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# Directors' & officers' liability

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# Shifting sands of D&O liability

New anti-corruption laws and the financial climate are having an impact on the pricing and expectations of directors' and officers' cover

**T**HE FINANCIAL CRISIS, WHICH peaked in 2008, continues to shape directors' and officers' (D&O) liability in several ways. One is a shift in regulator behaviour. With the threat of investigations and enquiries of most concern to directors and officers, it is clear a new era of assertive regulators with the power and will to enforce is dawning.

The tough economic climate and ongoing eurozone crisis is also fuelling D&O litigation, particularly as a result of insolvencies and securities actions. While dominated by financial institutions, sectors such as manufacturing and construction also continue to be hit by claims frequency and severity.

### Bribery action anticipated

One area to watch is an expected uptick in claims alleging violation of anti-bribery laws, such as the US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act 2010. Governments may pursue individuals for infringing these laws.

JLT head of management and transactional liability Michael Lea says: "There's certainly a higher incidence of people being named and requested to attend investigations [under the FCPA]. We're finding that people who step forward to represent the company at an investigation want their own legal

representation, as opposed to representation being used by the company. And that's expensive."

Although the UK Bribery Act has made it easier for the Serious Fraud Office (SFO) to prosecute, the powers have been introduced at a time when the SFO's resources have been cut and investigations into the manipulation of the Libor (London interbank offered rate) have taken centre stage. Nevertheless, Duncan Wiggetts, a partner in the securities litigation practice at law firm Dechert, expects to see more bribery action.

"Directors are under more threat than five or six years ago as a result of people being more willing to come forward and make whistleblowing allegations," he says. "We're seeing a greater willingness. That's partly because of people feeling bolder as a result of new, improved policies and procedures, encouraging the reporting of wrongdoing on the back of the Bribery Act."

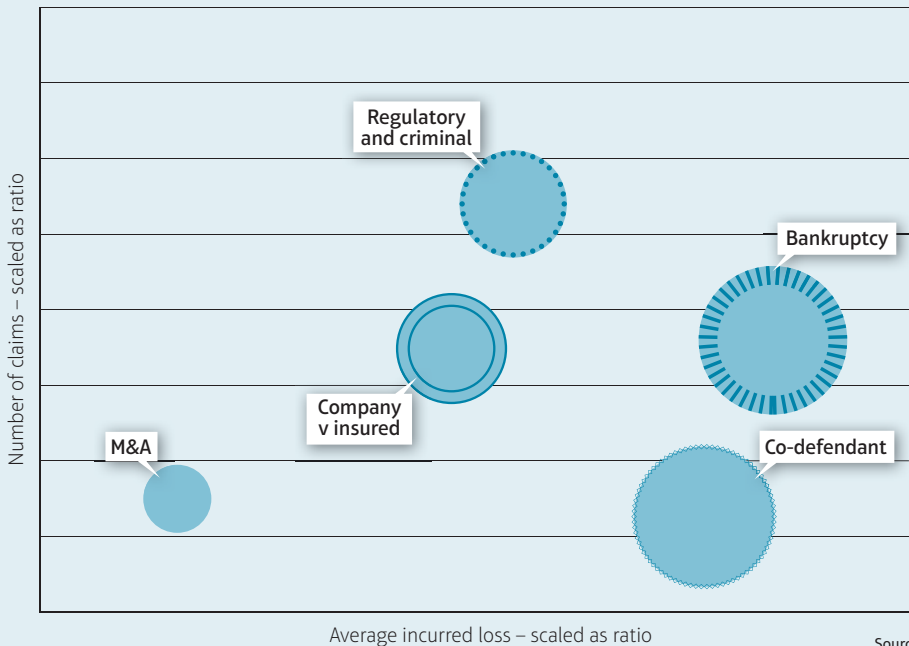
The SFO arrested three individuals last year as part of a global investigation into Libor. The investigation shows that regulators from different jurisdictions are increasingly willing and able to work together to mount cross-border investigations. "Regulators in the UK will tell you they had to beg and plead for help from other agencies, even five

## TOP FIVE

Commercial sectors with the highest claims paid/incurred in Europe (excluding financial institutions):

- Manufacturing
- Pharmaceutical
- Real estate development and construction
- Energy and power
- Hi-tech and telecoms

Exposures faced by all types of companies in Europe, private or publicly traded, but excluding securities-related claims



Source: AIG

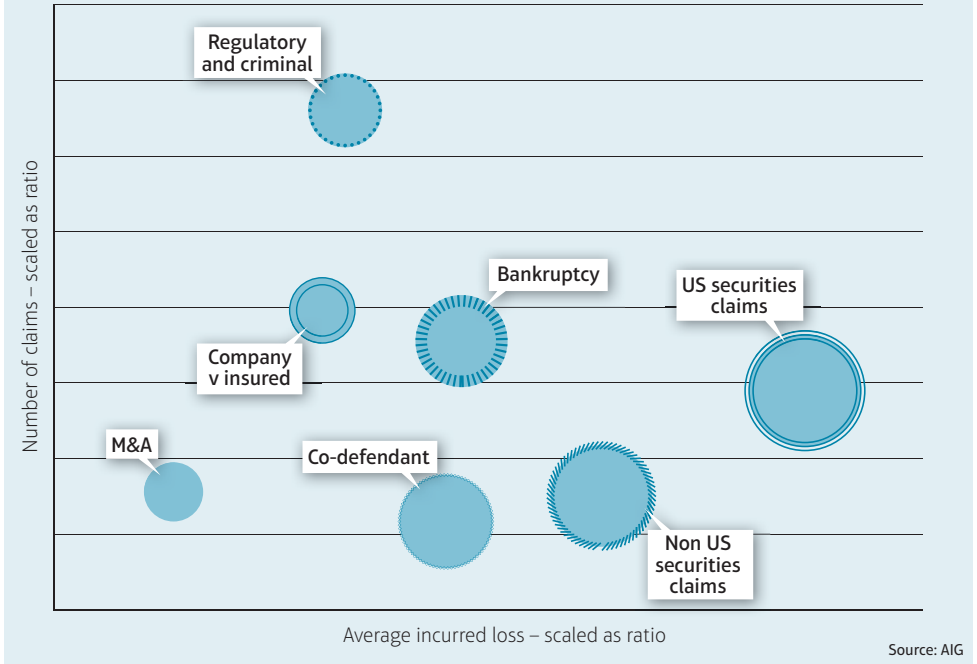
or six years ago,” says Wiggetts. “Now, there is daily information-sharing, allowing regulators to act very quickly and assemble a co-ordinated action.”

