FINEX

EXECUTIVE RISKS – A BOARDROOM GUIDE 2007

Published by White Page Ltd in association with Willis Limited, with contributions from:
Allen & Overy LLP • Allens Arthur Robinson • Baker & McKenzie SC • Bouckaert Ormen Passemard Sportes - BOPS •
Clyde & Co • Debevoise & Plimpton LLP • Gómez-Acebo & Pombo • Matheson Ormsby Prentice •
Naschitz, Brandes & Co • Orrick Herrington & Sutcliffe • Proskauer Rose LLP • Shepstone & Wylie • Taylor Wessing

Editor: Nigel Page

Design: John Plunkett

Production: Callie Leamy

Publisher: Claire Lavery

Printing and binding: Pyramid Press

EXECUTIVE RISKS – A BOARDROOM GUIDE 2007
is published by
White Page Ltd, 17 Bolton Street, London W1J 8BH,
United Kingdom
Phone: + 44 20 7408 0268
Fax: + 44 20 7408 0168
Email: mail@whitepage.co.uk
Web: www.whitepage.co.uk

First published 2007
ISBN 0-9552069-5-2

Foreword

We are delighted to be publishing *Executive Risks – A Boardroom Guide 2007* in association with WIllis Limited.

Bringing together contributions from leading legal practitioners in 14 jurisdictions worldwide, this publication has been designed to provide readers with a guide to developments affecting executive risk in these countries.

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.

White Page Ltd

Contents

Introduction 5
Willis Limited

Legal developments for directors and officers in:

Australia 11
Allens Arthur Robinson

Brazil 19
Clyde & Co

France 25
Bouckaert Ormen Passemard Sportes – BOPS

Germany 33
Taylor Wessing

Ireland 39
Matheson Ormsby Prentice

Israel 49
Naschitz, Brandes & Co

Italy 57
Orrick Herrington & Sutcliffe

Mexico 65
Baker & McKenzie, S.C.

The People's Republic of China 73
Allens Arthur Robinson

The Russian Federation 81
Debevoise & Plimpton LLP

South Africa 89
Shepstone & Wylie Attorneys

Spain 97
Gómez-Acebo & Pombo Abogados

The United Kingdom 105
Allen & Overy LLP

The United States 113
Proskauer Rose LLP

Author profiles 121

INTRODUCTION

MARK WAKEFIELD, EXECUTIVE DIRECTOR, FINEX, WILLIS LIMITED

Introduction

Willis is delighted to present *Executive Risks – A Boardroom Guide 2007* which we hope the reader will find both informative and an invaluable reference tool in exploring directors' duties and the risks that may arise when breaches of those duties occur. The landscape for modern directors is constantly evolving with almost daily reports of new claims pending, regulatory intervention, legislative upheavals and previously unforeseen threats to companies operating in an increasingly globalised corporate economy. No director today can rely upon the fact that they live and work in a single jurisdiction to protect them against potential claims in any territory where their company may operate.

This guide seeks to identify and discuss the hot topics which should be uppermost in the minds of company directors operating in 14 key jurisdictions from the USA and Mexico through Europe, the Russian Federation and the Peoples Republic of China and we have enlisted assistance from leading legal experts in these territories to help navigate through the maze. Each of the following chapters will discuss changes in corporate governance, developments in the legislative framework (in respect of how directors are defined, what their roles and duties are, and who may claim against them), the role of the regulators, and the development of more targeted and determined claimants.

Rather than a prescriptive approach to the subject, we have asked our contributors to focus on the issues which they believe to be most pertinent and to explore those areas where they foresee future developments which could prove to be the next big headache for company directors. The range of subjects is therefore diverse, with insights ranging from lessons to be learned from high-profile cases, to a detailed analysis of new securities laws. One very apparent observation is that the legislation relating to directors' liabilities is never a fixed subject, with case law and corporate scandals driving an ongoing debate at the highest levels as to how best to promote an equitable regime which adequately balances both the need for strong governance and the protection of investors with the need to promote a healthy marketplace unfettered by undue constraints. There has been a raft of new and draft legislation in the last years, including:

- Australia – CAMAC proposals to widen the definition of directors and officers
- France – draft proposals to introduce class actions for consumer litigation and expected legislation on stock-options
- Italy – adoption of key new forms of corporate liability
- Mexico – new Securities Market Law introducing stricter corporate governance and an extension of directors' responsibilities
- PRC – changes to Company Law during 2006 which have created new exposures to shareholders and given the Regulatory Commission new powers to impose fines
- Spain – new Unified Good Governance Code
- UK – new Companies Act introducing a codification of directors duties and putting derivative claims on a statutory footing.

From the broker's perspective, certain key issues have taken prominence in the last 12 months, driving claims and forcing a reconsideration of the protections available to directors whether by way of indemnification or through insurance – we discuss these below.

Extra-territorial jurisdiction

One of the most publicised developments of 2006 was the apparent willingness of foreign courts to exert extra-territorial jurisdiction over the directors of foreign companies. In particular the

US courts have exerted their rights under treaties to extradite white collar criminals to the USA, despite the fact that much of the legislation was originally introduced to help combat terrorism in the wake of the 9/11 atrocities, and there have been examples of company directors who have been extradited despite the fact that the crimes of which they are accused were not crimes at that time in the countries in which they were alleged to have been committed.

However, it is not just in respect of criminal actions that directors have faced potential actions in the US, as plaintiff law firms have sought to find new routes to actions against non-US companies by seeking to establish jurisdiction in the US courts – for example BP is the subject of a derivative claim being promoted by a US plaintiff law firm in the US courts, despite the fact that BP is a UK-registered company. We are seeing an increasing appetite for US law firms to get involved in litigation against non-US companies, with some of the leading firms in the US setting up shop overseas to explore the potential for actions against them. Only time will tell if these tactics are successful, but directors of multinational companies will be sure to be wary of this potential new source of claims which, even if unsuccessful, will be both worrying and complex to dispose of.

Stock options backdating

Options backdating is the practice of granting an employee stock option that is dated prior to the date that the company actually granted the option. In late 2005 and early 2006, the practice came under close scrutiny as analysts noticed certain irregularities in the behaviour of certain stocks immediately after the dates on which options were granted to senior management. While the practice of backdating is in itself not illegal, it can become illegal if the company's shareholders have approved an option plan at a different price to the one in fact granted to the employee. Most of the issues surrounding backdating have therefore involved accusations of improper disclosure in financial records and submitting falsified documents to regulators.

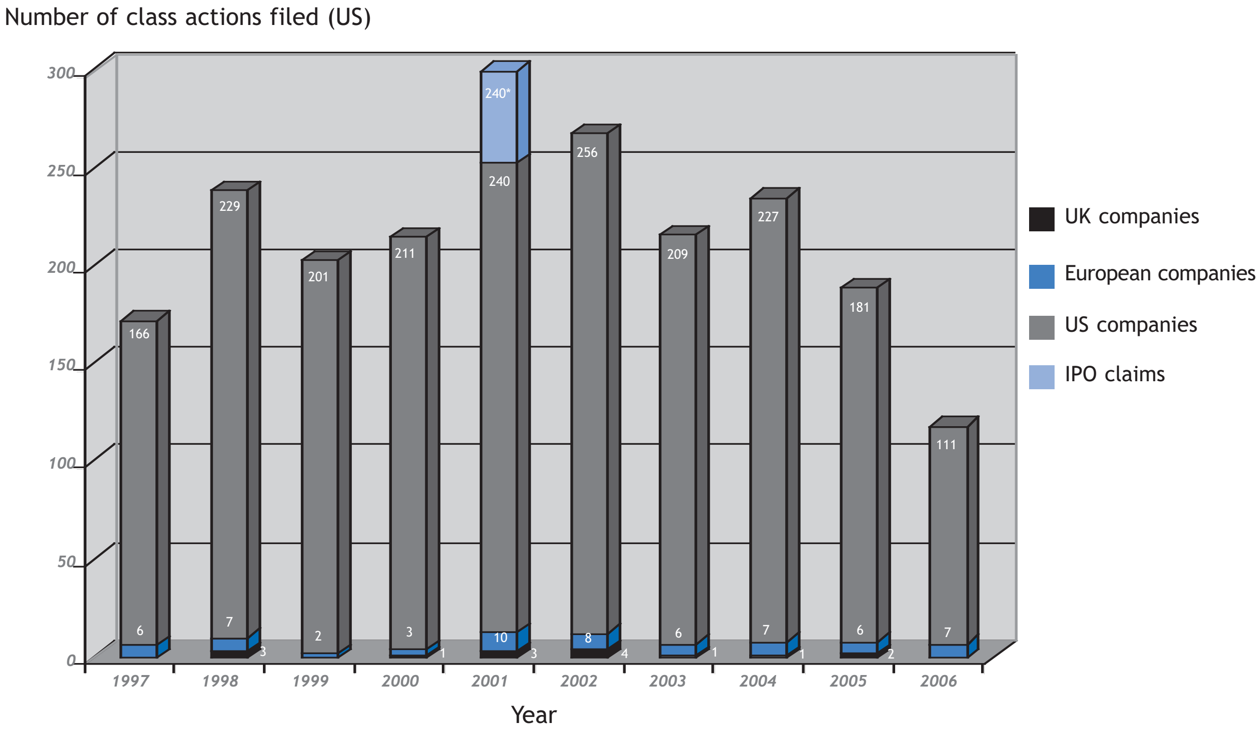
Another problem that can result from backdating is the accounting treatment of options. Until recently a company that granted stock options to executives at fair market value did not have to recognise the cost of the options as a compensation expense. However, if the company granted options with an exercise price below fair market value, there would be a compensation expense that had to be recognised under applicable accounting rules. If a company backdated its stock options, but failed to recognise a compensation expense, then the company's accounting may not be correct, and its quarterly and annual financial reports to investors may be misleading. Over 130 companies have been the subject of backdating investigations which have led to the firing or resignation of more than 50 top executives and directors of those companies, most of which have been in the technology sector.

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. In quantity and quantum, US class actions continue to dominate the claims scene, although in total, US class action litigation fell by over 40 per cent from 2005 to 2006 from 181 to just 111, and if we discount the 20 stock option backdating claims in 2006 (on the basis that there are likely to be far fewer of these in the future), the decline in claims is even greater at 49 per cent. Most commentators agree that this reduction is largely due to a combination of improved corporate governance standards following greater enforcement by local governments with an improved overall economic picture (in which rising stock

Introduction

FIGURE 1: CLASS ACTION LITIGATION TRENDS



*Note: *not to scale*

Source: Stanford Securities

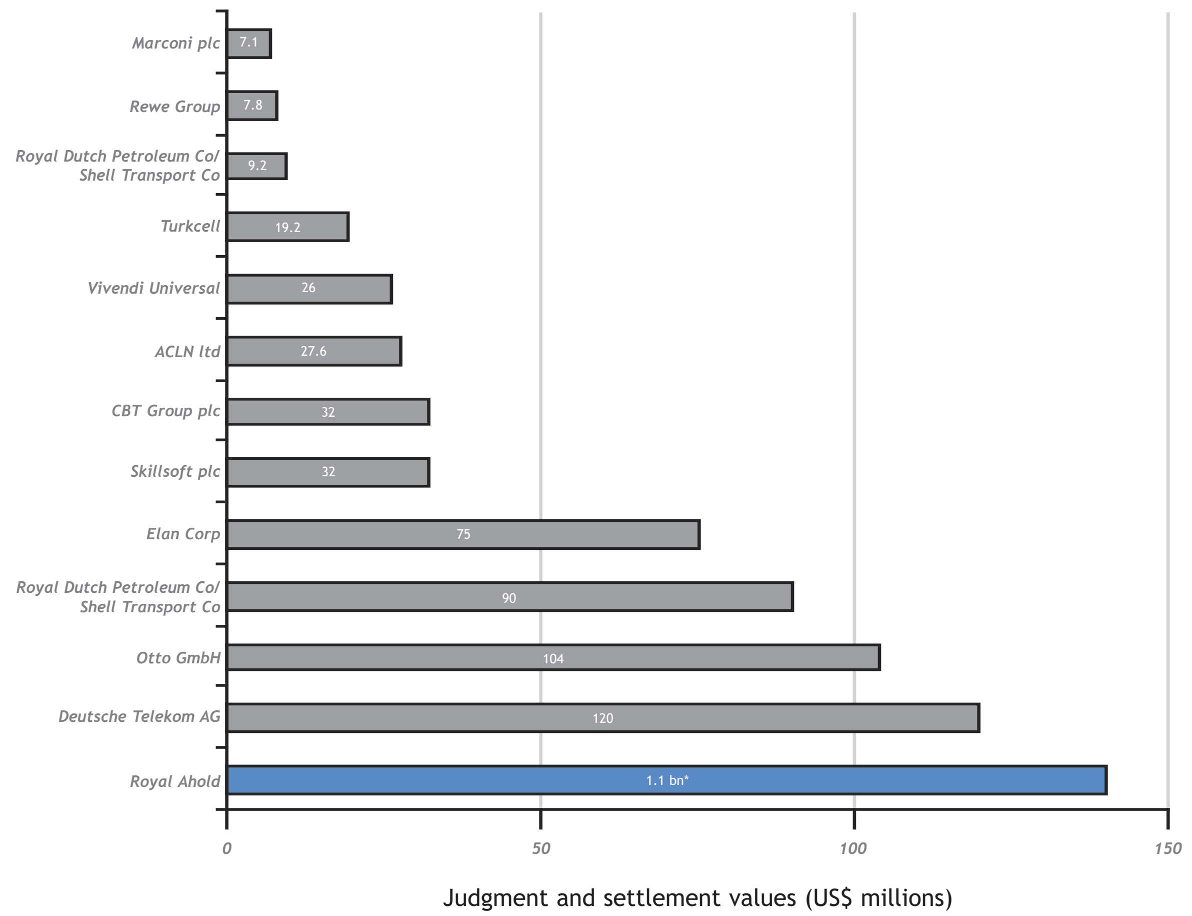
markets and lower volatility have helped to limit the opportunity for shareholder allegations of misconduct).

