably puts the spotlight on directors, as seen with the following:

- The practice of stock options backdating which led to widespread investigations and shareholders' class actions in the US.

- The alleged cartel activity in relation to fuel surcharges, which has led to class actions by passengers in the US against British Airways (BA) and its executives. Both the OFT and the DOJ are considering possible criminal prosecutions against BA executives.

- The recent problems arising from sub-prime mortgage lending, which have resulted in securities class actions in the US against sub-prime lenders and their directors and officers. This may have a knock-on effect in Europe.

In times like these, D&O insurance can prove invaluable.

D&O insurance: issues of concern

The wording of D&O policies varies enormously. Most D&O insurers in the London market have their own standard policy wordings, which means a thorough examination of the policy language is critical to ensure that the cover meets the needs and expectations of the company and its directors. This is particularly relevant in the context of global cover, where it is important to ensure that the policy wording takes account of differing legal requirements in the various jurisdictions covered and the differing claims and liabilities faced by the directors.

Up until recently, most UK companies would take out a single global policy to provide D&O cover for their worldwide operations. Some jurisdictions do, however, require insurance to be taken out locally by "admitted" insurers and local laws regarding the availability and enforceability of D&O cover need to be taken into account. Multinational companies may be required to take out a master policy together with local policies in those jurisdictions where local cover is required.

Within the EU, this is not likely to be an issue as EC regulations provide that a policy written in one member state should be valid in another. However, there are likely to be other considerations that need to be taken into account to ensure that the master policy operates effectively within each of the jurisdictions covered. These factors include:

- Director indemnification.

- Policy definitions.

- Claims notification.

- Who has the obligation to defend the claim.

- Dishonest or fraudulent conduct.

Director indemnification

Most D&O policies are structured around the indemnification provided by the company to its directors and officers. There are three main types of D&O cover:

- **Side A.** This covers the liabilities of the directors and officers to the extent that they are not indemnified by the company.

- **Side B.** Again, this covers the liabilities of the directors and officers but only to the extent that they have been indemnified by the company. Side B cover there-

Checklist: factors to consider when checking adequacy of global D&O insurance cover

✓ Thoroughly examine the policy language to ensure that the D&O cover meets the needs and expectations of the company and its directors. In the context of global cover, make sure that the policy wording takes account of differing legal requirements in the various jurisdictions covered and the differing claims and liabilities faced by the directors.

✓ Ensure that directors are aware of the extent to which the company has agreed to indemnify them. Directors should also ensure that indemnification agreements are appropriate and reflect any legal restrictions or requirements.

✓ Check the D&O policy for consistency with the indemnification arrangements and remove or modify any "presumptive indemnification" language.

✓ Ensure that all identifiable claims are covered by the policy. The D&O policy typically provides an express definition of the term "claim"; that definition should be sufficiently broad to cover the differing types of claim (civil, criminal and regulatory) likely to arise in any of the relevant jurisdictions.

✓ Check whether the policy covers the cost of fighting extradition and the cost of funding bail bonds.

✓ Put procedures in place to ensure compliance with the policy's claims notification provisions (such provisions specify the period of time in which claims have to be notified to the insurer and can vary depending on the policy). Ensure proper chains of communication are in place and consider the need for changes to the claims notification provisions to reduce the scope for non-compliance.

✓ In the event of a claim, the D&O policy should ideally provide for the directors to select their own defence lawyers and for the appointment of separate lawyers if there is a conflict of interest between any directors involved in the claim.

✓ Request appropriate "severability" language in the policy to ensure that the wrongful acts of one insured cannot be attributed to another to determine whether cover is available. This seeks to ensure that the fraud or dishonesty of one director will not impact on the cover available to other "innocent" directors.

fore operates to reimburse the company to the extent that it has indemnified its directors and officers.

■ **Side C.** This covers the liabilities of the company itself but the cover may be subject to limitations, for example public companies usually only have cover for securities claims. If Side C cover is not taken out then claims against the company will not be covered under the D&O policy. Most companies only take out Side A and Side B cover.