The type of organisation looking to purchase D&O cover has broadened substantially over the past decade. Once

primarily the concern of multinationals with a US presence, public European companies increasingly view D&O as essential insurance cover. It is also gaining traction with private companies. In its *State of the European D&O Market: 2013* white paper, Advisen notes that even »

# INTRODUCTION

Exposures faced by all types of companies in Europe, private or publicly traded, including securities-related claims



*Now, there is daily information-sharing, allowing regulators to act very quickly'*

**Duncan Wiggetts** Dechert

- » during the economic downturn, when overall non-life premium fell as companies cut insurance purchasing, take-up for D&O continued to rise.

### Plentiful capacity

Despite the shifting sands of D&O liability, with the exception of financial

institutions and loss-hit accounts, D&O pricing remains competitive and capacity plentiful.

"The ongoing financial situation is not a factor for most sectors," says Airmic technical director Paul Hopkin. "But for those at the heart of the crisis, it has affected D&O rates."

With plentiful capacity available, he thinks the insurance buyer is in a good position to ensure they have breadth of cover. "It's for the insurance buyer to make sure that when they renew their D&O policy, if other insurers are offering better coverage such as regulatory investigation, the buyer should make sure additional coverage is part of the renewal package they're offered." **SR**

# Going the distance

Directors and officers taken to court will not only need resilience and nerves of steel to see the claim through, but also financial stamina

**T**HE AVERAGE DIRECTORS' AND officers' (D&O) claim can take between five and seven years to resolve, sometimes longer. Having the stamina, typically with the help of insurance, to sustain a legal defence can make all the difference.

When a D&O claim is brought against a company's director, a decisive and robust response is essential. It can be difficult for strong-minded directors to take expert advice and guidance, particularly when they are facing difficult allegations, but care must be taken not to harm their defence.

JLT head of management and transactional liability Michael Lea says: "Directors who have never been sued before are often frightened. What happens after you notify a claim, and how the insurer treats you, is important.

"The number one thing for this team at JLT is claims certainty. We have a complementary claims protocol that goes with the policy. It says the following solicitors are pre-approved and you can get them involved early and mitigate your position."

### Help with claims

"Communication is key," Lea says. "We have monthly meetings on the claim. When the client gets an invoice from



## KEY POINTS

- A decisive and co-ordinated defence strategy is essential, with directors willing to take expert advice and guidance
- Claims – particularly regulatory claims – can take a long time to resolve. This is stressful and expensive for defendants
- With D&O insurance, directors need not be concerned about having the resources to defend themselves through lengthy proceedings

» their law firm they need to know what information underwriters need to process that invoice, otherwise the underwriters are bound to query it. We bridge those communication gaps and make sure everybody is on the same team and insurers are not taking an unnecessarily adversarial position on something that might actually be a victory.”

An experienced claims team can assist with settlement opportunities, interaction with lawyers and in navigating difficult investigations. Investigations by regulators can be particularly daunting, with such cases often long running and expensive to defend. Mock interviews can help directors rehearse for interviews with the regulator and bring out the most important points in their defence.

### Favourable results

Having the stamina to go the distance through a prolonged legal dispute is also important.

AIG Europe head of commercial management liability and fidelity Géraud Verhille says: “The better your defence and the longer you can keep on

.....  
*‘Financial stamina  
is a key factor  
for any director  
or officer’*

**Géraud Verhille** AIG

paying the bills of your legal counsel the more likely you’ll get a favourable result. It might seem like an obvious thing to say, but that costs a lot of money. Financial stamina is a key factor for any director or officer, and insurance is a reliable source of it.

“If directors and officers are looking for the strongest available protection in the face of the growing number of claims notifications and their diversity, they should seek to access ‘any one claim’ reinstatement, as opposed to aggregate policy limits.

“This enables them to secure a new limit for each unrelated claim and have the peace of mind of using their lead insurer’s claims expertise each time. However, few insurers offer this in the market.

“If you know you have the ability to sustain a defence and take it through first instance to appeal if necessary, this can change the dynamics between claimant and defendant,” he says. “It is not systematic of course, but we’ve observed many cases where the appeal court decision has been materially more favourable than in the first instance.” **SR**





## Bankruptcies fuel litigation

Administrators are increasingly looking to D&O policies to pick up the tab, especially in western Europe

**I**NSOLVENCIES CONTINUE TO DRIVE directors' and officers' (D&O) claims, especially in continental Europe, as administrators see this class of insurance as a way to satisfy creditors.

The hangover from the global economic downturn continues to cast a shadow over the whole of Europe, with insolvencies still responsible for the biggest source of D&O claims. Overall claims

frequency remains markedly higher than it was before the financial crisis.

"We saw a big peak between 2008 and 2010, and it started coming down a bit in 2011, but still the 2012 level of claims notifications is far in excess of what we'd see in 2007 or before that," says José Martínez, major claims manager for financial lines at AIG Europe. "So the figure is still at a historic high level, but it »



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» is coming down a little bit from the peak years, such as 2009.”

In western Europe, the sovereign debt crisis had the peripheral states of the eurozone firmly in its grip in 2011-12. The PIGS (Portugal, Ireland, Greece and Spain) are among the countries seeing big increases in corporate insolvency over the past two years, according to a survey by the Creditreform Economic Research Unit.

In total, there were almost 175,000 in western Europe in 2011, up from 131,000 in 2007 but a reduction from the peak in 2009, when 178,235 companies declared

bankruptcy. Despite the growing influence of the PIGS economies, France once again led the charge (see case study, left), with almost three corporate failures in every 10 in western Europe (28.3%).