Despite this, the number of claims against European companies has remained at a relatively constant level for the last three to four years. Scandals at Parmalat, Hollinger, Vivendi and other European companies have caught the headlines and led to sweeping reforms of European corporate governance and audit procedures, and we have started to witness the emergence of a far more aggressive class of shareholders in Europe. As noted above, US law firms have started to establish themselves in Europe, and there appears to be growing willingness from shareholder activist firms and pension funds to participate in litigation. Add to this hedge funds, who are prepared to underwrite some of the costs of bringing an action against the executives and recent legal reforms in a number of European territories which will ease the passage of derivative or class action litigation, and we have a cocktail of circumstances which could give rise to heightened exposures for directors of companies outside of the already well-established threats of US securities law.

The insurance market

Despite these growing concerns, the overall position for purchasers of D&O insurance has remained favourable, with declining claims in the US driving

FIGURE 2: EUROPEAN MEGA-JUDGMENTS AND SETTLEMENTS



Note: *not to scale

Source: Willis Ltd

an improving claims picture for many of the global insurance companies who provide this cover. Our regular benchmarking of premium rates for a sample of European and Bermudan insurers shows that rates have continued to decline for a considerable time now, following an 'over-correction' in the early part of the decade. Reductions of over 20 per cent are still not uncommon for many European purchasers and now is an excellent time for companies to negotiate improved cover at lower cost, with insurers looking for ways to both attract and retain business.

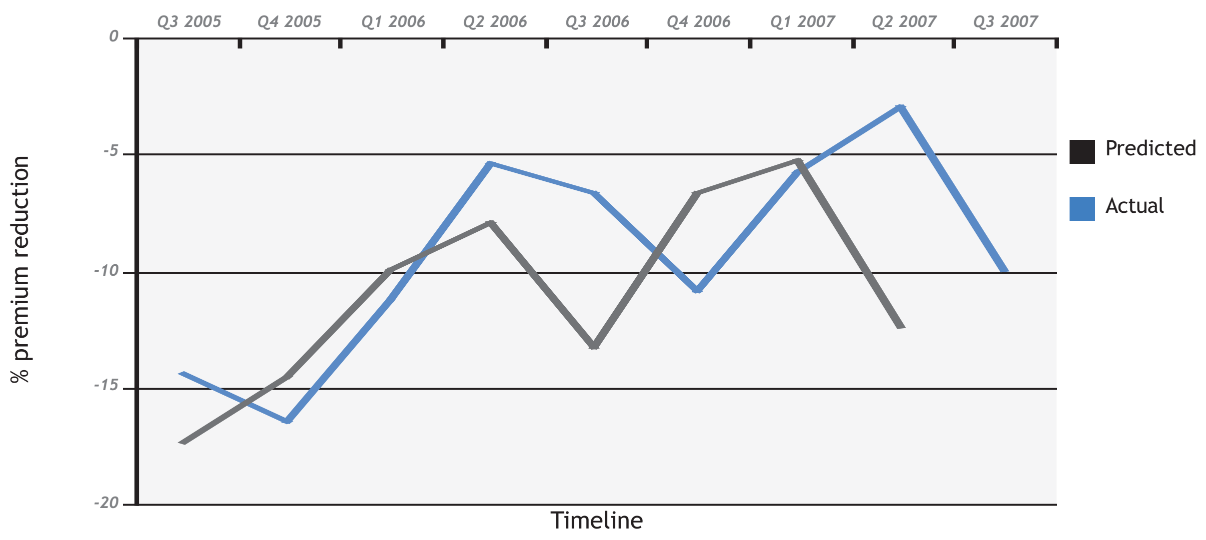
Some of the more recent developments in policy coverage are highlighted below, and purchasers should interrogate their insurers to ensure that they are availing themselves of the widest cover in the market:

Additional limits for non-executive directors

Most major insurers will now provide additional excess limits for the

Introduction

FIGURE 3: PREDICTED VS ACTUAL RATE CHANGE



Source: Willis Ltd

benefit of the non-executive directors which may operate on a Side A or a Side A & B basis. Care should be taken to ensure whether the insurer stipulates that cover will apply in excess of 'any other indemnification' available since this may impact the operation of the policy.

Non-rescindable policies

Insurers are generally willing to limit the situations in which they will have the right to rescind a policy of insurance for non-disclosure or misrepresentation by the directors. The extent to which this can be agreed will vary from case to case but, as a minimum, policies should be non-rescindable for Side A claims where the non-disclosure or misrepresentation has been free of fraudulent intent.

Automatic cover for acquisitions

Nearly all policies will provide some element of automatic cover for newly acquired subsidiaries, but will usually impose limitations in respect of acquired entities which are over a certain size or which have exposures in the US. Increasingly, insurers are willing to loosen these limitations by increasing the thresholds of size and overall risk exposure below which they will provide cover automatically.

Secondary offering cover

As with cover for acquisitions, modern policies are more likely to provide automatic cover for liabilities arising from secondary offerings of equity or debt securities. While the extent of cover will vary according to the risk, many insurers will provide automatic cover for private placements of equity securities and possibly public debt offerings. In addition it may be possible to negotiate cover for secondary public offerings of equity securities up to an agreed threshold.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN AUSTRALIA

OSCAR SHUB, PARTNER, AND ANGELA MARTIN, SENIOR ASSOCIATE, ALLENS ARTHUR ROBINSON

Oscar and Angela would like to thank Louise Jenkins, Matthew Skinner (partners), Penny Holloway, Philip Hopley, Mark Lindfield, Richard Harris (senior associates), Perry Herzfeld (lawyer) and James McComish (articled clerk) for their significant contribution to the Australian chapter.

Australia

In Australia there is an increasing trend to impose personal liability on corporate officeholders for the shortcomings of companies. In some circumstances, officers are deemed to be liable for certain outcomes unless they can exculpate themselves. This trend is reflected in statutes of the Commonwealth of Australia, the States and Territories.

In addition to imposing liability, there is legislation in Australia which limits the extent to which insurance may be taken out by a company against directors' and officers' liabilities and the extent to which a company may provide indemnities in respect of those liabilities.

The market for directors' and officers' ('D&O') insurance in Australia has tightened over the last five years, with the number of insurers and the capacity of the market declining. Insurers have placed greater limitations on the coverage under policies offered and have increased premiums markedly, although – in the last year – the rate of increase has begun to level out. Clearly, start-up and other small- to mid-size enterprises, and companies in higher-risk sectors, have more difficulty obtaining cover than more established companies in stable sectors.

Recent legal developments

Over the last 12 months there have been a number of legal developments in Australia relevant to D&O insurance. On the question of liability generally, the most significant recent development has been the publication of proposals by the Commonwealth Government's Corporations and Markets Advisory Committee ('CAMAC') which, if passed as legislation, will widen the current definition of directors and officers and so substantially change the nature of insured risks for D&O cover.

In its report, *Personal Liability for Corporate Fault*; published in September 2006 (the 'September Report'), CAMAC concludes that while corporate compliance with the law should be encouraged, the imposition of personal liability on directors by virtue of their office, and without regard to their actual acts or omissions, is objectionable. CAMAC has recommended that in order for directors and officers to be held personally liable, as a general principle, they should be shown to have personally been accessories to the offensive conduct. The significance of this report is reflected in the way it touches on all elements of this paper and is therefore dealt with throughout this chapter.

New legislation has been introduced which limits the ability of companies to indemnify their directors and officers for the consequences of breaching competition law. These limits relate to anti competitive conduct such as price fixing and abuse of market power. This largely follows the current position arising from s199B of the Corporations Act 2001 (Cth) ('the Act').

Who can be liable?

Recent developments

The most significant recent development has been the publication of the CAMAC proposals referred to above. The proposals were made by CAMAC, which published its recommendations for the extension of corporate liability below board level in April 2006 (the 'April Report'). The impetus behind CAMAC's report was the Royal Commission report into the collapse of HIH Insurance in April 2003. The Royal Commissioner recommended that the duties imposed on directors and officers should be applied to a wider class of persons, since the current definitions under the Act potentially exclude from liability middle managers, consultants and contractors.

CAMAC essentially agreed with this recommendation and put forward an alternative definition of an 'officer' to achieve this effect, which would include all persons who take part in, or are concerned with, the management of a corporation.

Australia

While it remains to be seen whether the federal government will act on CAMAC's proposals, its recommendations have obvious implications for insureds, underwriters and brokers alike operating 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.

CAMAC has also recently published separate proposals to reform the way in which individual officers can currently be made personally liable for certain corporate breaches of the law, regardless of their actual involvement in any offence. This is considered in more detail in the section below dealing with recent developments in the personal liability of directors and officers.

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 duties. There is an increasing trend for statutes to impose liability on directors and other officers personally, merely by virtue of their holding office rather than arising from their acts or omissions. This trend has prompted a Federal Parliamentary inquiry into the personal liability of directors and officers, which is outlined in this section.

Directors owe a fiduciary duty to act in a manner that is beneficial to the corporation as a whole. For this reason a company may bring an action for breach of that duty against the director, but it is also possible for the members to bring what is known as a 'derivative action' against directors whose conduct is contrary to the interests of members, or whose conduct discriminates unfairly against one or more members. The fiduciary duties of directors are reflected in the civil penalty provisions contained in the Act, which empower the court to impose civil penalties if directors breach 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 whilst insolvent, and so on. However, other legislation in Australia imposes personal liability on directors, even where there has been no conduct by the director in breach of these duties.

The April Report released by CAMAC in relation to *Corporate Duties Below Board Level* made recommendations that a number of the current statutory duties of directors and officers contained in the Act be applied more broadly to individuals by reference to the functions they perform in the company, rather than the traditional classification by reference to their relationship with the company.

Broadening the scope

The substance of the recommendations is that the provisions in the Act relating to directors' and officers' duties be broadened to capture any individuals who are involved in 'managing or carrying out the business' of the company. The April Report recommends that the duties:

(a) of care and diligence

(b) to act in good faith

(c) to act for a proper purpose, and

(d) the restrictions on indemnification and insurance which companies can provide to directors

should be expanded to '*any person who takes part in, or is concerned in the management of a corporation*'.

The amended regime proposed by the April Report would also extend a number of existing protections contained in the Act to any person who takes part in, or is connected with, the management of the corporation including:

(a) the business judgment defence

(b) the protection currently 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

(c) the protection currently afforded to directors where, in certain circumstances, they may rely on information or advice provided by another person.

The April Report further recommends a number of other obligations of directors and officers be extended to persons who perform functions for, or otherwise act on behalf of the corporation including:

(a) the prohibition on the improper use of corporate position or information

(b) the provision of false or misleading information

(c) 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

(d) offences for misconduct concerning corporate books and records.

While the April Report does not recommend that the definition of 'officer' be changed, it is clear that if the recommendations contained in the April Report are adopted by the government there will be a very significant new class of persons who are potentially liable for conduct for which previously only directors and officers were responsible. It seems likely that, in that event, there will be a significantly wider class of persons seeking D&O-type insurance.

Focus on liability

CAMAC's September Report deals with the tendency of Australian legislation to impose personal criminal sanctions on directors and officers, not only for breaches of the duties referred to above, but also merely by reason of occupying their office. CAMAC also reported on the inconsistency of liability provisions that apply across Australia to directors personally. In its report, *Personal Liability for Corporate Fault*, CAMAC concludes that while corporate compliance with the law should be encouraged, the imposition of personal liability on directors by virtue of their office and without regard to their actual acts or omissions is objectionable. Particularly given the proliferation of non-executive directors, an individual director may be deemed personally liable despite having been unable to influence the relevant corporate conduct. CAMAC also compared the liability provisions contained in Commonwealth, State and Territory legislation relating to environmental protection, occupational health and safety, hazardous goods and fair trading. It found that across Australia there is a variety of standards of responsibility imposed on directors, obfuscating compliance.

CAMAC has recommended that in order for directors and officers to be held personally liable, as a general principle, they should be shown to have personally been accessories to the offensive conduct. Further, directors of companies incorporated under the Act should not be subject to individual offence provisions that do not apply more widely. Finally, a more consistent approach at Commonwealth, State and Territory levels of the legislature would provide certainty for individual directors and would promote corporate compliance and good risk management.

In a recent address to the Australian Institute of Company Directors, the Parliamentary Secretary to the Federal Treasurer described CAMAC's recommendations as 'useful' and stated that he looked forward to discussing them with his State and Territory counterparts in the near future.

Australia

Who can sue?

While there have been no specific legislative or case-law developments in recent years in relation to the type or classes of potential claimants against directors or officers, a number of recent issues are likely to have an impact on both the likelihood of claims being made and the manner in which such claims are brought.

In particular, the following matters are likely to have an impact:

CAMAC

The April and September Reports published by CAMAC referred to above are likely to expand the categories of potential litigants, given the proposed broader application of the statutory duties of directors and officers in the Act.

Litigation funding

While the crimes and torts of maintenance and champerty have been abolished for some time in most Australian jurisdictions, until the recent High Court of Australia decision in *Campbell's Cash & Carry Pty Ltd v Fostif Pty Ltd* (2006) HCA41, there remained scope for courts to conclude that some parts of a third-party litigation funding agreement might render it contrary to public policy and, as such, an abusive process. The High Court considered the issue and found that conduct, such as exercising a significant degree of control over the proceedings and obtaining a profit by funding proceedings, were not contrary to public policy in states where the tort had been abolished.

The effect of the High Court's decision in *Fostif* is likely to provide further encouragement to litigation funders to fund proceedings against companies, and where relevant, against the directors and officers of those companies. It is likely that the decision will, in particular, encourage representative proceedings or 'class actions', because the economies of scale involved in such actions make them more attractive for litigation funders.

Shareholder actions against insolvent companies and their directors

The decision of the High Court of Australia in relation to *Sons of Gwalia Limited (subject to Deed of Company Arrangement) v Margaretic* [2007] HCA 1 will also have 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 breach of continuous disclosure obligations can prove in the administration or liquidation of the company, and will for those claims rank equally with unsecured creditors. Further, all shareholder claims will rank equally whether the shares were acquired by subscription or transfer.

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

Such claims may often conveniently be brought by way of representative proceedings which, as mentioned above, are now much more likely to be attractive to third-party litigation funders.