It is important, given the way in which D&O cover is structured, that directors are aware of the extent to which the company has agreed to indemnify them. This is particularly important in the context of a global policy as, depending on the country of incorporation, different indemnification standards may well apply.

The scope and availability of corporate indemnification varies between different jurisdictions. In the UK, for example, the Companies (Audit, Investigations and Community Enterprise) Act 2004 (now incorporated into the Companies Act 2006) broadened significantly the extent to which companies can indemnify directors in respect of civil and criminal claims and regulatory investigations. In other jurisdictions, such as France and Germany, the ability of companies to indemnify directors is more limited. In some jurisdictions, the law does not require indemnification or is silent on the issue, for example in Switzerland.

The question of whether a particular claim is covered by indemnification will determine whether or not it falls under Side A or Side B of the D&O cover. D&O insurers typically impose a retention or excess that applies in relation to Side B claims (and is payable by the company) but not in relation to Side A.

Some D&O policies also include what is known as a "presumptive indemnification" clause which presumes, for the purpose of policy cover, that the company will indemnify the director to the maximum extent permitted by law. The effect of this is that, regardless of whether the company has indemnified, any claim that can be indemnified will fall under Side B where the retention applies. This could result in a gap in cover if the company has not agreed to indemnify to the maximum extent permissible and the company is unable or unwilling to do so. The director will then have to fund the retention out of his own pocket.

Similar considerations may apply if the law does not expressly prohibit indemnification, or is silent on the issue, as D&O insurers might argue that all loss is potentially indemnifiable and falls under Side B where the retention applies.

In most cases it is preferable, from the directors' point of view, to ensure that appropriate indemnification agreements are in place which reflect any legal requirements. The D&O policy wording should also be checked for consistency and any "presumptive indemnification" language removed or modified to avoid any potential gaps in cover.

Policy definitions

D&O policies are normally written on a "claims made" basis, which means they cover claims made and notified to insurers during the policy period (or during an extended discovery period). It is particularly important in the context of a global policy to ensure that all identifiable claims are covered. The D&O policy typically provides an express definition of the term "claim" and the definition should be sufficiently broad to cover the differing types of claim (civil, criminal and regulatory) likely to arise in any of the relevant jurisdictions.

D&O policies usually provide additional cover for costs incurred in relation to regulatory investigations. The cover provided in relation to such investigations is potentially one of the most important

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aspects to be considered, as significant costs can be incurred by individual directors caught up in these types of investigation, who often wish to seek independent legal advice.

Many D&O policies impose restrictions as to the type of investigations that will be covered and at which stage of the investigations cover will be triggered. It is important in the context of global cover that these restrictions do not make assumptions about the way in which investigations are conducted which could prove unworkable in certain contexts. An apparently minor difference in wording can make a significant difference in terms of the amount of costs recoverable.

Most D&O policies define "claim" to include criminal proceedings but the publicity surrounding the NatWest Three prompted many questions about whether the costs of fighting extradition are covered under D&O insurance. In theory, if defence costs relating to criminal proceedings are covered, then the costs of fighting extradition to a foreign jurisdiction to avoid criminal prosecution should fall within defence costs. Some D&O insurers have acknowledged this but some are now providing express cover for the costs of fighting extradition. If, however, there is a US exclusion then the costs of fighting extradition to the US would also be excluded, unless there is a specific carve out in respect of such costs. While a US exclusion may reduce the premium, this could prove to be a false economy bearing in mind the willingness of US prosecutors to look outside their own jurisdiction.

Some D&O insurers are also providing cover for the cost of funding bail bonds and security bonds, where acceptable for the purpose of being released on bail. This can be an important consideration in some jurisdictions where criminal proceedings can be protracted and there may be a lengthy period between charges being brought and the actual trial. From the directors' point of view, this cover could prove invaluable if the company is unable or unwilling to fund the bail bond.

Claims notification - potential pitfalls

As D&O policies are written on a "claims made" basis, they typically include express provision regarding the notification of claims to insurers. Claims normally have to be notified either within a specified period, or "promptly" or "as soon as practicable". Such provisions are often expressed as conditions precedent to the liability of D&O insurers, which means that failure to notify within the requisite period can result in claims being rejected, even if insurers have not suffered any prejudice as a result.