Germany was once again in second place, with 17.3% of insolvencies. There is also a potential pipeline of bankruptcies made up of zombie firms – those only kept alive by very low lending rates.

### Intelligence insight

In terms of D&O liability, bankruptcies are increasingly fuelling D&O claims. According to an AIG Europe claims »

## FRENCH DIRECTORS IN THE FIRING LINE

The strict law for bankruptcy in France is one reason behind an increasingly litigious D&O claims trend in the country. In France, bankruptcy litigation rose from 47,000 cases in 2006 to 61,000 in 2009.

When a company is declared bankrupt and its assets prove insufficient to cover its outstanding liabilities, any manager can be held personally liable to cover the company's liabilities. There are many ways management fault can be determined, a decision that is left largely to the bankruptcy court's discretion.

This includes failure by directors to exercise adequate control over the chief executive, allowing a chronically loss-making company to continue trading, and failure by the chief executive to file for bankruptcy within the prescribed 45-day notification period.

In a statement, Paul Sterckx, assistant vice-president for financial lines at AIG France, and Didier Seigneur, head of financial lines at AIG France, say: "The bankruptcy law is quite strict in France and there is a pretty significant liability for all the directors and officers when they are filing for bankruptcy. If they have been failing in their fiduciary duty or their duty of care, clearly their personal assets are at stake.

"About 60,000 entities filed for bankruptcy last year," they continue. "It used to be that about 6% of them were sued for lack of assets. According to the latest numbers we have, that figure has increased to 10%-12% being sued by the liquidator."

Where directors are sued because of a lack of assets, the average payments are increasing. In the past, total settlements were typically less than 10% of the assets left by the company. This has now increased to between 15% and 20%.

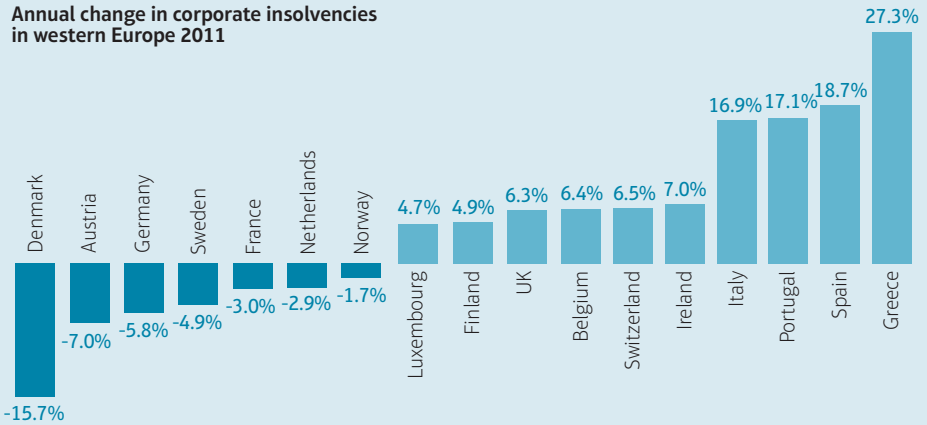
"So the amount of claims is increasing because of the financial crisis and the average settlements have significantly increased from what we were seeing in the past," add Sterckx and Seigneur.

"Previously, where the directors or officers took too much time to file for bankruptcy, it was the only way they would be held liable," they add. "What we have seen as part of the financial crisis is that there are a lot of new failings that judges are using to put some liability on the directors and officers. We are facing cases where the judge has concluded that the dividends given to shareholders for the past three years were too aggressive and the judge said they did not run the company with diligence. That would never have been the case five or 10 years ago.

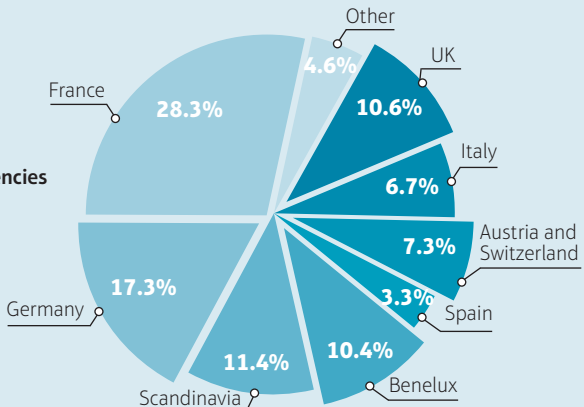
"Ten years ago, none of the liquidators would be asking if they have a D&O policy. Now it's almost their first question."

# BANKRUPTCY

Annual change in corporate insolvencies in western Europe 2011



Distribution of corporate insolvencies in western Europe



## DENMARK'S STABILISING INFLUENCE

» intelligence report, published in May 2012, bankruptcy actions are historically the second biggest source of claims for all types of companies in Europe, excluding securities-related claims.

The largest source of claims comes from regulatory and criminal actions – investigations brought by state attorneys or regulators for matters such as alleged corruption, antitrust, unlicensed activity or misappropriation of assets.

“Tough macro-economic situations polarise performers: poor management quality stands out more in difficult times,” says AIG Europe head of commercial management liability and fidelity Géraud Verhille. “There is a correlation between failing in your fiduciary duties and your performance. As such, performance is a proxy for claims susceptibility.”

### Badly hit sectors

“Insolvency is a key source of claims, and certain sectors have been hit particularly badly,” he continues. “Transport, automotive, construction, real estate and renewable energy are some of the sectors that have suffered most, and where many of their constituents have gone into bankruptcy. As a result, we see a spike of claims coming from those sectors.”

Taking on responsibility to maximise insolvency proceeds, liquidators have »

The Danish banking sector was considerably affected by the financial crisis, with its profits dropping by 148% between 2007 and 2009. Since the beginning of the crisis, about one in four Danish banks has been forced to shut down. While there were 159 Danish banks in 2007, only 121 were in operation in 2011 – a decrease of 23%.