Proportionate liability

Many claims against directors are made in circumstances where claims may lie against other 'concurrent wrongdoers' for the same loss or damage. This often occurs when a company becomes insolvent.

As a result of recent legislative reforms, both at Commonwealth level and in each State and Territory, such claims may be subject to proportionate liability. This means each wrongdoer is liable only to the extent of its degree of responsibility for the loss, rather than jointly and severally liable for the whole of the loss. This places greater incentive on plaintiffs to include all relevant directors and officers in any claim, to ensure full recovery. The proportionate liability legislation is relatively new, and there are some important differences between the various jurisdictions. A number of questions arise as to the meaning and scope of these provisions which are likely to require consideration by the courts.

In summary, it seems likely that the scope of liability for breach of statutory duties ordinarily associated with directors is likely to be expanded. Further, as a result of decisions such as *Fostif and Sons of Gwalia*, substantial proceedings, including class actions against directors and officers, are more likely to be commenced.

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

Recent legislative developments

The Trade Practices Legislation Amendment Act (No 1) 2005 recently received Royal Assent. It inserts new sections into the *Trade Practices Act 1974* (Cth) ('TPA') which limit the ability of companies to indemnify their officers (defined in s9 of the Act and extending beyond titular officers to include sufficiently senior managers) for the consequences of breaching competition law. These amendments took effect in January 2007, and are not retrospective.

The new s77A of the TPA will prohibit companies from indemnifying officers for any liability to pay a pecuniary penalty under s76 of the TPA for a contravention of a provision of Part IV of the TPA. Part IV covers anti-competitive conduct such as price-fixing and abuse of market power.

Companies will also be prohibited from indemnifying their officers for legal costs incurred in defending or resisting proceedings in which the person is found to have such a liability. The new s77B will render void any prohibited indemnity.

These amendments mirror existing provisions in ss199A and 199C of the Act, which prohibit indemnity for certain liabilities arising under the Act and render void any such indemnities. However, the amendments do not insert any provision into the TPA equivalent to s199B of the Act to prevent a company paying premiums for insurance (as opposed to granting indemnity) for its officers' actions.

Recent case law

In *Whitlam v National Roads and Motorists' Association Ltd* ('NRMA') (2006) 58 ACSR 370, Justice Bergin confirmed that an appropriately-drafted indemnity clause can oblige a company to indemnify an officer for legal costs incurred in bringing, and not merely defending, proceedings relating to their status as officer. Whitlam had instituted two defamation actions that arose during his time as president of the NRMA. Justice Bergin held that an indemnity 'against any liability' incurred by Whitlam as an officer of the NRMA included Whitlam's costs of defending himself against defamatory claims; those costs being a 'liability' within the meaning of the indemnity that arose out of a 'claim' made against him (ie the defamatory allegations). Whether such an indemnity by the company would be covered under its D&O policy is questionable and would depend on the wording of the policy, far more than on this decision.

On the other hand, the wording of the policy can restrict rather than facilitate a novel claim for indemnity. Although much will depend upon the particular policy wording, in *Intergraph Best (Vic) Pty Ltd v QBE Insurance Ltd* (2005) 11 VR 548, the Victorian Court of Appeal indicated that directors and officers liability policies do not generally insure the company (as opposed to its officers), except to the extent that the company indemnified the insured directors and

Australia

officers. A company's claim for its own costs was thus rejected.

What types of directors' insurance are available?

The market for directors' insurance in Australia is a mature and competitive market in which a broad range of cover is available to be purchased from both local and overseas markets.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:

- advance payment of defence costs until such time as the conduct is established by admission or final determination
- bail bond or civil bond expenses
- challenges to detention, deportation, extradition, or orders seizing or freezing assets
- challenges to disqualification
- entity cover
- formal examinations by a liquidator or regulators
- royal commissions, commissions of inquiry and stock exchange investigations, and
- 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, please contact your insurance broker.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN BRAZIL

ELIZABETH LEONHARDT, SOLICITOR AND RICHARD HAWKINS, SOLICITOR, CLYDE & CO

This article supplements the section on Brazilian D&O insurance written by the same authors in the Willis *Worldwide Directory of D&O Liability* 3rd Edition 2005. Unless stated to the contrary below, the information in the previous article is still up to date.

Brazil

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

Although D&O insurance is a recent innovation in Brazil, the stricter laws, the phenomenon of globalisation and the trend for privatisation have fuelled the growth for D&O cover in Brazil.

Who are directors and officers?

By way of background, in order to explain the definition of directors and officers under Brazilian law, it is worth briefly reviewing some general issues concerning 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)** privately or publicly-held companies incorporated as '*Sociedades Anonimas*' (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 'LSA') 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'). Publicly-held *S/As* must be registered with the Brazilian equivalent to the US Security and Exchange Commission (the 'Comissão de Valores Mobiliarios') ('CVM').

A *Limitada*, on the other hand, is commonly formed by two or more individuals or entities and its 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 the present discussion, we will refer to both the *S/A* and *Limitada* as the 'company', unless stated otherwise.

The term 'directors and officers' does not have a formal definition 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 ('*Conselho de Administração*') and its board of officers ('*Diretoria*'). As for *Limitadas*, these have no board of directors and/or officers; *Limitadas* are managed by one or more administrators. The management of the company will therefore include the board of directors and board of officers of *S/As*, the administrator ('*administrador*', who is basically the person who manages the *Limitada* and 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 the present discussion, we will refer to the management of any company as 'administrators' unless stated otherwise.

Liability of administrators and recent developments

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

(i) the BCC – see articles 927 (a party who commits an illicit act and causes damage to another must indemnify), and articles 1009, 1011, 1012, 1016, 1017, 1036, 1053, 1080 (dealing primarily with the duties and liabilities of the administrators of *Limitadas*; however, given the generality of the provisions of the BCC, it

Brazil

is now understood that the various provisions under the LSA and miscellaneous provisions under other laws and statutes also apply to *Limitadas*) and article 1093

(ii) the LSA – Articles 153 to 160

(iii) the Brazilian National Tax Code ('NTC') of 1966 – Article 135

(iv) the Brazilian Consumer Protection Code of 1991 ('BCPC') – Article 28

(v) Tax Enforcement Law no. 6.830 of 22 September 1980 ('*Lei de Execuções Fiscais*') – Article 4

(vi) Antitrust Law 8.884 of 11 June 1994 ('*Lei Antitruste*') – Articles 16 to 19

(vii) Money Laundering Law 9.613 of 3 March 1998 ('*Lei de Lavagem de Dinheiro*') – Articles 9 and 12

(viii) Banking Intervention and Extra-Judicial Liquidation Law 6.024 of 13 March 1974 ('*Lei da Intervenção e Liquidação Extra judicial de Instituições Financeiras*') – Articles 39 and 40

(ix) The Financial Institutions Law 4.595 of 31 December 1964 – Articles 42 to 44

(x) Environmental Law 9.605 of 12 February 1998

(xi) The Brazilian Criminal Code of 1940 – Article 177

(xii) Law Decree no. 2.321 of 25 February 1987 – Article 15.

Generally, under Article 158 of the LSA, administrators will be personally liable for their acts while representing the company **(i)** when acting within their corporate powers with fault or malice; or **(ii)** in breach of any statute or regulation. The administrator will also be jointly liable for the acts of its peers should he have acted in connivance with them or, despite knowledge of any wrongful conduct, he fails to investigate or take steps to prevent such acts.

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

It is interesting to note that, 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.

Originally only the directors and shareholders of companies (in particular *S/As*) were held liable. Nowadays, as stated above, personal liability also attaches to managers of the company or anybody who has decision-making powers appointed by the company. 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 LSA and BCC) to specific duties and liabilities in respect of tax, environmental, consumer, financial and criminal matters.

With regard to tax liability in particular, recent Brazilian case law has interpreted article 135 of the NTC and Article 28 of the BCPC to the effect 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 rules 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 represents 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 spheres. 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 per cent 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 or *penhora on-line* to freeze administrators' assets has been very controversial in Brazil, causing considerable alarm to administrators.

On the corporate governance side, Brazilian law still does not provide for a specific set of rules in relation to corporate governance. Publicly-held *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 São 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, they will also be free to choose the level of governance applicable. The CVM has powers to investigate and instigate administrative proceedings against companies and/or their administrators. The CVM may apply sanctions against companies or administrators who are found to be in breach of their corporate obligations. In the past two years the number of sanctions applied by the CVM for non compliance with corporate governance practices has substantially increased.

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

D&O insurance in Brazil

Due to the internationalisation of the Brazilian market and the developing legislative framework, companies and administrators have slowly become aware of the need to obtain D&O insurance coverage. D&O insurance is relatively new in Brazil and is not mandatory.

At present, the leading companies offering D&O insurance coverage in Brazil are Unibanco AIG, Chubb, ACE and Bradesco Seguros. Many commentators predict that the Brazilian insurance market will experience substantial growth in the sector of D&O insurance in the coming years.

There is no specific regulation under Brazilian law dealing with D&O insurance coverage. D&O insurance will be governed by the general rules applicable to insurance contracts provided for under the BCC, as well as the rules established by the Brazilian Private Insurance Superintendence ('SUSEP') – Regulations no 256 of 16 June 2004, no 252 of 26 April 2004 and no 336 of 22 January 2007.

Despite the lack of specific regulation on D&O insurance, the

Brazil

Instituto the Resseguro Brasileiro, ('IRB'), has made available draft general conditions and endorsements via its website which may be used as a model by Brazilian insurers when implementing their own D&O policies. Having said that, most of the insurers offering D&O insurance in Brazil are now using their own policy wording. It is important to note that, since 16 January 2007, the IRB no longer has a monopoly in the Brazilian reinsurance market and as a result we should expect the Brazilian insurance and reinsurance markets to start slowly assimilating aspects of international insurance and reinsurance practices, including those related to D&O insurance.

Following below is a summary of the general concepts of D&O insurance in Brazil.

- Coverage is usually taken out 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 validity period of the policy. It is not always clear whether coverage also extends to ex-administrators or informal administrators
- Coverage will usually include **(i)** the indemnification for any loss and/or damage suffered by the insured as a result of any claim filed against him in respect of his activities as administrator of the company; and **(ii)** reimbursement of legal costs and expenses incurred by the insured company as a result of any claim filed against its administrators
- Coverage is commonly taken out 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)
- 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, except when taken out as a separate coverage. It also does not extend to damage to the company's reputation
- Finally, D&O policies are typically written on a 'claims made' basis as provided by SUSEP Regulation no 336 of 2007.

In summary, although D&O insurance is relatively new in Brazil, if, as appears likely, claims against administrators are set to become a fact of life in Brazil, D&O insurance will become commonplace and part of the cost of running a business in Brazil, or '*custo Brasil*' as it is known locally.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN FRANCE

RÉMI PASSEMARD, AVOCAT,

BOUCKAERT ORMEN PASSEMARD

SPORTES – BOPS

France

In recent years, directors' and officers' liability has become an increasingly sensitive topic in France. In the wake of various worldwide events, some legal changes have been introduced, and others will undoubtedly be introduced in the future, the general trend being to increase directors' and officers' liability at both European and domestic levels.

At the same time, the D&O liability insurance market has grown significantly, first for policies taken out by the listed companies and then for policies taken out by small- and medium-sized businesses. Various D&O carriers are quite active, leading to strong competition among market players.

D&O liability in France

Executive risks are impacted by the changing environment in terms of corporate governance, expected legislation on stock options, European legislation and the likely introduction of class actions. Transparency and independence are key underlying principles in this changing environment.

Corporate governance

On 1 August 2003, the post-Enron Financial Safety Act introduced significant changes, including those in the area of corporate governance for public limited companies listed on a stock market.

The chairman of the board has to prepare a report detailing the conditions under which the board's work is prepared and organised, as well as internal supervision procedures implemented by the company. The same obligations are imposed on the chairman of the supervisory board in companies with a two-tier management structure.

The above-mentioned procedures may be put in place by an internal audit department, a control committee, etc. One of the main procedures relates to financial and management information. The scope of the internal supervision procedures extends to areas such as industrial risks, environmental risks, health and safety risks, and insurance.

The Act also established new rules on:

- information to be communicated by the chairman of the board to the board members
- transparency concerning the remuneration of directors
- information on transactions between the company and any shareholder holding 10 per cent or more of the company's share capital, or between the company and its CEO or a board member.

New legislation on stock options

There is clearly a focus on the remuneration of executives. In the wake of some matters that attracted considerable media attention during 2006, new legislation on stock options was expected. In September 2006, a bill was submitted and passed by parliament on 30 December 2006, empowering boards of directors/supervisory boards to decide whether stock options granted to executives could be exercised before the end of the executives' term of office, or whether a percentage of the resulting shares needed to be kept by the managers up to the end of their term of office.

EU legislation

Several European directives have already been – or will soon be – transposed into French law. EU legislation is a significant factor impacting executive risks, as shown below from excerpts of new directives. Transparency, again, is a key principle:

- Under the European Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading (the 'Prospectus Directive'), the persons responsible within the issuer must sign the prospectus and state that '*to the best of their*

France

knowledge, the information contained in the prospectus is in accordance with the facts and that the prospectus makes no omission likely to affect its import' and that the issuer has obtained a letter from its statutory auditor certifying that he or she has applied professional standards in reviewing the prospectus

- The Market Abuse Directives and the Regulation on Insider Trading and Market Manipulation set a common EU framework to prevent and punish market abuses
- Law No 2005-811 of 20 July 2005 implemented the provisions concerning the drawing-up of insider lists, the disclosure of transactions by managers and persons closely associated with them and the notification of suspicious transactions. Law No 2005-842 of 26 July 2005 implemented the provisions concerning the enlargement of the AMF's territorial jurisdiction, the defaults committed abroad and the extension of the AMF's power to impose sanctions
- New requirements are also imposed by Directive 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC:
  - The issuer must make public its annual and half-yearly financial reports including statements by the persons responsible certifying that they have been prepared in accordance with the applicable set of accounting standards and that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer
  - The directive also provides that: "*Member States shall ensure that responsibility for the information to be drawn up and made public . . . lies at least with the issuer or its administrative, management or supervisory bodies and shall ensure that their laws, regulations and administrative provisions on liability apply to . . . the persons responsible within the issuers.*"
- On 17 May 2006, Directive 2006/43/EC on statutory audit of annual and consolidated accounts was also adopted
- Directive 2006/46/EC amending various other directives concerning annual and consolidated accounts was adopted on 14 June 2006 with effect as from 5 September 2006. It must be transposed by Member States by 5 September 2008.