It is therefore essential that procedures are put in place to ensure compliance with the claims notification provisions. This is particularly important where the policy provides global cover. The danger is that a foreign subsidiary, despite being aware of the claim, will not immediately notify its head office with the result that there is a delay in notifying D&O insurers, who may then seek to deny cover. It may be worth seeking improvements to the claims notification provisions with a view to restricting the scope for non-compliance.

D&O policies normally provide for the notification not only of claims but of "circumstances which might give rise to a claim". In policies with sufficiently broad notification provisions, any claim that later arises from a circumstance notified during the policy period will then be deemed to have been notified during the policy period. The provisions in some policies are fairly stringent and require the notification to include details of the type of claims anticipated and the parties involved.

It is essential to ensure compliance with such provisions; if the circumstance is not accepted as properly notified, it may be excluded on renewal of the policy, either specifically or under a general exclusion in respect of any circumstances known to the insured before the inception or commencement of cover. There is therefore a real danger that, if claims are anticipated but not notified to D&O insurers, they will fall into a black hole where no cover is available. As a result, it is important that directors of all subsidiaries are aware of the notification requirements, both in terms of claims and circumstances or matters from which claims are anticipated.

The defence of the claim

D&O policies typically provide that the insured will defend any third party claim. This is different from professional indemnity policies where the insurer normally defends the claim and will appoint its own chosen lawyers to represent the professional in its defence.

Despite the fact that the defence obligation rests with the insured, some D&O insurers seek to impose lawyers from their chosen panel even though the policy may not specifically provide for this. Most directors, when faced with civil, criminal or regulatory action, prefer to appoint lawyers they are familiar with or to at least be able to select lawyers who have both the relevant local expertise and a reputation for successfully defending that type of claim. Ideally, the D&O policy should provide for the directors to select their own lawyers and for the appointment of

separate lawyers in the event of a conflict of interest between any directors involved in the claim.

D&O policies normally provide for the reimbursement, or preferably advancement, of defence costs as they are incurred, but only those costs incurred with the "prior written consent" of insurers. This is another reason why the prompt notification of claims is important as costs incurred before consent is given may not be recoverable.

Once a claim has been notified, some D&O insurers seek to impose their own defence costs guidelines or litigation management guidelines. These guidelines:

- Usually impose restrictions regarding the costs and disbursements that insurers are prepared to cover and the costs breakdowns that the appointed lawyers must provide.

- Are not normally contractually agreed but insurers seek to justify them on the basis that only costs that they regard as "reasonable" are covered under the policy.

In practice, such guidelines can prove overly restrictive. Lawyers in some jurisdictions where methods of time recording are less sophisticated may find it difficult to comply with them. As a result, it may be worth asking D&O insurers at the outset whether they will seek to impose any restrictions in the form of defence costs guidelines. D&O insurers are more likely to agree changes to such guidelines at the pre-contract stage than when a claim has already been made.

Dishonest or fraudulent directors

The D&O policy provides cover for a number of different insureds. One of the potential problems arising from this is the extent to which dishonest or fraudulent conduct on the part of one director will impact on the cover available to other innocent directors. There have been a number of cases in the US where D&O insurers have sought to rescind D&O cover against all of the directors on the grounds of fraudulent conduct, for example in the cases of Enron and Worldcom.

Under English law, a typical D&O policy is likely to be treated as a composite policy comprising separate contracts of insurance with each director. This means that, in theory, the fraud or dishonesty of one director should not impact on the cover available to other directors. In practice, it is worth requesting appropriate "severability" language in the policy to ensure that the wrongful acts of one insured cannot be attributed to another to determine whether cover is available.

Have you got it covered?

The reality is that the only way to ensure that policy cover is sufficient is to conduct a detailed review of the policy wording. Minor variations in the wording can have a significant impact on the scope of cover available and it is particularly important in the context of global cover that local regulatory and other requirements are taken into account. D&O claims on the scale of those seen in the US may not have arrived in Europe but times are changing and it is important that D&O cover takes account of the evolving landscape.

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