In 2010, a scheme was set up to handle distressed banks in Denmark. Finansiel Stabilitet (FS) is a government-owned financial stability company established to wind up distressed banks. If a bank was unable to fulfil its minimum capital requirements, FS would acquire the bank and liquidate it in a controlled manner, providing capital and, if necessary, liquidity.

“This entity has taken over all the distressed banks and, as standard procedure, it is looking into the old period of management and bringing claims against the former management of those banks,” says AIG Europe major claims manager for financial lines José Martinez. “Most of the claims we see against the former management of distressed European banks arise out of aggressive or irregular lending practices.”

.....  
*‘There’s no question that liquidators increasingly look for directors’ liability to boost the estate’*

**Geraud Verhille** AIG

- » the power to bring claims against directors and officers for mismanagement, misrepresentation, fraud or allegations that they conducted business for their personal profit, rather than in the best interest of the company.

“Usually, when a company files for bankruptcy, the debts they have exceed the assets by tens of millions of euros,” says Martinez. “So the only other real asset available to make up for that deficit is a substantial amount paid by the directors if they are to blame for the bankruptcy.

“As part of their standard investigation into the causes of the bankruptcy, the administrators look at whether directors are to blame,” he continues. “There is increasing awareness across Europe of D&O insurance and it is seen as one of the few areas in which they can get back a bit of money to distribute to

the creditors. As a result, we see them being quite aggressive in the pursuit of those claims.”

To ensure they don’t miss out on this potential source of capital, bankruptcy trustees are increasingly ensuring that an extended reporting period is purchased on the D&O policies of companies that have entered bankruptcy.

This is because claims are only typically covered while the policy is in effect, which typically come to an end soon after a company declares insolvency, or within a contractually agreed extended reporting period.

## Number one claim

“Bankruptcy claims are number one in Europe when it comes to amounts paid in 2013,” says Verhille. “With the consequences of the sovereign debt crisis and a recessionary environment, these are increasing – although it does depend on jurisdiction. For instance, some have legislation more focused on saving companies rather than liquidating them.

“Overall across continental Europe, there’s no question that liquidators increasingly look for directors’ liability to boost the estate. The more that can be dragged from other sources to satisfy creditors the better, so directors’ and directors’ assets, and if possible insurance policies, are all looked at.” **SR**

# D&O goes global

Exposure is now international and variations in regulatory climates, tax rules and the status of global policies make compliance a complex task

**A**S GLOBALISATION BECOMES A reality for many organisations, there is a growing requirement for global directors' and officers' (D&O) policies to meet local conditions.

Large multinational companies could easily have operations in more than 50 countries. Navigating the varied regulatory and tax rules pertaining to D&O insurance in each of those countries is an arduous but necessary task. For insureds buying international insurance programmes, there is an inevitable tension between the need to aggregate risks and reduce overall premium using a global programme, versus the need to meet local rules.

The challenges from a compliance and tax perspective can be expensive and time-consuming, particularly as local regulatory and tax authorities become stricter in their enforcement. AIG Europe head of commercial management liability and fidelity Géraud Verhille says: "As exposures of directors and officers grow outside of the usual countries the topic of dealing with issues internationally becomes more critical.

"Business is becoming more international. European companies have to do more and more business abroad, especially outside the eurozone, to tap growth. This inherently forces them into »





# GLOBALISATION

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## KEY POINTS

- As companies become more global in scope, they must keep abreast of local rules pertaining to D&O insurance
- Global D&O policies may not be sufficient to protect directors' assets in certain jurisdictions
- Companies should seek to plug any gaps by taking out global programmes with local D&O policies
- Emerging markets provide their own unique D&O liability challenges

» new exposures," he continues. "They need insurance carriers that can provide that geographical span and jurisdictional specifics. Companies should make sure their programmes will respond appropriately, especially in jurisdictions where there is a high amount of activity."

### Avoiding gaps in cover

Most countries have laws that make it illegal to use non-admitted insurance, so if the global policy is provided by a non-admitted carrier it will be unable to protect the directors and officers in that country. Corporate law may prohibit any form of indemnification by the company or sister company.

And it is an ever-changing landscape, with rules concerning directorial liabilities subject to sudden modification. "One of the increasing areas of concern for Airmic members who are buying a D&O policy in the UK to cover all their exposures in all other territories is that the policy will have non-admitted status," explains Airmic technical director Paul Hopkin. "The requirements to comply »

.....  
*'There are issues when a claim arises, such as how it will be paid and in what currency'*

**Paul Hopkin** Airmic

- » with non-admitted rules can be quite complex, right the way from, 'Am I allowed to do this?' to, 'Do I have to pay insurance premium tax, even though it's a non-admitted policy?'

"Then there are issues when a claim arises, such as how will it be paid. Where will it be paid and in what currency?" he adds. "Do I have to issue a policy in the local language, even though it's non-admitted?"

"If the global policy has not got it right in that territory, there could well be difficulties in paying claims and acknowledging if the claim is legitimate. This is a challenge and it is complicated."

In some jurisdictions D&O cover may be compulsory, but only if it is bought from a local insurer. It is also now accepted that premium tax is subject to the relevant laws of each country where a company has operations. Failure to understand and uphold the rules



concerning foreign premium tax may result in hefty fines and penalties.

As part of the tripartite relationship of insurance buying, the insurer, broker and buyer all have a role to play in ensuring they are meeting local requirements and there are no gaps in cover. In countries where there is a significant exposure, directors' assets may best be protected by purchasing a local D&O policy via an admitted insurer.

"One of the biggest issues we have is companies going into jurisdictions where they're uncertain of the governance environment, and they don't know the insurance compliance rules," says JLT head of management and transactional liability Michael Lea.

"As a result, there's a lot of pressure on us to advise them on what they need to be doing and whether a locally issued D&O policy or their global cover will cover them, or if they need to adopt rules »

## EMERGING MARKET DANGERS



The recent case of Vodafone and its prolonged battle with the Indian government over a tax bill highlights another potential area of exposure for directors and officers. It shows how different the rules of engagement can be when an organisation moves into an emerging market.