Further new EU legislation is expected, such as a directive on shareholders' rights.

Introduction of class actions

Some European countries have adopted legislation introducing class actions into their judicial systems (Germany, Sweden, Norway, Portugal, Spain, the Netherlands and UK), while others are in the process of adapting their legislation (France, Italy and Finland).

In France, a draft bill submitted to Parliament at the end of 2006 contemplated the possibility to introduce class actions in order to obtain compensation of physical damage and consequential loss individually suffered by numerous consumers as a result of the non-performance by a professional of its contractual obligation arising from the sale of products or services.

The class action was contemplated only for consumer litigation and for small claims (so far, €2,000 at most). The action could be introduced by an approved consumer association acting, at least in the first instance, with the intention of obtaining a declaratory judgement on the defendant's liability. At the second stage, any consumer considered to have suffered damage corresponding to that defined by the declaratory judgement could claim an indemnity from the defendant. The defendant could be under an obligation to offer an indemnity. If the offer is rejected, the consumer could then refer the case to the Court.

However, the process concerning the adoption of this draft bill was stayed in February 2007, pending the elections of the French President and the new Parliament in May and June 2007. Whether the new President and Parliament would restart the process is unknown. Of course, if class actions were to be introduced with a limited scope of application, there is an obvious risk that they would subsequently be expanded to other areas such as shareholders or other litigation

Who can be liable?

Under French law, people who can be liable (and are usually covered under the D&O policy) are the *de jure* executives (chairmen of boards of directors, directors, members of executive boards and of supervisory boards where the two-tier board structure applies, permanent representatives of legal entities acting as directors, managers, voluntary liquidators) and any individual invested under foreign legislation with similar functions.

De facto executives may also be liable. They are usually defined as individuals exercising, with independence, a management or supervision activity.

Personal liability of directors and officers

Directors and officers face various types of liability in France. These are summarised below, along with any recent developments affecting their position.

Liability to the company

The company can bring suit against the company's current and/or former directors and officers for compensation for losses incurred by the company, in respect of a wrongful act committed by an executive. The requirements are the usual ones for a liability claim, namely a wrongful act, a loss and a causal link between the wrongful act and the loss.

The wrongful act may be an error or omission such as an *ultra vires* act, a breach of mandatory rules and regulations (non-observance of statutory quorum or majority rules; improper distribution of dividends, failure to convene a shareholders' meeting), or mismanagement (failure to inform the shareholders of the seriousness of the company financial position; tax evasion; negligence that caused the company to pay damages for unfair competition etc).

This type of legal action is rarely commenced, especially when the management is still in office. Individual shareholders may also bring a derivative action. This action has a certain number of particularities. The legal entity must be a party to the proceedings. The shareholder will bear the costs of the action but the company will collect any damages awarded. Derivative actions are rare too.

Liability to the shareholders personally

A shareholder may sue directors and officers for loss sustained by the shareholder in his or her capacity as such. Any damages awarded by the court accrue to the shareholder, not the company. The victim must prove a wrongful act, a loss and a causal link between the two.

The loss must not only have been suffered by the shareholder personally but also must be separate from loss, if any, suffered by the company. For example, the depreciation of a company's securities arising from the tortuous conduct of its managers does not constitute personal harm to each member, but harm suffered by the company itself.

The requirement that shareholders must personally have suffered harm separate from the harm suffered by the company is not easy to satisfy, but not impossible for all that.

In a judgment dated 30 January 2002, the Criminal Division of the Cour de Cassation held that since presenting or publishing annual accounts that do not give a true and fair view of the company's financial position, made a criminal offence by the Commercial Code, may cause direct personal harm to the members of the company or holders of securities in the company, the application by a shareholder to join the criminal proceedings as a civil party to claim damages had rightly been declared admissible.

Liability to third parties (faute détachable)

Initially, the purpose of the *faute détachable* criterion was to separate the liability of managers from the liability of the legal entity. However, *faute détachable* became a *de facto* cause of immunity for managers, since the courts would never characterise the managers' wrongdoing as a *faute détachable*.

In a landmark judgment given on 20 May 2003 in a matter involving an assignment of the same debt to two different assignees, the Commercial Division of the Cour de Cassation established a new definition of *faute détachable* by holding that a manager may be held personally liable to third parties only if he or she has committed a wrongful act capable of being dissociated from his or her duties; this is so where the manager wilfully commits a particularly serious wrongful act incompatible with the normal performance of corporate duties.

Since the above-mentioned judgment, the courts have made findings of *faute détachable* in various circumstances, for example:

- where a manager was the active initiator of a scheme to market products of another brand after repackaging them (infringement) and was personally involved in marketing the infringing products (Cass Com, 7 July 2004, No 02-17729)
- where a manager deliberately and persistently committed acts of infringement over several years, despite warnings and lawsuits (Cass Com, 25 January 2005, No 01-10740)
- where a manager personally took out motor insurance for a car owned by the company, deliberately failed to pay the premium and, despite various reminders from the insurer and cancellation of the policy, authorised a company employee under his orders to use the uninsured vehicle (Com 4 July 2006 N° 05 13930).

However, the Criminal Division of the Cour de Cassation does not apply the *faute détachable* criterion and considers that committing an intentional criminal offence always triggers the director's personal liability. If the victim is a civil party to the criminal proceedings, he or she may claim damages before the criminal court.

Liability to the creditors of an insolvent company

The Company Rescue Proceedings Act, which came into force on 1 January 2006, has introduced a new penalty, namely liability for corporate debt, in addition to the existing liability action for wrongful trading.

Liability action for wrongful-trading

Where mismanagement has contributed to a shortfall in a company's assets, the directors and officers of the company may be ordered to pay all or part of the company's debts in cases of winding-up by the court ('*liquidation judiciaire*'), or rescission of the recovery plan ('*résolution du plan de sauvegarde*' – a Chapter 11-type procedure enabling the court to intervene before the company is adjudged in cessation of payments), or rescission of the reorganisation plan ('*plan de continuation*').

Mismanagement is easily accepted by the courts. The archetype of mismanagement is continuing to engage in a loss-making business and failing to file a petition in bankruptcy within 45 days. Mismanagement may also consist, for example, in a director's failure to attend board meetings and to discharge his or her duty of supervision, or in officers' failure to equip themselves with the management tools necessary for monitoring changes in the company's financial position, or failure to reduce the number of employees in a difficult economic climate.

An action for wrongful trading may have serious consequences, with directors and officers forced to pay significant damages. The risk is even greater for investment funds that are members of the board of an insolvent legal entity ('deep pocket').

Action for payment of corporate debts (*action aux fins de paiement des dettes sociales*)

This new action for payment of corporate debt enables directors and officers of a company to be made liable for all the debts of the company, where they are found guilty of any of the five types of serious misconducts established by law, such as disposing of the assets of the body corporate as if they were their own; misappropriating or concealing all or some of the assets of the body corporate, or fraudulently increasing its liabilities.

Tax liability

Executives of a company are liable for fraudulent schemes or serious and repeated non-compliance with tax obligations that have prevented the collection of tax and penalties owed by the legal entity. If the executive has not otherwise been ordered to pay corporate debts, he or she may be found jointly and severally liable for the payment of such taxes and penalties.

For instance, the payment of secret remuneration or the use of false invoices issued by non-existent or unidentified companies has been held to constitute a fraudulent scheme.

Serious and repeated non-compliance with tax obligations is mainly established either by failure to file a tax return (or filing an incomplete or late return) or non-payment of duly assessed taxes.

Criminal responsibility and corporate indemnification

Criminal responsibility is a very serious risk for directors and officers in France.

Directors and officers may incur liability both for offences under corporate criminal law (white-collar crime such as misuse of company property, publication of accounts not giving a true and fair view of the company's financial position, forgery etc) and for offences under the ordinary criminal law (manslaughter, pollution etc).

A common offence is misuse of company property. Misuse of company property is a French company law offence that only applies to managers of companies incorporated in France. The offence arises where a director, officer or other manager of a French public limited company uses the company's assets or credit for personal advantage and to the detriment of the company's interests.

A company's indemnification of directors for their defence costs and for any damages awarded against them would qualify as misuse of company property and is therefore unlawful.

For companies not incorporated in France, the offence is breach of trust, consisting of misappropriating, to

France

the detriment of another, any funds, assets or property, by a person who has taken delivery of them and who has accepted them with the duty to return them or put them to a specified use. In some cases, the management may be deemed to be entrusted with the company's assets with a duty to use them in the company's interest.

The disclosure of misleading financial information may also give rise to proceedings by the French stock market regulatory authority (the 'AMF'), which may ultimately impose heavy fines on directors and officers. In this respect, the trend represents an increased role for the French regulator in terms of defining the rules and investigating (and sanctioning) malpractices.

Furthermore, executives can also be prosecuted in respect of the offence of dissemination of misleading information and face criminal responsibility. This offence may be linked with the publication of accounts not giving a true and fair view of the company's financial position, when these accounts have been manipulated. The French courts' intention is to penalise executives with severity. The Sidel case, decided by the first instance Criminal Court in Paris on 12 September 2006 is an example, even if the decision was appealed (in addition to the criminal sanctions, the executives were personally condemned to pay damages to more than 700 shareholders).

Other criminal offences also involve labour law, anti-competition law, company law, etc.

Types of directors' insurance available

Insurance policies are available for listed and non-listed companies, multinationals and small and medium-sized businesses. Depending on the risks and industry sector, policies available range from coverage with a €1 million limit to layered excess programs involving substantially higher limits.

The insurance policy usually covers the individuals listed in section II above in respect of defence costs and damages that executives may be ordered to pay, on a Side A basis. Side B, often provided in the policy wording, may operate in respect of subsidiaries incorporated in foreign jurisdictions, if the local law permits corporate indemnification.

Legal entities are usually not covered. Extended coverages are sometimes available on an optional basis for the legal entities (securities claim, legal entity acting as director of its subsidiaries, joint claim extension) and the individuals (employment practice liability).

Finally, it is worth reminding readers that D&O insurance policies operate on a claims made basis, subject to compliance with various requirements. One of them is a compulsory five-year discovery period from the expiry of a coverage, or of the contract. The discovery period's limit must be an entirely fresh one for the whole period, in an amount at least equal to the limit of the last insurance period. Other requirements have also been imposed in 2003 so that liability insurance policies operate on a claims made basis in France.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN GERMANY

WOLFGANG SCHALLER, PARTNER, AND DR DIRK LORENZ, PARTNER, TAYLOR WESSING

Germany

The *Mannesmann* case (in respect of premium payments following the hostile takeover of Mannesmann by Vodafone) brought extensive publicity to the standard of care and liability of board members in Germany. The liability of executives in Germany is subject to recent court decisions, and newly-introduced legislation has considerable impact on D&O insurance.

In the first section of this article we provide an overview of some of the major aspects of the standard of care applicable to directors and officers of German corporations and the liability that arises from breaches of that standard of care. For the purposes of this article, we differentiate between the managing directors of a limited liability company ('*GmbH*'), and members of the management board and (of the) supervisory board of a stock corporation ('*AG*'). A special paragraph focuses on publicly-listed companies. In the second section of the article, we describe the types of D&O insurance currently available in Germany.

Standard of care and liability of directors and officers

Managing directors of a GmbH

The GmbH is the most common corporate legal structure in Germany. Its board consists only of managing directors – non-executive members are not recognised under German law. Managing directors should apply the care of prudent businessmen 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 judgement rule (as recently introduced in s93 para 2 of the German Stock Corporation Act, also applicable to a GmbH): broad entrepreneurial discretion, but careful preparation of business decisions (risk evaluation) 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, there is a duty to file for insolvency proceedings without undue delay) and introduction of a risk management system
- payment of taxes and social security contributions.

In case of a breach of any of these duties, managing directors are liable to the company for damages. The burden of proof is reversed, ie the company need only prove that it has suffered damages as a result of the actions of the managing director, while the managing director has to prove that s/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 related to damages. The time-limit for claims for damages is five years.

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

Germany

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 limited liability company. In particular, the business judgement 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 per cent, or more, 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 one per cent 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 interests of the company and in accordance with the business judgement rule. The supervisory board is not obliged to follow instructions from shareholders. Stock options cannot be granted to supervisory board members in order to secure their independence. Further, 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 conflict of interest.

Any contract, in particular advisory agreements, with supervisory board members or with consulting firms where a supervisory board member is involved, require the consent of the supervisory board (the respective member has no right to vote) and must describe in detail the scope of the services to be rendered (which 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. Premium payments granted to management board members are only admissible if already stipulated in the employment contract. Without such provision, bonus performance-linked payments (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 one per cent or €100,000 of the registered share capital) may demand the assertion of claims for damages.

Listed companies

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

In addition board members have to observe various duties under the Securities Law:

- **prohibition of insider trading:** nobody who has gained access to inside information is permitted to use such information for trading in insider securities
- **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:** any board member has to 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, all financial statements are true and correct.

D&O insurance

In Germany it is possible for board members (see above), as well as employees holding executive positions in a company, to be insured against third-party legal liability. This insurance is, from a legal perspective, liability insurance against financial loss, offered on the market as so-called 'D&O insurance'. 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.

The conditions and coverage of the products offered by the leading insurance companies in this market segment are diverse. In general, the insurance contracts are based on the claims-made principle – ie contracts in which the first claim is fixed as an insured event. These claims-made insurance contracts must be distinguished from the insurance contracts based on the principle of an occurrence, also offered on the German market, regularly on advantageous terms for the policy holder. The insured event under these types of insurance contracts is not the assertion of a claim, but the breach of a duty of the insured person.