The Supreme Court backed Vodafone's argument that it did not owe the tax after the company's 2007 acquisition of a controlling stake in an Indian telecom company. However, the government retroactively amended the country's law on taxing overseas deals involving local assets. Following the retroactive law change Indian officials sent Vodafone a notice demanding over \$2bn (€1.55bn) in tax.

Another case involved the Indian Patents Office, which granted its first compulsory licence for the manufacture and sale of an international pharmaceutical company's patented drug.

The move alarmed the pharmaceutical industry amid concern that similar compulsory licences could be issued under the provisions of India's competition law. Intangible assets including intellectual property (IP) make up as much as 70% of a firm's stock market value in the life sciences sector.

"What the regulators care about in emerging markets might be quite different to what companies are used to in the US or Europe," says AIG Europe head of commercial management liability and fidelity Géraud Verhille. "Whereas some countries may focus on corruption, IP or health and safety, others may be more focused on matters linked to tax, pollution or unlicensed activity.

"It's important that management teams are aware of these differences and avoid the many pitfalls this complexity generates."



# Alert and unforgiving: regulators on the prowl

The likelihood – and associated cost – of regulatory action on companies has stepped up dramatically in the years since the financial crisis

**I**N THE FIVE YEARS SINCE THE height of the financial crisis, regulators' behaviour has changed as they have been given more power and resources to investigate and prosecute.

The threat of regulatory investigations and enquiries is of most concern to directors and officers, according to a recent survey by broker Willis and law firm Allen & Overy. The study showed that 89% of respondents were worried about regulatory investigations, while 69% were concerned about criminal and regulatory fines and penalties.

"Directors and high-ranking officers in public and privately held corporations are under scrutiny like never before, as they conduct business in an increasingly regulated and complex global business environment," says Allen & Overy counsel Andrew Barton.

"As regulatory authorities have responded to public and shareholder pressure in the wake of the credit crisis with more rules, heightened vigilance and tougher enforcement powers, corporate leaders find themselves exposed to even greater risks on a daily basis in going about their roles."

Regulatory oversight and enforcement has continued to grow in the wake of the financial crisis. "Generally, there's

a lot of pressure for regulators to be alert and unforgiving, in part due to the fact that some were considered to be asleep at the wheel during the 2008 crisis," says AIG Europe head of commercial management liability and fidelity Géraud Verhille.

"A further shift lies in the regulators seeking to bring individuals to account, not only the company."

### UK change of focus

This has been a key feature in the UK, where regulators including the Financial Conduct Authority (previously the FSA), Serious Fraud Office (SFO), Office of Fair Trading and Health & Safety Executive (HSE) have turned their focus on senior decision-makers.

Airmic technical director Paul Hopkin says that this has prompted close discussions between insureds and their carriers, with requests that regulatory investigation coverage be part of their renewal packages.

"Regulators in many cases can now impose fines – the HSE will now charge you for prosecuting you – and the data protection and financial services regulators can now impose fines and penalties and launch investigations," he says. "I would argue – and our members »

# REGULATORS



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## KEY POINTS

- Regulatory oversight and enforcement has continued to increase in the wake of the financial crisis
- Where regulators' resources have been cut, self-reporting has become more important, with the onus on companies and other third parties to spot and report wrongdoing
- The legal costs associated with regulatory investigations in the UK and Europe is increasing significantly

» reinforce this – that the change in regulators' behaviour and authority is more important than changes in the regulations they're responsible for.

"The UK regulators, data protection people and financial regulators have new sets of powers to impose penalties of their own. I'm aware, through discussions I have with insurers about regulator behaviour across the world, that regulators do seem to be becoming more active. That's because in many cases it is a revenue generator."

### Growing self-regulation

Nevertheless, in the current environment, resourcing is becoming an issue for UK regulators, to some extent reining in their activities. The UK government has cut more than a third of the SFO's budget over the past four years. Anti-corruption group Transparency International says this will lead to a decline in future UK enforcement.

The SFO handled more than 100 cases in 2011, up from 60 in 2006. "There might »



## DEFERRED PROSECUTION AGREEMENTS TAKE SHAPE IN UK

Although it still has a long way to go, the UK is moving towards introducing a US-style deferred prosecution agreements (DPAs). While DPAs can help companies avoid lengthy legal proceedings and resume trading as quickly as possible, their introduction could result in increased exposure for company directors.

A DPA can be made between a prosecutor and organisation to defer prosecution for alleged economic wrongdoing, as long as certain conditions are met. Companies that admit wrongdoing and co-operate with the regulators may be required to:

- make amends to victims;
- pay substantial financial penalties; and
- reform their practices to prevent such conduct occurring again.

"DPAs will give prosecutors an effective new tool to tackle what has become an increasingly complex issue," said UK justice minister Damian Green in a statement last year. "This will ensure that more unacceptable corporate behaviour is dealt with, including through substantial penalties, proper reparation to victims, and measures to prevent future wrongdoing."

AIG UK chief underwriting officer for financial lines Grant Merrill says: "One potential outcome of the introduction of DPAs is an increase in self-reporting, a trend we are already experiencing.