When selecting D&O insurance based on the claims-made principle, the following factors have to be observed:

- accurate and sufficient description of the insured activity of the insured person
- timely sufficient retroactive cover (in case of a first contract, possibly timely unlimited retroactive coverage)
- timely sufficient run-off liability period
- cover of slight and gross negligence
- sufficiency of cover
- transparent and understandable contractual terms and conditions.

D&O insurance contracts often do not cover intentional (ie knowingly and willingly committed breaches of duty by the insured person). Furthermore, contractual conditions

Germany

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.

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 market segment to select the insurance product offering the most suitable terms and conditions. Since the policyholder of this insurance is regularly the company, the insured person (ie the board member) should insist that the signed policy is as transparent as possible, helping him/her to understand whether and to what extent s/he is covered, as well as the limits of his/her personal liability to the company.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN IRELAND

SHARON DALY, PARTNER,

MATHESON ORMSBY PRENTICE

Ireland

Since the late 1990s, issues of corporate governance in Ireland have risen sharply in importance in the aftermath of international corporate scandals such as WorldCom and Enron. In the past two years alone there have been a number of significant developments in relation to financial regulation and the scope of Directors' and Officers' ('D&O') liability. In this chapter, we will explore these significant developments, both case law and legislation, with a view to highlighting the issues that affect multinationals in Ireland.

The main areas that will be explored are:

- High Court decision of *Fyffes plc v DCC plc and Ors*
- *Kavanagh v Delaney (re Tralee Beef and Lamb Ltd)*
- Section 45 of the Companies (Auditing and Accounting) Act 2003
- European Market Abuse Directive
- Consumer Protection Code
- Financial Regulator's Administrative Sanctions Procedure
- Office of the Director of Corporate Enforcement developments.

Fyffes plc v DCC plc & Ors

On 21 December 2005, Ms Justice Mary Laffoy found that DCC plc, Mr Jim Flavin, and two wholly-owned subsidiaries of DCC, namely S&L Investments Limited and Lotus Green Limited, had not engaged in unlawful trading as defined in section 108 of the Companies Act 1990 (the '1990 Act'). This decision concluded the most significant insider-dealing case in Irish legal history.

The proceedings were initiated by Fyffes plc under Part V of the 1990 Act. That part creates a civil liability for a party that deals in shares on the basis of materially price-sensitive insider information.

The judge said that the evidence clearly indicated that it was Mr Flavin who negotiated, agreed and controlled the process in respect of the sale of the shares in Fyffes on behalf of DCC. Consequently, Laffoy J decided that Mr Flavin had dealt in the shares for the purposes of Section 108. The key issue to be determined was whether or not the information in the possession of Mr Flavin at the time of the sale of the shares in Fyffes constituted 'price-sensitive information' for the purposes of section 108.

Section 108(1) defines price-sensitive information as '*information that is not generally available, but if it were, would be likely to materially affect the price of those securities*'. The court held that in carrying out the assessment of whether the information was price sensitive, it should do so from a perspective of the 'reasonable investor' making an investment decision. The subjective views of the insider are therefore irrelevant in this decision-making process. Laffoy J said that this notional individual should be representative of the type of investor typically found in the particular market at the time. Hence, in this case, investors who were anxious to own stocks with an 'internet' element were regarded as 'reasonable investors'. This supported DCC's argument that, by virtue of the existence of Fyffes' World of Fruit internet venture, the shares in Fyffes had an internet element that decreased the potential material impact of the information contained in Fyffes' trading reports.

In determining the price-sensitivity issue, the judge identified the key question as being whether, as a matter of probability, on 3 February 2000, the reasonable investor, having assessed the information in the Fyffes' trading reports in the context of the total mix of information available to the market at that time, would have concluded

Ireland

that the information would probably impact on Fyffes' share price to a substantial or significant degree. The judge concluded that they would not and the share sales were not found to be unlawful. Consequently, Fyffes' action for compensation under section 109 was unsuccessful.

Section 109 of the 1990 Act, which formed the statutory basis of Fyffes' action, has subsequently been repealed by Section 31 of the Investment Funds, Companies and Miscellaneous Provisions Act 2005. However, the judgment remains the leading authority in the context of insider-dealing legislation, as many provisions of Part V of the 1990 Act (the legislation governing the old insider-dealing regime), have been replicated in either the 2005 Act and/or the Market Abuse (Directive 2003 16/EC) Regulations 2005.

Kavanagh v Delaney (re Tralee Beef and Lamb Ltd)

This 2004 case concerned a High Court application under section 150 of the Companies Act 1990 brought by the liquidator of a company in respect of a director and three non-executive directors of the company. The application was for a restriction on each of the directors being appointed as director or secretary of a company for a period of five years (subject to certain provisions).

In analysing the case, the court stated that, in relation to applications of this kind, the court cannot ignore the common law duties of directors, which are based on fiduciary principles as well as the duties of skill and care based on principles in the law of negligence. The court must have regard not only to the extent to which a director has or has not complied with any obligation imposed on him/her by the Companies Acts, but also with duties imposed by common law.

The judge approved the accepted general principle that: '. . . the directors owe a duty to the company to exercise skill and diligence in the discharge of their functions'. She also said that the courts have broken down this general principle into a number of sub-propositions, most of them tending to limit or modify the extent of the duty owed by the directors. In particular, one of these propositions was that '[e]ach individual director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them.'

The court confirmed that delegation to the executive directors of the day-to-day management of the company 'does not absolve the non-executive directors from the duty to acquire information about the affairs of the company and to supervise the discharge of delegated functions' but that 'the court should take into account the differing roles of each director.'

The judge went on to state that the question of whether a director had acted responsibly within the meaning of section 150 of the 1990 Act must be judged by an objective standard, which must include the minimum common law duty imposed on a director of participating in the affairs of the company. She said that it would be difficult, therefore, to envisage that a director could establish that s/he has acted responsibly if, during a significant period, s/he either failed to inform himself/herself about the company's affairs, or if s/he did not take steps to join with his or her co-directors in supervising and controlling the affairs of the company, at least in the sense of taking reasonable steps to guide and monitor the management of the company.

The judge noted that section 150 does not appear to give a court any discretion to consider how a party acted or acts as a director of any other company. The party must satisfy the court that he or she acted responsibly as a director in relation to the conduct of the affairs of the company in liquidation for which the application is made.

In making declarations of restriction against all of the directors, including a non-executive director (a wife of one of the directors), the judge stated 'that by agreeing to become a director of the company, she undertook a separate and distinct role, which imposed on her certain obligations and which I cannot be satisfied she discharged in a responsible manner.'

Section 45 Companies (Auditing and Accounting) Act 2003

When it was first brought onto the statute books in 2003, section 45 of the Companies (Auditing and Accounting) Act envisaged placing a particularly heavy burden on company directors to prepare compliance policy statements covering three main areas of company compliance. However, implementation of this particular section of the legislation was postponed and referred to the Company Law Review Group ('CLRG'), which is a statutory body established to review and consolidate Irish Company Law.

The CLRG's key recommendation was that section 45 be repealed and not be replaced. However, following further discussion, the Group suggested a compromise replacement section and the minister has accepted this rewrite. At time of writing, it is anticipated that implementation of this section will be sometime in 2007.

The new obligations will apply to Irish incorporated public limited companies ('PLC') and private companies with a turnover of over €25m **and** a balance sheet over €12.5m. It is likely that the minister will exempt securitisation vehicles and certain investment fund vehicles.

Affected directors will be required to make a statement in the annual accounts acknowledging their responsibility for securing the company's compliance with its relevant obligations, which is defined as meaning indictable (serious) offences under the Companies Acts and Tax Law.

Confirmation must be given that the company has a compliance policy statement in place or, if not, why not. In addition to these statements, directors will also be required to confirm that the company has 'appropriate arrangements or structures' in place, which, in the opinion of the directors, are designed to secure 'material compliance with these relevant obligations'. Again, if these are not in place, the reasons why must be explained.

These 'arrangements or structures' can include the directors relying upon internal/external advisors who 'appear to the directors to have the requisite knowledge and experience to advise the Company on compliance with its relevant obligations'. These arrangements or structures must also be designed to provide a 'reasonable assurance' of 'compliance in all material respects'.

Aside from section 45 requirements, the Irish financial regulator was given a parallel power to request compliance statements of the entities that it regulates. Contained in the Central Bank and Financial Services Authority of Ireland Act 2004, these powers have not been used by the financial regulator on the basis that it wanted to wait and see how section 45 was going to be implemented. The financial regulator has now indicated that it would like to initiate a consultation process on how it should utilise its powers.

The key features of this requirement are:

- it applies to all financial service providers, regulated by the financial regulator, irrespective of size. There are no turnover or balance sheet thresholds

Ireland

- there is no automatic requirement to prepare them each year. Rather they are triggered by a formal request from the financial regulator. This will allow the financial regulator to focus on specific issues or themes within the industry, or to ask for a compliance statement in advance of one of their periodic inspections
- details of each breach of relevant obligations (see below) must (in accordance with any guideline issued) be reported
- the definition of 'relevant obligations' is broad, covering:
  - **(i)** financial legislation contained in certain designated enactments and statutory instruments
  - **(ii)** codes, guidelines and notices issued by the financial regulator and applicable to the company, and
  - **(iii)** all other enactments and statutory instruments with which the company must comply
- although the compliance statement itself does not need to be included in the company's audited accounts, the auditor must add its opinion that the statement is fair and reasonable or, if not, why not.

Market abuse regulations

The European Market Abuse Directive (Directive 2003/6/EC) (the 'Directive') has been implemented in Ireland by the Investment Funds, Companies and Miscellaneous Provisions Act 2005 (the '2005 Act') and the Market Abuse (Directive 2003/6/EC) Regulations (SI 342 of 2005) (the 'Regulations').

To comply with the Irish market abuse regime, a person must have regard to these regulations and also to the Interim Rules issued under section 34 of the Investment Funds, Companies and Miscellaneous Provisions Act 2005 (the 'Interim Rules') and CESR Guidance and Information on the Common operation of the Market Abuse Directive (the 'CESR Guidance').

The Directive introduced a new concept of 'market abuse', comprising insider dealing and market manipulation. The new regime has introduced some new requirements, such as the requirement to notify managers' transactions. This requirement became effective on 1 October 2005. Now managers of an issuer of financial instruments, and persons closely related, must notify transactions conducted on their own account related to the shares of the issuer.

The regulator has not applied the possible €5,000 threshold for transactions to be notified. Therefore, every transaction falling within the scope of the definition must be notified. The transaction must be notified within four business days of the date on which the transaction occurred. The legislation provides for significant sanctions, including criminal prosecution, where the new rules are deemed to have been breached. The Financial Regulator is the enforcement authority for the new Market Abuse Regime.

The basic prohibition on insider dealing remains the same as the old regime. Insiders must not misuse or seek to misuse inside information for their own, or others', advantage. Market manipulation is, as the name suggests, the actual manipulation of the market, for example, where someone (who is not necessarily an insider) tries to distort the price of a share, or other financial instrument, by misleading the market by engaging in artificial transactions, or disseminating false or misleading information.

The Directive applies to financial instruments admitted to trading on a regulated market in an EU/EEA

Member State, or for which a request for admission to trading on such a market has been sought, irrespective of whether or not the transaction itself actually takes place on that market. The Directive also applies to financial instruments not admitted to trading on a regulated market in an EU/EEA Member State, but whose value depends on a financial instrument admitted to trading on a regulated market in an EU/EEA Member State or for which such an admission to trading has been sought. The Irish Stock Exchange is a market covered by the Directive.

Relevant transactions relate to transactions on those managers' or closely related persons' own account. These requirements may cause problems where managers or senior staff within an organisation seek to invest in the units of a collective investment scheme.

Consumer Protection Code

The Consumer Protection Code ('CPC') and Minimum Competency Requirements ('MCR') provide a standardised approach to the conduct of business for all entities regulated by the financial regulator, across all financial products and services in Ireland. The new codes are not voluntary; rather, they are legally binding with contraventions being subject to possible administrative sanctions. Such administrative sanctions could lead to fines of up to €5 million for companies or personal fines of up to €500,000 'for persons concerned in the management' of such companies. Where a requirement of the CPC conflicts with a requirement of a voluntary code (such as the codes of conduct of the Irish Insurance Federation and Irish Banking Federation) the CPC will take precedence. As such, and in common with all regulatory matters in recent years, compliance professionals, legal teams and management of regulated firms will need to devote time to considering the implications of these changes on their businesses. The precise impact will vary from business to business, but all will need to review their processes, procedures, systems, documentation and staff training and, from this review, develop a comprehensive implementation plan.

The CPC was effective from 1 August 2006, but the financial regulator acknowledged that some changes would take regulated firms some time to implement. However, it expects firms to take 'immediate steps' towards implementing the necessary changes.

Some specific new requirements must be adhered to from the end of August 2006 including, *inter alia*, a prohibition on making the sale of one product contingent on the purchasing of another product; new rules on notification of changes in interest; a prohibition on unsolicited pre-approved credit; and new requirements for warning statements on all advertisements created after 31 August 2006.

CPC and MiFID

The Markets in Financial Instruments Directive (2004/39/EC)('MiFID'), which came into force end-January 2007, must be fully implemented by November 2007. MiFID is a wide-ranging directive, applying to firms dealing with investment products, which includes a new set of comprehensive pan-European conduct of business rules for investment instruments. Unlike the UK, where the FSA is undertaking an exercise to ensure that the same conduct of business rules will apply to all financial products (whether covered by MiFID or not), the financial regulator will, in the future, have two sets of rules: the CPC, which contains general principles and specific rules for most financial products and services, and separate 'MiFID rules', which will cover MiFID instruments only.

Ireland

While the broad thrust of both enactments is similar, regulated firms will need to examine both sets of requirements in detail to ensure that they are all being complied with. A practical example is tracker bonds. While typically structured as deposits, they are classified as investment instruments for the purposes of the Investment Intermediaries Act; however, they are covered by the CPC and not MiFID rules because they are not listed as investment instruments in MiFID. Indeed the CPC has extensive new disclosure requirements with respect to these instruments.

Application of the CPC

Twelve general principles are set out and apply to all dealings with customers in Ireland. These include obligations to act honestly, fairly and professionally in the best interest of customers and the integrity of the market, to make full disclosure of all relevant material information, including all charges, in a way that seeks to inform the customer, to act with due skill and in the best interests of customers and not to deliberately mislead a customer as to the real/perceived advantages or disadvantages of any product or service, and to comply with the spirit and letter of the Code.

Specific conduct of business rules are set out for dealings with **consumers**. The definition of consumer mirrors that in the Financial Services Ombudsman's scheme and means a person acting outside his/her trade, business or profession, an unincorporated body, or an incorporated body with a turnover below €3 million, or a member of a credit union.

While the general principles apply to both consumers and customers, as defined, the majority of the Code applies only to consumers, and therefore will not apply to professional clients of financial services firms.

Before transacting any business for a consumer, all regulated firms must provide him or her with a copy of their terms of business. The firm must take steps to 'know their customer' by ensuring an appropriate fact-find is completed. Having regard to all the facts disclosed, a suitability letter must be given to the consumer. These requirements do not apply to 'execution-only' transactions, or to sales of foreign currency, or of basic banking products or services.

The term 'execution-only' is not in fact used in the CPC, but it is described where a consumer has specified both the product and the product provider and has not received any advice.

A 'basic banking product' is defined as a current account, overdraft, ordinary deposit account, or a term deposit account with a term of less than one year.

In addition, the CPC deals with a range of other matters – from restricting cold-calling, to requiring full and transparent disclosure to consumers of all charges, to imposing time-limits within which complaints must be investigated and resolved, and imposing a specific six-year 'from the date the relationship ends' time-limit for the maintenance of customer records.

Administrative Sanctions procedure

The new Administrative Sanctions enforcement powers will allow the financial regulator to conduct inquiries in public, fine regulated entities up to €5 million, fine individuals up to €500,000 and, in certain circumstances, disqualify persons from working in the financial services industry. They are contained in Part IIIC of the Central Bank Act, 1942 (the '1942 Act'), which was inserted by a combination of provisions of the Central Bank and Financial Services Authority of Ireland Act 2003 and the Central Bank and Financial Services Authority of Ireland Act 2004, (the so-called 'IFSRA No 2 Act').

Most of the changes are contained in section 10 of the IFSRA No 2 Act.

The Administrative Sanctions procedure can be invoked where a 'prescribed contravention' is suspected. A 'prescribed contravention' is defined in the second schedule to the 1942 Act (as updated by section 31 of the Central Bank and Financial Services Authority of Ireland Act 2003 and section 20 of the IFSRA No 2 Act). It is widely drafted to include primary and secondary legislation and notices issued by the Financial Regulator, which, in practical terms, will mean that most, if not all, contraventions could potentially be subject to the Administrative Sanctions procedure. The Criminal Justice Act 1994 is not 'prescribed', therefore a breach of anti-money laundering rules will not currently attract sanctions under this procedure.

Aside from monetary penalties, an important practical concern for the industry – and for directors individually – will be that the financial regulator will generally publish details of any sanction imposed (or any settlement reached with the financial regulator). In certain circumstances, where for example the information is confidential, details will be published on an anonymous basis.

The sanctions that can be imposed are:

- a caution or reprimand
- a direction to refund or withhold all or part of any amount of money charged or paid, or to be charged or paid with the provision of a financial service
- a monetary penalty (not exceeding €5 million for a corporate body, not exceeding €500,000 in the case of a person)
- a direction disqualifying a person from being involved in the management of a regulated financial service provider
- a direction to cease the contravention, if it is found the contravention is continuing
- a direction to pay all or part of the costs of the investigation and inquiry.

Office of the Director of Corporate Enforcement ('ODCE') developments

Director of Corporate Enforcement v Rogers & Rogers

The applicant sought an order under section 160(2) of the 1990 Act declaring each of the respondents to be disqualified on the grounds that they had breached their duties as directors and, in particular, failed to keep proper books of account, operated a bank account for their company which was not recorded in the company's books and failed to disclose the existence of that account to the company's auditor, misappropriated company funds to personal bank accounts, failed to file Revenue returns, and caused the company to trade while insolvent for a considerable period of time.

O'Leary J, in granting the application, held that the conduct of the respondents amounted to a lack of commercial probity and, consequently, a five-year disqualification was required in order to protect the public from a respondent's future misuse of the company law structure. He said that the making of a section 150 restriction order would not provide adequate protection for the public in this case.

Kavanagh v Kelly

The applicant applied for orders restricting the five respondents from acting as company directors pursuant to section 150 of the Companies Act 1990. The first, second and fourth respondents were directors of the company at the time of its winding up. The third respondent was a director during a period within 12 months of the liquidation date. The fifth respondent was not formally appointed a director of the company, but the applicant contended that he was a *de facto* director under section 27 of the Companies Act 1990.

MacMenamin J, in granting the relief in respect of the first, second and fourth respondents, held that the burden of establishing that a person was somebody to whom section 150 applied lay with the liquidator and, in refusing the relief sought in respect of the third and fifth respondents, he said that the burden had not been discharged in respect of these persons.

In respect of the other respondents, the court found that the applicant had satisfied the five criteria laid down by previous case law and they should be restricted. He also approved the additional test, identified by Finlay Geoghegan J, that the court should have regard not only to the extent to which a director has or has not complied with any obligation imposed on him/her by the Companies Acts, but also with duties imposed by common law.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN ISRAEL

YOAV DANIEL RAZIN, PARTNER, NASCHITZ, BRANDES & CO

The author wishes to thank Dana Zigman of Naschitz Brandes, who made significant contributions to this article.

Israel

In the last few years, there have been far-reaching changes in Israeli law affecting the standards that govern the conduct and liability of directors. There has been a marked trend to impose high standards of professionalism on directors, and to subject directors to increased liability appropriate to their position within the company.

Israeli jurisprudence with respect to management now emphasises the importance of the role of directors in setting and overseeing a company's policies. Directors are viewed as an integral component of the professional management of a company. In large part, the change in attitude stems from the significant privatisation that the Israeli economy witnessed in recent years, in which government, municipal and union-owned companies were privatised and often listed on the stock exchange. These structural processes had a corresponding effect on the liabilities and obligations of the board of directors. As a result, we are now witnessing legal developments that reflect this trend, which began in the 1980s and reached new heights in the last few years. The principal thrust of these developments has been to expand the fiduciary duty and duty of care owed by directors to the company.

On the legislative front, in 2000 Israel's completely revamped Companies Law (the 'Companies Law') introduced new provisions imposing a higher duty of care and fiduciary duty on directors and officers. On the judicial front, in May 2003 Justice Aaron Barak, the President of the Israeli Supreme Court, formulated a new standard of conduct required of directors and officers in the civil appeal of *Buchbinder v Official Receiver in its capacity as Liquidator of the Bank of North America* 610/94 (the '*Bank of North America* case'). The relevant part of the judgment is as follows:

> '*Being a director is not only a position of honor or respect. It is not only a reward for services rendered in the past to the country or to society. It is not only a respectable way to transition into retirement. To be a director means performing a central role in a company. To be a director requires that one use all means that a reasonable director would use to carry out his duty to the company.*'

The first part of Justice Barak's comments reflects the view that prevailed in Israel prior to the judgment. Therefore, this judgment is considered revolutionary in that it signalled a dramatic shift in the perception of obligations imposed on directors (see Professor Joseph Gross, '*The Revolution in Directors' and Officers' Liability*' 152 *Management: The Managers' Magazine of Israel* 8).

The trend to expand directors' liability stems not only from domestic developments in Israel. Rather, it is also a consequence of various financial scandals occurring in the United States and Europe. These scandals formed the impetus for extensive legislative change in the corporate governance regime in the United States, and as a result also influenced the legal system in Israel. The influence of United States regulation on Israel is magnified by the fact that there are dozens of Israeli companies that are publicly traded on NASDAQ. Over the years, many amendments to US securities laws have been incorporated into the Israeli Securities Law. Furthermore, recent years have witnessed an increasing number of 'quasi-legislative' activities such as the promulgation of new regulations, amendments to stock exchange by-laws and the issuance of regulatory directives. The cumulative effect of these actions has been the adoption of a new framework.

Development of the duty of care

Historically, courts held that a director's duty of care was governed by the general rules of the tort of

Israel

negligence, as set out in the Civil Wrongs Ordinance (New Version). In May 2003, however, the *Bank of North America* case dramatically changed the scope of a director's duty of care towards the company.

The circumstances of the case centre on the collapse of the Bank of North America. The specific facts of the case – persistent failure by the directors to attend board meetings, delegation by the board of most of its authority to management, directors' repeated failure to read Supervisor of Banks reports and their failure to familiarise themselves with the bank's overall situation – simplified the court's finding of negligence. Nevertheless, the case is noteworthy for its detailed analysis of the duty of care.

'Reasonable Director' – the standard of care

The *Bank of North America* case, which was brought prior to enactment of the legislative provisions contained in the Companies Ordinance and Companies Law concerning the obligations of directors, was based generally on the tort of negligence. The judgment went beyond a straightforward analysis and established the standard required in order to fulfil the duty of care. The court ruled that it is necessary to analyse who owed the duty of care, whether they could have taken reasonable measures to prevent the damage that was caused, and whether they took such measures. Although the case did not enunciate a clear standard of care, the circumstances of the case provide helpful insight. In the judgment on the appeal to the Supreme Court, President Barak stated that:

> '*To be a director means to take all measures that a reasonable director would take in carrying out the role of director. The issue is not what precautions should have been taken by a director with the knowledge and experience of the respondent (in accordance with In Re City Equitable Fire Insurance Co Ltd [1925] 1 Ch 407). The question is what precautions a reasonable director would have taken in the same circumstances.*'

In other words, a director's performance must be assessed objectively against the standard of a reasonable director in similar circumstances. President Barak added that the standard of care expected of directors of a bank was no different from that expected of directors in other companies, *but the nature of the duty changes in relation to the level of risk*. That is, the extent of the necessary precautions must be determined in the context of the particular circumstances of the company.

Alternate director

An additional question that arose in the *Bank of North America* case related to the appointment of an alternate director. President Barak stipulated that:

> '*The appointment of an alternate director does not release the director from his duty of care towards the company. Nevertheless, a reasonable director may fulfill his obligations towards the company as a director, in certain circumstances, by appointing an alternate director . . . if the alternate director is properly appointed for a specific meeting. Even in these instances, however, it is the responsibility of the director to assess the activities of the alternate director and to supervise him. The director must obtain reports from the alternate director . . . and employ the alternate director in a reasonable manner, without the appointment becoming, in effect, a permanent arrangement.*'

This judgment was handed down prior to the enactment of the Companies Law. When the

Companies Law was adopted, Section 238(b) embraced the essence of the judgment.

Joint and several liability

Another significant aspect of the *Bank of North America* case was its reversal of the approach to joint and several liability that had been adopted by the District Court. President Barak ruled that where damage is caused by a number of parties and individual responsibility cannot be ascertained, the law of torts will consider the offending parties jointly and severally liable. The apportionment of blame will be established by the defendants when they determine their individual contribution to compensation. The justification for this approach is that the collective activity of the board of directors binds the company. An interesting question beyond the scope of this article is whether a director who opposes a negligent decision made by the board of directors is relieved of liability. Apparently oral opposition is not enough, and the director must do everything in his power to prevent the decision from being adopted or implemented, including tendering his resignation (see Professor Tsipora Cohen, '*Liability of a Director of a Company – The Trend in Legal Developments in the Case Law*', 5764 *The Legal Campus – Yearly of the Academic Campus* 79, 86).

The development of fiduciary duty in Israeli law

In the seminal case on corporate fiduciary duty of *Kosoi v Feuchtwanger Bank Ltd 817/79*, the Supreme Court held that those with the authority to manage the company must assume a level of liability commensurate with their position. Protecting the interests of the company and preventing a director from exploiting his authority is achieved by the imposition of fiduciary duties. These duties obligate directors to act in good faith, honestly and for the purpose of fulfilling their roles in managing the company. In the *Bank of North America* case, President Barak revisited this principle and stated:

> '*Fiduciary duties are predicated on the fact that only one party's interests need protection and those are the interests of the company . . . fiduciary duties are distinct from the duty of care. Fiduciary duties are designed to prevent a director's misuse of his power for his own benefit. The duty of care is designed to prevent damage to the company . . . whereas a director may violate his fiduciary duty even if his conduct causes no damage.*'

President Barak further explained the essence of the fiduciary duty, which is based on the principle of trust, and said that the fiduciary duty is a far-reaching obligation that requires more than simply good faith:

> '*Fiduciary duty is more than the obligation to act in good faith (objectively) imposed on every person in Israel in doing a legal act . . . . Indeed, if the basis of the principle of good faith is to prevent men from "acting like wolves" and to require them "to act as human beings," the purpose of a fiduciary duty is to ensure that [the person in the position of trust] "will act like an angel"*'.

The directors must prefer the good of the company over their personal interests, and act accordingly. As a result, it is the responsibility of the directors to avoid conflicts of interest with the company and to avoid taking advantage of business opportunities for their own good.

In 1991, Amendment 4 to the Companies Ordinance [New Version] was passed. This amendment codified the principle of director fiduciary duties. This innovative legislation was the first codification of the duties of directors.

In relation to fiduciary duties, the amendment stated the following:

Israel

(a) Officers and directors owe a fiduciary duty to the company, to act in good faith and for the company's benefit, including:

(1) to prevent any action where there is a conflict of interest between the individual's duty to the company and his personal interests

(2) to prevent any action where there is competition with the company's business

(3) not to exploit any business opportunities of the company for the purpose of obtaining a benefit for himself or another, and

(4) to disclose or to transmit to the company any knowledge and or any document which relates to the Company's business that came validly into his hands while acting in his position.

Eventually, this was incorporated verbatim into Section 254 of the Companies Law.

To whom do the directors owe a fiduciary duty?

Kot v Estate of Yesahayahu Eitan (Deceased) 741/01, handed down in May 2003, introduced important developments to fiduciary duties. The issue was whether directors owe a fiduciary duty to shareholders (ie not just to the company). Kot, a shareholder, argued that the board of directors provided him incorrect information regarding the valuation of the company in connection with an issuance of shares, resulting in the dilution of his holdings.