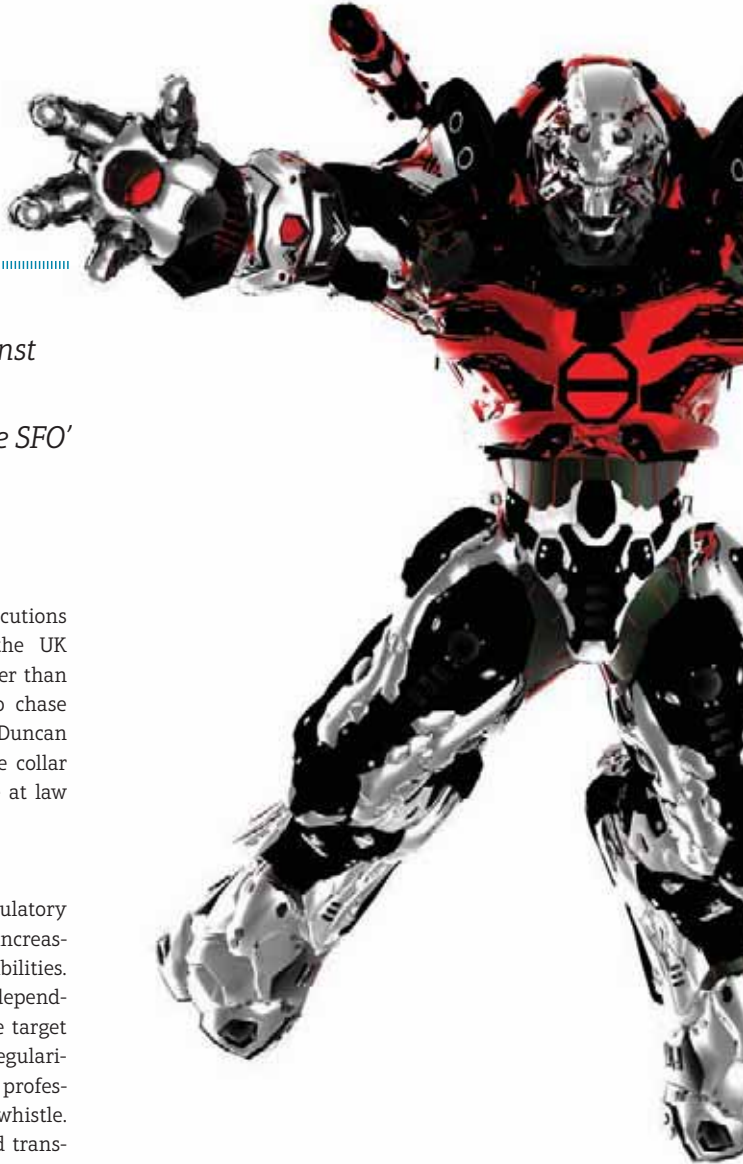
"The incentive to admit wrongdoing, pay a fine and avoid criminal charges can be very attractive to companies."

DPA agreements are overseen by an independent judge and agreed in open court, and the outcome is published to ensure transparency. If at the end of the period, the prosecutor is satisfied that the organisation has met its obligations, there is no prosecution. Otherwise, a prosecution could be brought.

"Royal Assent was given to the Crime and Courts Act 2013 on 25 April 2013, which will provide the criminal regulatory bodies with the right to enter into a DPA with a company or partnership," says law firm Dechert partner Duncan Wiggetts. "The new regime will, in appropriate cases, allow companies to defer, and potentially avoid, a prosecution for wrongdoing by agreeing to a series of conditions, including the making of admissions, improving compliance systems, the payment of financial penalties and co-operation in relation to the investigation of any offence. They'd only be prosecuted if they breached the terms before the expiry period of the DPA.

"The new DPA regime, which is likely to be introduced in early 2014, does not apply to individuals such as directors. And it may increase the risk of directors and officers being prosecuted, as companies may be more willing to report wrongdoing by directors and officers if they believe a DPA may be available. Those companies may need to agree to hand over all of their investigation work on the matter, indicating potential culpability of certain directors and officers, as a condition of a DPA. This would mirror the conditions traditionally imposed in DPAs in the US."

JLT head of management and transactional liability Michael Lea says: "The danger in having a civil case and criminal case running concurrently is that one will affect the other. We've seen companies that have been subject to investigation on a criminal basis and because they've stepped forward, they've been immune from disqualification and treated leniently. Then they get slammed in the civil suits that follow because they're effectively plea bargaining. These policies need to be set up carefully, so that self-reporting is not construed as an admission of liability in a civil case."



.....  
*‘There might have been more prosecutions against directors if the UK had increased funding to the SFO’*

**Duncan Wiggetts** Dechert

- » already have been more prosecutions brought against directors if the UK government had increased, rather than reduced, funding to the SFO to chase down wrongdoers,” comments Duncan Wiggetts, a partner in the white collar and securities litigation practice at law firm Dechert.

### Third-party shift

In lieu of increased funding, regulatory bodies – not just in the UK – are increasingly outsourcing their responsibilities. Regulators are becoming more dependent on third parties, be they the target companies revealing internal irregularities through self-reporting or professional services firms blowing the whistle.

JLT head of management and transactional liability Michael Lea says: “The onus is on potential target companies to »





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## SEC'S ROBOCOP ACCOUNTANT FOR FINANCIAL DISCLOSURES

As regulators' resources come under pressure in many jurisdictions, supervisors have been forced to become more innovative in the way they scrutinise companies' data. Self-reporting has become a big feature of the regulatory landscape, with regulators then looking to spot any inconsistencies in reported disclosures.

The US Securities and Exchange Commission has taken this thinking a step further. Later this year, it is expected to launch a computerised tool that is designed to automatically trigger alerts when any suspicious accounting practices are detected. The warning system is based on computer-readable XBRL (business reporting) tags and will be able to compare financial data between publicly traded companies around the world.

Described as accountancy's answer to *RoboCop*, the new tool will examine whether an organisation stands out from the crowd by analysing patterns in financial disclosures. It will look for a variety of warning signs, such as having a high proportion of off-balance-sheet transactions, frequent changes in auditor or delays to earnings announcements.

.....  
*'The cost of going through an investigation is much higher than it was three or four years ago'*

**Michael Lea** JLT

- » mitigate their exposure by stepping forward, particularly in industry-wide investigations where a whole industry is subject to scrutiny," he says.

Although funding for UK regulators is being eroded, in the rest of Europe the regulators are being given increased powers and resources to go after offending organisations.

Anticipating increasing claims in this regulatory environment, AIG launched its CorporateGuard D&O policy in February 2013. The product provides emergency funding to directors in case their property is confiscated or assets frozen in the event of a regulatory investigation. It also provides 'any one claim' reinstatement coverage for certain sectors and jurisdictions in the face of this increased claims activity.

"I understand the budget for the regulators in the UK is not being increased

and there's talk about cutting it," adds AIG Europe financial lines manager for major loss claims José Martínez.