Justice Procaccia acknowledged that the primary fiduciary duty is owed to the company. However, she also recognised that directors may owe a fiduciary duty to individual shareholders in certain circumstances, such as where equity and principles of good faith require the imposition of such duty. For instance, directors may owe a fiduciary duty to a shareholder if the facts demonstrate a special relationship of trust, such as where the directors personally provide information that they know will be relied upon by the shareholder. The court gave great weight to the fact that directors control the property of others, which can establish a fiduciary duty towards shareholders:

> '*. . . the directors, Eitan and Gutman, incurred liability and fiduciary duty towards the individual shareholders by virtue of the offer they presented to shareholders when the company changed its capital structure, and because of their ability to dilute the holdings of shareholders who did not make additional investments in the Company. The managers presented various alternatives for raising equity and dealing with the shareholders' property. Therefore, the directors assumed liability and a fiduciary duty towards the shareholders to act in good faith, so that they simultaneously had to act in the best interest of the Company and its shareholders. The shareholders relied on the representations and information provided to them in order to reach a decision . . . Moreover, this is a small private company where the relationship resembles a partnership, and the trend is to impose a fiduciary duty on directors . . . As a consequence of the special relationship that was created, the directors owed a fiduciary duty to act with honesty and integrity towards the shareholders in all respects . . .*'

Although, in effect, the court recognised a fiduciary duty owed by directors to shareholders, it limited the obligation to the specific facts, such as the board's initiation of the process that harmed shareholders. In addition, the court made the fiduciary duty to shareholders subordinate to the fiduciary duty to the company. Finally, the case related to a small private company with close relationships, which made it easier for the court to determine that a special fiduciary relationship existed. Having said that, there is no question that the judgment revolutionised the norms of conduct by broadening the liability of directors and officers to shareholders.

Duty to consult

The *Nizbah* case, which dealt with a tender offer for shares in a company called Nizbah, added a new layer to this issue (Initiating Motion 485/03 *Atar Meir v Nizbah Settlement Company Ltd* (not yet published)). The plaintiff claimed that the directors of Nizbah who approved the tender offer had a conflict of interest because they also served as directors of an affiliate of the bidder. The court noted that the directors did not obtain an updated valuation of Nizbah; rather, they relied on their subjective view that the value of Nizbah's assets had declined since a previous valuation. The court stated that:

> '*The members of the Board were not professionals in corporate valuation. They chose not to consult with professionals, a critical mistake in and of itself.*'

The result is that the court will review the reasonableness of the decision-making process of the board of directors and establish standards of conduct for the board, which may entail additional costs and delay in such financings.

Exculpation, insurance and indemnification of directors and officers

In order to complete the picture, the Companies Law allows for officers to be exculpated, insured and indemnified in certain situations. For example, the Companies Law entitles a company to exculpate an officer from liability resulting from a breach of his duty of care towards the company, but a company may not exculpate an officer for breach of his fiduciary duty. A company is entitled to indemnify an officer for a liability or expense incurred while serving in his capacity as an officer, subject to certain conditions. Similarly, a company may insure a director for liabilities he incurs while serving in his capacity as a director (even if by incurring such debts he has breached his duty of care towards the company or another person) or for a breach of his fiduciary duty (on condition that he acted in good faith).

Amendment 3 to the Companies Law

The Companies Law, which came into effect in 2000, devotes much attention to the functions of the board of directors, its obligations, liabilities, dealings with insiders etc. However, in light of case law experience and developments, in 2005 the legislature approved Amendment 3 to the Companies Law ('Amendment 3'). Although Amendment 3 did not fundamentally change the rules relating to the obligations of directors and officers, it introduced some important changes, outlined below.

Director qualifications

With the increasing complexity of business and financial activity, directors must be appropriately qualified in order to perform their duties. This is particularly true of public companies.

Prior to Amendment 3, the Companies Law disqualified certain individuals from serving as directors (bankrupts, criminals, minors and legal incompetents), but did not specify any prerequisite expertise to serve as director. Amendment 3 imposed a requirement that at least one of the two outside directors mandated by the Companies Law for a public company must have accounting and finance expertise, and the other must have professional qualifications as specified by regulations.

Israel

Section 219(d) of the Companies Law adds a requirement that the board of directors in a public company should set a minimum number of other directors with accounting and financial expertise. Amendment 3 makes clear that determination of the number of directors with this expertise should take into account the size and nature of the company as well as the complexity and scope of its activities. In any event, the expertise of outside directors does not detract from the responsibility of the other directors in the Company.

Indemnification
Amendment 3 revises the rules regarding indemnification of directors and officers to situations that are reasonably anticipated in light of the company's activities. The amendment also makes the process for approval of indemnification to directors who are controlling shareholders much more difficult. Moreover, the amendment states that an indemnity against liability for breach of fiduciary duty is generally invalid, and the very grant of such an indemnity is itself deemed a breach of a fiduciary duty.

Expanded authority of board committees
Amendment 3 expands the ability of a board of directors to delegate authority to committees. Previously, in many cases a committee could only make recommendations, but could not act. For example, the right to issue equity securities was limited to the board of directors. Amendment 3 liberalises this aspect of the board function, by allowing a committee to grant equity incentives as part of a compensation plan.

Latest developments
A mid-March 2007 decision in a criminal case represents another milestone in the field of director liability. The district court ruled that directors are the guardians of the corporation, and must therefore be constantly alert, aware, suspicious and proactive. The court found that the specific directors in question were unqualified, and it castigated them for agreeing to serve in the capacity of directors. In ruling that the individuals should be barred from serving as directors for at least five years and imposing heavy fines, the court said:

> '*Let every director know that he can serve as a director only if he is appropriately qualified. . . . And let every director know this as well – if he acts in a manner that a reasonable director would not have acted, there will be a heavy price to pay for the consequences.*'

Summing up
The last few years have seen fundamental changes in Israel in the perception of corporate directors. A board of directors seat is no longer an honour that does not require any real knowledge, experience or effort – it now entails considerable responsibility and potential liability. The Israeli Supreme Court has expanded the obligations and potential exposure of directors and officers, while the Israeli legislature has imposed professional standards for outside directors. In order to correspond to the complex reality of the modern corporation, further changes will doubtless be adopted to reinforce the role of the board of directors as an autonomous institution that is independent of outside influence, and to raise the general level of professionalism for all directors.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN ITALY

DIEGO RIGATTI, PARTNER, AND CLAUDIO CUCINOTTA, ASSOCIATE, ORRICK HERRINGTON & SUTCLIFFE

Italy

The operating environment for corporate entities in Italy has been significantly affected by the global focus on corporate governance which began in 2001. In particular, this has resulted in the introduction of a new form of corporate liability (see para below '*Officers' liability*'), as well as in the reformation, in 2003, of the part of the civil code applying to the so-called '*società di capitali*'.

Italian legislation provides for the division of companies into two different groups – the '*società di capitali*' on one side, and the '*società di persone*' on the other. The main difference between the two relates to the extent of their liability for the company's obligations (limited to the company's assets in the first case, but extended to individual partners in the second).

The Italian Civil Code provides, with exclusive reference to '*società di capitali*', for different kinds of directors' and officers' liability:

- towards the company (articles 2392-2393 bis c.c.)
- towards the company's creditors (Article 2394 c.c.)
- towards shareholders and third parties individually (Article 2395 c.c.).

In each case, provided an action is brought within the five-year limitation period, directors and officers can be sued by:

- the company
- a significant minority of the stock/quota-holders
- the board of statutory auditors (new article 2393, III c.c.)
- the court-appointed director
- the liquidator
- the officer in charge of preparing the company's accounts.

Each of the above areas of liability is dealt with below, with reference to both directors and officers.

Directors' liability

Towards the company

Under article 2392 c.c., as reformed in 2003, the directors must fulfill the obligations imposed on them by law, or by the articles of association, with the diligence required by the nature of their duty and by their specific skills (and not, as previously, with the diligence of an agent). Any failure to fulfill these obligations results in the joint liability of the members of the board of directors towards the company, unless the liability is related to those functions which have been specifically entrusted by the board to an executive committee, or to one or more directors (managing directors and presidents).

Whilst the directors, being an executive body, are vested with all necessary powers required to manage the company, article 2392 of the Italian Civil Code provides for a contractual liability deriving from negligent default (non-fulfillment) of their duties. In particular, besides the specific duties set out by law, or by company by-laws, the directors are expected to fulfill two general duties:

- to administrate diligently; and
- to pursue the collective (company's) interest.

The impact of these two general clauses will be linked to the specific circumstances of each particular case. While it is easy to evaluate non-fulfillment when referring to a specific duty or proscription, it is much harder to do so when the same job is to be performed at the directors' discretion.

Italy

Of course, the risks facing any company can only be predicted to a limited extent. Business risks are often, by their nature, unpredictable. That is why directors cannot be considered responsible for the ordinary or extraordinary risks that may arise: mere financial failure – and potentially bankruptcy – cannot, on its own, give rise to liability.

The directors cannot be expected to guarantee the success of the company. But they should act diligently and in the company's interests. Management decisions may not be challenged by the court because of their consequences, but only in the event of a lack of diligence and/or care on the part of the directors.

In any event, all directors, including non-executive directors, are jointly liable towards the company. If the directors violate their obligations, the company can bring a liability action against them, such an action to be approved by a resolution of the shareholders' meeting (see articles 2393 c.c.). As stated, the directors' liability towards the company is contractual in nature. Therefore the company bringing such action need not prove the directors' guilt.

It must, however, establish the following:

(i) the misconduct of directors who violated the specific obligations imposed on them by law, or by the articles of association

(ii) the existence of damages suffered by the company

(iii) the link (ie '*nesso di causalità*') between the directors' misconduct and the damages suffered by the company.

Where stock companies quoted on the stock exchange are concerned, specific rules are provided for by the '*T.U.F.*' ('Unified Financial Statute', legislative decree 58/1998).

Towards the company's creditors

Under article 2394 c.c., the directors are liable to the company's creditors if they failed to fulfill their obligations concerning the preservation of the company's assets (article 2370 c.c.).

This action can be brought by the company's creditors when the company's assets prove to be insufficient to satisfy whatever claims they might have. Any waiver by the company of a liability action against its directors does not prevent the company's creditors from pursuing an action. In case of bankruptcy or compulsory winding-up, this action can be brought by the bankruptcy receiver or by the commissioner who manages the winding-up (see article 2394-*bis* c.c. and articles 146 and 206 of law 267/1942).

Although there is some uncertainty as to the nature of the liability of the directors towards the company's creditors, it should probably be regarded as '*extra-contractual*' (tortious) in nature, with the consequence that creditors who bring this action must prove not only mismanagement and damage resulting from it, but also the directors' guilt.

Towards shareholders and third parties individually

Article 2395 c.c. provides that article 2393 and 2394 c.c. do not prejudice the right of a single shareholder, or of a third party, to bring an action against single directors to obtain refunds for damages directly suffered by them as a result of directors' misconduct. This action is extra-contractual in nature, with the consequence that the plaintiff bears the burden of proof not only with respect to mismanagement and damage, but also with reference to directors' guilt.

Officers' liability (towards the company, towards the company's creditors and towards the shareholders and/or third parties individually)

The officer is normally, although not necessarily, appointed under the articles of association, or by resolution of the shareholders' meeting, particularly in larger companies.

The officer is the highest-ranking executive employee, bound to the company by a subordinate job contract. This represents an important difference from the position of directors, who are not themselves bound to the company in this way.

As regards the liability of officers, this is strictly linked to the liability of directors, meaning that the provisions regarding directors' liability also normally apply to them. The officer's duties are relevant throughout the company – he has the task of carrying out the resolutions of the board of directors, as well as responsibility for managing and coordinating the employees.

But when, eventually, his powers could also have an external relevance (that is, he is vested with the power to represent the company towards third parties), he acts as an *institor* (agent). Because he acts unsupervised, this gives him wide-ranging representative powers as regards (see article 2204, c.c.) the fulfillment of all acts pertaining to the conduct of the enterprise of which he/she is in charge ('*esercizio dell'impresa cui è preposto*'). The law draws no distinction between acts of ordinary or extraordinary administration – the only limitations to his powers relate to the sale and mortgage of real estate.

Relationship between officers and directors

As with company directors, officers cannot be held liable for having been 'unlucky' in the fulfillment of their duties. However, the extent of their liability does differ where duties 'imposed by law, or by the articles of association', are concerned. This needs some clarification. The extent of their duties is not defined solely by the provisions of any law or by-law, because their duties can also be specified by the Assembly, as well as by the company directors.

Joint and several liability with directors

The issue of joint and several liability of directors and officers is a key point. This is because, where the officer acts together with the management body, his subordinate position becomes particularly relevant. He/she can be held liable only for his own acts or omissions, not for those of individual directors. The directors, however, can be held liable for the officer's acts or omissions, if they have failed to exercise the level of management oversight that is required of them. There is just one exception to this rule – if the officer's duties are extended to general corporate management, meaning that he/she assumes responsibilities usually reserved to the directors, then he/she can be declared jointly and severally liable with them.

The officer in charge of drafting the company's accounts

The appointment of an officer in charge of drafting the company's accounts recently became a legal requirement for publicly-quoted companies (introduced in article 154-bis of the *T.U.F.* by article 14, Law 262/2005 and latterly modified

Italy

by Legislative Decree 303/2006). This officer's liability is strictly limited to his duties – that is the establishment and correct application of appropriate procedures for preparing the accounts (and related communications), as well as for evaluating their accuracy.

Societas delinquere (et puniri) potest

Another important development has been the effect of European law on the liability of the company itself. Until recently, the principle of '*societas delinquere non potest*' ('the company cannot be a criminal') has been a feature of Italian – and civil law countries in general – corporate law. Now, however, this has changed – under certain circumstances, companies can themselves be liable for the acts or omissions of their directors and officers. Law 300/2000 brought into effect various International Conventions set out in article K. 3 of the *Treaty on European Union*, specifically:

- the *Convention on the protection of the European Communities' financial interests* of 26 July 1995;
- the *Convention on the fight against corruption involving officials of the European Communities or officials of Member States of the European Union* of 26 May 1997;
- the *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* of 17 December 1997.