"This is different from the rest of Europe, where the budget is stepping up a little bit. However, with self-reporting and whistleblowing being actively encouraged in the UK, we would expect more regulatory claims in Europe as a whole in future."

He says the defence costs associated with such cases is increasing, falling more in line with the US. "In the UK, regulatory action has traditionally been one of the most important causes of loss for us, especially when we get involved in investigations by the SFO or the FSA [now the FCA]. Those tend to be very expensive to defend," says Martínez.

"We also tend to see internal disputes between the directors and officers of a company, making it necessary to hire separate counsel, and that drives up the total price to defend these actions. We have seen a handful of cases where we've paid the entire policy limit just to defend the directors."

Lea agrees. "The cost of going through an investigation is much higher than it was three or four years ago. It's certainly not unusual to see £600,000 (€710,850) to £800,000 defence costs being spent just to get to that point where you know you've been prosecuted or excused." **SR**

## ITALY'S PUBLIC FUNDS SUPERVISOR

The Corte dei Conti is one of the Italian public authorities that has become increasingly active in its investigation and legal action against organisations that it believes has misused state funds. It was set up in 1862 to control the public administration and prevent misuse of funds and unsound management.

"It is the arm of the government that can investigate private companies, and companies or authorities that are controlled by the government in their use of public funds," explains AIG Italy financial lines commercial account manager Marco Vantellino.

"Corte dei Conti acts in cases of gross negligence. It can go directly to the individual, investigate and claim against that person. Any such investigation generates extensive legal costs for the individuals targeted."

Because of the increasing action being brought by the Italian state audit court, Vantellino has witnessed increased demand for D&O policies that include gross negligence cover.

"In just the past two years, it started to be an important cover and we face increasing actions by Corte dei Conti. So now it is more common that almost all D&Os have policies covering gross negligence," he says.



# Litigation barriers come down

While grand-scale US-style class actions have not reached Europe yet, angry shareholders are finding it easier to have their day in court

**E**UROPE IS SET FOR MORE shareholder lawsuits as it becomes easier to sue companies and their directors.

In a seminal case for shareholder lawsuits in the UK, The Royal Bank of Scotland (RBS) and several of its senior executives – including former chief executive Fred Goodwin – are being sued for up to £4bn (€4.72bn) by a group of shareholders who bought shares as part of the bank's £12bn (€14.1bn) rights issue in April 2008.

While the RBS case in the US has been finalised, non-US shareholders were able to secure £12m in the first high-profile shareholder class action in the UK.

The lawsuit is the second in the UK courts to focus on disclosures made over the bank's rights issue. The first was brought by a group of 21 claimants, including pension funds. Both claims have been brought under section 90 of the UK Financial Services and Markets Act 2000, which is relatively untested. They allege there were omissions and misleading statements made by the bank in the prospectus accompanying its rights issue.

"The Companies Act 2006 widened the grounds upon which shareholders could bring actions for compensation

against directors for damage allegedly done to the company to include negligence in the performance of duties," says law firm Dechert's white collar and securities litigation partner, Duncan Wiggetts.

"However, it still remained the case that shareholders have no direct right of action against a director. They have to go to court and ask for permission to bring an action in the name of the company, as directors only owe a duty to the company, not the shareholders."

"There was initially an expectation that the wider ambit would lead to an increase in claims against directors, but this hasn't transpired mainly due to the requirement to seek leave of the court and to sue the directors in the name of the company – so there's still that barrier."

"The recent investor action against the RBS directors did not require such consent because investors are alleging in that action that there were misleading statements in the bank's circular for its rights issue," he adds.

"There are certainly more regulatory investigations and actions involving individual directors, but in terms of actual straight compensation or civil claims from investors, I'm not seeing that. The biggest current risks for directors in the UK are potential actions by »





» liquidators, regulators and criminal prosecution bodies.”

Nevertheless, the various barriers that have held back shareholder litigation in the UK and the rest of Europe are coming down. In the UK, under Lord Justice Jackson’s recommended reforms, new funding methods have been made available to claimants, such as damages-based agreements (DBAs).

This litigation landscape is slowly but surely changing, says AIG Europe head of commercial management liability and fidelity Géraud Verhille. “Across Europe, elements are coming together that provide an environment making it easier to sue. Comparing Europe to the US, certain aspects have historically made litigation less attractive – criteria such as loser pays, the difficulty of



## CONVERIUM CLASS ACTION

On 17 January 2012, the Dutch Court of Appeal in Amsterdam concluded class action proceedings in the *Converium* securities litigation. In its decision the court referred to the 2010 US Supreme Court judgment in *Morrison v National Australia Bank*. The decisions of the Dutch courts in the *Converium* case confirm the Netherlands as the main European centre for the settlement of international collective claims outside the US, according to law firm DLA Piper.

Securities litigation began against Swiss reinsurance company Converium in October 2004 when investors sued the company and its former partner, ZFS, for violating US securities laws. The plaintiffs alleged that when ZFS spun off Converium as an initial public offering its earnings were materially overstated because Converium concealed a massive deficiency in its North American loss reserves. Ultimately, Converium increased its loss reserves by \$562m (€436m), reported a loss for 2004 of \$761m and placed its North American operations into run-off. This caused a drop in share price, resulting in losses to investors.

The action was originally brought on behalf of all investors who purchased Converium common stock on the SWX Swiss Exchange and American depository shares in New York. However, in March 2008, the US federal court certified a class that excluded all non-US purchasers who bought their shares on the SWX Swiss Exchange, concluding that there was insufficient evidence of subject matter jurisdiction over their claims.

Converium and ZFS agreed to settle investors' claims for a total of \$143m. Because of the US court's decision, this settlement was split between those who purchased Converium shares in the US and those who purchased them on the SWX Swiss Exchange. The US federal judge presided over the former; the Amsterdam Court of Appeal, the latter.

“Every year collective action ratchets up and there is no turning back”

Géraud Verhille AIG

funding litigation, the absence of lawyer solicitation, the greater difficulty of benefiting collectively from a single litigation – there's been a gradual erosion of those barriers.”

### Collective action gains momentum

While full-blown US-style class action style lawsuits are still some way off, a growing number of shareholder claims are being filed in courts across Europe. More actions are anticipated in the future as a result of altered US securities law. As a result, foreign shareholders are no longer able to sue foreign-domiciled companies in US courts and may instead turn to the European courts for redress.

The Netherlands has set a precedent with the *Converium* case in January 2012 (see left) and a growing number jurisdictions offer collective redress regimes. “Year after year across Europe there's an expansion of the legislative framework »

## ANOTHER SHAREHOLDER SPRING?

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*'Last year's scale of rebellion would have been unheard of even two years ago'*

**Duncan Wiggetts** Dechert

- » that enables collective action – every year it ratchets up with more jurisdictions able to do it and there is no turning back” says Verhille. “The Dutch Court of Appeal in Amsterdam is one to watch especially as a forum of choice for collective settlements in Europe.”

The Court of Appeals secured jurisdiction in the *Converium* case although the claims were not brought under Dutch law, the alleged wrongdoing took place outside the Netherlands, and none of the potentially liable parties and only a limited number of the potential claimants are domiciled in the Netherlands. The ruling allowed the settlement to be declared binding on an entire class on an ‘opt out’ basis, which is the same under US class action procedure.

Because the Netherlands is the only European country with such a collective settlement procedure it has become an »

Shareholder activism has become an increasing feature of the tough economic environment, with the US setting the trend. It is seen as a legitimate form of self-regulation, particularly where regulators and boards of directors are perceived to have failed to cure poor performance and curb corporate excesses.

Corporate executives should expect to see increasing opposition from shareholders into 2013, according to *Shareholder Activism Insight*, published by Schulte Roth & Zabel LLP in association with mergermarket. Using poor financial performance and the need for management or operational change as motivation, hedge funds, pensions and unions will continue the growth of shareholder activism.

“Activist investing is becoming its own asset class and no company is immune,” says AIG UK financial lines chief underwriting officer Grant Merrill. “Even Apple came under pressure to return cash to shareholders recently from the American hedge fund manager and Greenlight Capital president David Einhorn.”

The financial services sector will receive the brunt of this activism as investors look to repair the still recovering industry in the aftermath of the financial crisis, according to the report. “Shareholders have not seen any returns because of the extended fall in share prices, but management has not been affected,” said a hedge fund partner. “Shareholders will raise questions.”

While Europe is lagging behind, last year’s ‘shareholder spring’ protests against executive pay in the UK demonstrated a change in shareholder behaviour. A



number of high-profile shareholder votes against remuneration packages forced the departures of some well-rewarded directors, including Aviva group chief executive Andrew Moss.

In May last year, Aviva announced Moss would be leaving with immediate effect. It followed one of the biggest shareholder revolts in UK corporate history over executive pay. Investors called for Moss to resign over the company's performance, especially its share price.

Other companies that faced shareholder opposition to executive pay included Trinity Mirror (with boss Sly Bailey also stepping down), William Hill, Barclays, mining group Xstrata and Premier Foods.

Whether last year's revolt was a one-off remains to be seen. "So far it's been largely concentrated in terms of remuneration committees and executive pay," says Dechert's Wiggetts. "That's been the major focus and last year shareholders voted against several remuneration packages at well-known companies. That scale of rebellion would have been unheard of even two years ago, and it shows how shareholder activism has been brought to bear. I don't think that's going to go away."

### **Online engagement**

Social media tools are increasingly giving activist shareholders a platform from which to air their grievances. When Eric Jackson posted videos on YouTube in 2007 to complain about Yahoo's business performance, other shareholders responded positively. He challenged chief executive Terry Semel during a stockholder meeting by asking him to apologise for the company's

poor performance. Shortly after, Semel stepped down.

Jackson has since taken to blogging and exchanging ideas with other investors on a wiki. And he is not alone. Facebook, blogs, websites, YouTube, wikis and Twitter are increasingly becoming an avenue for shareholders to get their messages out to the greatest number of investors.

Investor and analyst interaction with digital and social media has increased substantially and deeper online engagement is increasingly driving investment action. This is according to the Brunswick Group, which released its latest survey on the investment community's use of digital and social media in January 2013.

Fourteen per cent of participants included "digital and social media" among their top three most influential sources, up from 6% just two years ago. And 86% of investors say digital and social media sources have become more important this year, with investors in Asia appearing to lead the charge.

"Usage and engagement of digital and social media among those in the investment community is increasing rapidly," said Brunswick partner Rachele Spero. "More telling, however, is that its influence on investment decisions continues to grow too. Now, a quarter of those surveyed said they have made an investment decision or recommendation after initially reading a blog. For Twitter, that figure is one in eight, up considerably from our last survey two years ago. This suggests now is the time for companies to adopt digital and social media for investor-related content distribution and influencer engagement."



## KEY POINTS

- Barriers to shareholder litigation in the UK and Europe are gradually being eroded
- The Netherlands is an attractive venue for collective redress
- Last year's shareholder spring signalled a change in shareholder behaviour in the UK

» attractive venue for settling international mass claims, irrespective of whether any litigation has taken place in the Netherlands. "The *Converium* class settlement decisions signal a willingness in the Netherlands to pick up where the US courts left off, with implications for the EU," note DLA Piper lawyers Wouter De Clerck, Jeffrey Rotenberg and Jean-Pierre Douglas-Henry in an article on [kluwerlawonline](#).

There are growing examples of shareholder action across Europe where the motivations for litigation are changing. In the past the main impetus for disgruntled shareholders was to prompt a change in management. While this is still evident in many examples of shareholder activism, there is increasingly a threat of litigation and damages coming into play, notes Verhille.

He points to the rise of damage recovery services, such as Brussels-based Deminor, as evidence of the changing landscape. "It's a whole new avenue of problems that boards are facing that I don't see stopping anytime soon," says Verhille. "In an environment where you have firms providing damage recovery services, an availability of litigation funding and the ability to achieve collective redress you potentially have a perfect storm." **SR**





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