Under this new law (L.300/2000), the government dictates the 'administrative' (*amministrativa*) liability of corporate and non-corporate bodies. Legislative Decree 231/2001 was issued to enact that 'legislative proxy', but limited to the crimes specified by the European Conventions above, while L.300/2000 had a wider scope. It is important to realise that this particular type of responsibility has widened considerably in recent years, as a result of various specific regulations, including:

- Article 6, Law 409/2001 – punishing the forgery of money and tax stamps
- Article 3, Legislative Decree 61/2002 – extending the entity's 'administrative' liability to corporate crimes
- Article 3, Law 7/2003 – enabling the prosecution of entities for crimes of terrorism and similar, as provided by the Criminal Code and specific criminal provisions
- Article 5, Law 228/2003 – regarding slavery, prostitution, paedophile pornography and similar crimes
- Article 9, Law 62/2005 – providing for an entity's liability in cases of insider trading and market fixing
- Article 22, Law 29/2006 – introducing the entity's 'administrative' liability for crimes of money laundering, stolen goods recycling and of illicit profits.

The principal features of these various new areas of liability are listed below.

The 'administrative' nature of the liability

The legislator opted not to classify this as 'criminal', because of the consequences that this would have had for Italian constitutional law

The absence of a system whereby the entity can be charged directly

Liability arises in connection with any crime committed by a person who can objectively be judged to be 'joined' to the entity. In this respect, the test is whether the person was acting either in the interests of the corporate entity, or for its benefit, or both. If this cannot be objectively established, then no liability attaches to the corporate entity itself – only the director or officer will be liable (or both jointly liable, depending on the circumstances of the case). A distinction must be made here between executive directors and non-executive directors:

(i) If the perpetrator of the offence occupies a high-level position within the company (Article 6, l. 231/2001), the company's liability will be practically unlimited (and the burden of proof is on the company to show that this should not be the case)

(ii) However, where non-executive directors are concerned (Article 7, l. 321/2001), the company's liability is limited to organisational culpability. Here the burden of proof rests with the claimant.

Common to both, in terms of giving rise to some form of corporate liability, is the non-fulfillment of a duty. However, the level of diligence required will differ according to the position occupied by the perpetrator.

D&O insurance

The liability of directors and officers can be insured against via two complementary instruments – a 'legal protection policy', covering any legal costs incurred, and a 'D&O policy' ('*Polizza RC Amministratori*'), designed to cover liability risks.

In any case it is not possible to indemnify directors from criminal liability risks: in this case there is only the chance to cover bar costs and expenses through a 'legal protection policy'.

The insurance/indemnification policies above are applicable to both directors and officers, but one more reference should be done: as provided for by the officers' collective labour contract (*contratto collettivo nazionale dirigenti*), civil liability risks as well as bar costs and expenses for officers' civil and criminal liability shall be faced by the company.

Various issues should be borne in mind when drawing up a D&O policy, as listed below.

Towards the company

In the event that the damaged party is not a third party, but the company itself, it may be doubtful whether the premium for an insurance policy covering damages caused to the company by its directors should be paid by the company itself. To cover this situation, some policies highlight the possibility of conflicts of interest, while others specify that the company will indeed pay the premium. Where this is an issue, and to avoid executive directors being in a position where they may be able to approve resolutions in their own favour, this could be voted on by the company's shareholders or non-executive directors. Alternatively, the directors might decide to pay for this insurance coverage themselves (having factored the cost of doing so into their compensation). In any case, when the policy is stipulated by

Italy

the company, the relevant premiums cannot be considered as fringe benefits.

Towards creditors, shareholders and/or third parties

Such insurance covers extra-contractual liability, excluding any fraudulent acts or omissions. Directors' and officers' liability towards a company's creditors can definitely be insured against, and in most cases, the relevant premium will be paid or refunded by the company. As before, to avoid any conflict of interests, any resolution in favour of this insurance should be voted on by either the company's shareholders, or by its non-executive directors.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN MEXICO

MARÍA CASAS LÓPEZ, PARTNER,

BAKER & MCKENZIE, S.C.

Mexico

Mexican financial laws and regulations have been amended during the last months to incorporate basic corporate governance principles.

During recent years, Mexican public corporations have undergone significant evolution with respect to their internal decision-making processes. This arises from the introduction of internal control mechanisms and formal processes governing, amongst other areas, risk management, competitive strategy and other matters affecting financial results.

To comply with these new corporate governance provisions, Mexican public companies have created internal committees formed by independent members whose primary function is to support the board of directors in their decision-making processes.

The participation of independent members in the board of directors and internal committees of public companies has also enabled the management to implement more effective and objective decision-making processes.

Adequate corporate governance, internal control and organisational mechanisms in a public company guarantee and protect the interests of shareholders, investors and employees. In this regard, the Mexican regulators have also amended various corporate laws to incorporate new provisions relating to the liability of directors and officers of public companies.

The initial corporate governance reforms

In June 2001, the Mexican Securities Market Law was amended to incorporate certain basic principles of corporate governance. Likewise, the regulations applicable to issuers and other participants in the securities market, the so-called 'Circular Única' published by the National Banking and Securities Commission (the 'Commission') in March 2003, contained general principles relating to corporate governance.

Corporate governance principles under the new Securities Market Law

To enhance the regulatory framework of the Mexican securities market, effective 29 June 2006, the authorities issued a new Securities Market Law which contains stricter principles of corporate governance, similar to those in other international markets. Likewise, effective 23 September 2006, the Circular Única was amended to reflect the current needs of the securities market and provide continuity with the New Securities Market Law.

Management structure of public companies.

The management of a Mexican public company is entrusted to its board of directors and to a general manager ('*Director General*'). The board of directors is assisted in its management functions by the audit committee and the corporate practices committee, each of which has specific duties and is responsible for assisting the board of directors in *strategic corporate issues*, such as the approval of transactions with related parties and executive remuneration.

Board of directors' integration

The New Securities Market Law requires that at least 25 per cent of the board members of a public company be 'independent' directors. Independent directors are appointed based on their experience, capacity and professional reputation. To assure the 'independence' of board members and members of other committees, the New Securities Market Law requires that individuals appointed as independent directors must be able to perform their duties *free from any conflict of interest* and without being subject to any conflicting personal, economic or business interests.

Individuals with a significant influence in the corporation (or in any entities under its control), or

Mexico

shareholders of the controlling group, among others, may not be appointed as independent directors of the corporation.

Board of directors' responsibilities under the New Securities Market Law

The New Mexican Securities Market Law contains a *comprehensive revision* of the responsibilities of the board of directors, extending and more closely defining the nature of these responsibilities. The Law provides that board members shall perform their functions *procuring the creation of value for the benefit of the company, without favouring a specific shareholder or group of shareholders*. Board members must act diligently, in compliance with duties imposed by the Law, as well as the company by-laws.

Diligence duties

The new Law includes provisions relating to the duty of diligence and the fiduciary and loyalty duties of board members.

Diligence duty ('deber de diligencia')

Board members must act in good faith and in the best interests of the company and of the entities under its control. To comply with their duty of diligence, board members have the right to:

(i) request information from the company (and from entities under its control), which may be reasonably necessary for decision-making; the board of directors is entitled to establish, with the prior authorisation of the audit committee, guidelines setting out the way in which that information may be requested

(ii) request the presence of relevant executives and other individuals, including external auditors, who may assist in the adoption of resolutions by the board

(iii) request the postponement of board meetings for no more than three calendar days, in the event that a board member has not been called to the meeting, or where a member was not called in time, or where a member was not provided with information delivered to other board members

(iv) discuss and vote, requesting the exclusive presence of board members and the secretary of the board.

Board members of a public company, and any individuals employed by entities under its control, must act with discretion and confidentiality when providing information to the board.

Liability for violation of the diligence duty

Board members will be liable if they cause any damage to the company's business, or to entities under its control, or in which it has a significant influence, in the following cases:

(1) If a member of the board, without a justified cause, does not attend a meeting of the board or of the audit or corporate practices committees, and due to his or her absence, the respective board or committee is not able to hold the meeting

(2) If board members do not disclose to the board, or to the respective committee, any information they have which is required for the adoption of resolutions (except if they are legally or contractually sworn to secrecy or confidentiality on a particular matter)

(3) If board members do not comply with any of the duties imposed by the Law, or corporate by-laws.

Liability for losses and damages

Board members shall be jointly liable to indemnify the company (and entities under its control, or in which it has a significant influence), for loss and damage suffered as a result of their failure to comply with their diligence duty, resulting from the acts or the decisions adopted by them, or for decisions that were not taken when it proved impossible to hold a board meeting.

This liability may be limited under company by-laws, or by a shareholders' resolution, except in cases involving willful misconduct, bad faith, or illegal acts.

In practice, public companies can grant indemnities to their board members, or contract insurance, bonds or other types of guarantees to cover any damage caused to the company or its subsidiaries by the performance of its board members, unless there has been willful misconduct, bad faith, or an illegal act.

Fiduciary and loyalty duties

The Law regulates the fiduciary and loyalty duties that directors and officers have to the public companies in which they serve. Board members and the secretary of the board are bound to keep confidential any information and matters which they are aware of as a result of their positions in the company.

Likewise, if the members or secretary of the board face a conflict of interest in any matter, they must abstain from participating in, or deliberating/voting on the matter, provided that this does not affect the quorum required for the meeting.

Board members must report in writing to the audit committee and to external auditors any irregularities that they encounter in connection with the company or its subsidiaries. Likewise, the directors of a public company are jointly liable to former board members for any irregularities incurred by the latter that are not reported in writing by them to the audit committee and to the external auditors.

The Law provides that the directors and secretary of the board will be in violation of their fiduciary duty and be liable to the company for any loss and damage caused to it (and to any entities under its control, or in which it has a significant influence) if, as a result of their employment, charge or commission, they obtain any economic benefits for themselves or for third parties, including any shareholder or group of shareholders, which should have accrued to the company.

The Law also provides that board members will be in violation of their fiduciary duty and obliged to indemnify the public company (as well as any entity under its control, or in which it has a significant interest) for any loss or damage caused to those companies, in the following circumstances:

(1) If, having a conflict of interest, they vote in meetings, or take decisions related to the business of the company (or of entities controlled under its control, or in which it has a significant influence)

(2) If they do not disclose a *conflict of interest* they may have *vis-à-vis* the company or related entities, at the meetings of the board, or of the above-mentioned committees. The directors must also specify details of the conflict of interest, unless they are contractually restricted from doing so

(3) If they benefit a shareholder or group of shareholders of the company to the detriment of other shareholders

(4) If they approve any transactions of the company (or entities under its control) with related parties in contravention of policies already approved by the board

(5) If they use, or allow third parties to use, the company's assets in violation of policies approved by the board

Mexico

(6) If they unlawfully use any inside information concerning the company or its controlled subsidiaries

(7) If they benefit or exploit for their own benefit, or in favour of third parties, business opportunities related to the company (or entities under its control) without board authorisation.

The following activities will be deemed to be business opportunities related to the company: if a member of the board, directly or indirectly, engages in activities that **(i)** are within the ordinary course of business of the company and its controlled subsidiaries; **(ii)** imply the execution of a transaction or a business opportunity originally addressed to the company or its controlled subsidiaries; or **(iii)** involve, or pretend to involve, commercial projects or businesses to be developed by the company or its controlled entities, provided the director has knowledge of that situation.

Entities in which the public company has a significant influence can also claim against any board members (including the secretary), if they, without justifiable cause, may have helped to secure, for themselves or for third parties, any economic benefits rightly belonging to the company.

In public companies, board members and the secretary of the board must not engage in any of the following:

(1) Disclosing, publishing, or providing, or requesting a third party to disclose, publish or provide to the public false information concerning the company (or its controlled entities) or its securities

(2) Ordering or omitting to register any transactions undertaken by the company (or its controlled entities), or altering, or requesting somebody to alter, company records with the purpose of concealing the true nature of any transactions

(3) Concealing, omitting or causing to conceal or omitting to disclose relevant information that may have to be disclosed to the public, to the shareholders or to the holders of securities, unless otherwise permitted by the Law

(4) Requesting or accepting false information for entry into the company's accounts (or those of any entity controlled by the company). The Law presumes, unless otherwise proved, that the information in the accounts is false if, having requested this information, it proves impossible for the company to provide it

(5) For the purposes of concealment, destroying, altering or causing to destroy or alter, the accounts, systems or supporting documentation of a company or entities under its control, before the expiration of the period during which the information must be retained

(6) Destroying or causing to destroy, totally or partially, information, documents or files, including electronic files, with the purpose of preventing or obstructing surveillance by the Commission

(7) Destroying or causing to destroy, totally or partially, information, documents or files, including electronic files, with the purpose of manipulating or concealing relevant information or data from any persons with a legal interest in that information

(8) Presenting to the Commission false or altered information, with the purpose of concealing its true content

(9) Altering the statement of results, or the terms and conditions of company agreements to register, or cause to register, inexistent transactions or expenses, exaggerating actual transactions or costs or intentionally engaging in any illicit or prohibited act or transaction causing prejudice to the business of the company, or entities under its control, for its own benefit, whether directly or through a third party.

The above provisions also apply to any individuals tasked with making critical decisions in the company, such as senior executives.

Board members, the board secretary and other senior executives responsible for any of these acts shall be jointly liable to indemnify the company or entities under its control for any loss or damage caused. Those held liable will also be removed from their positions within the company.

Prohibition on obtaining insurance covering indemnification for loss and damage

The Law prohibits public companies from providing (in their corporate by-laws, or in any other agreement), any provisions, benefits, or exclusion of liability, that limit, exempt, replace or compensate the liability imposed on board members.

Finally, public companies are not entitled to contract or obtain in favor of the above individuals, insurance, bonds or other guarantees covering the amount of the indemnification for any loss or damage caused.

Liability actions ('*Acciones de responsabilidad*')

The General Commercial Company Law ('*Ley General de Sociedades Mercantiles*') contains some provisions related to shareholder actions.

This law permits shareholders representing a minimum 33 per cent of a company's shares to bring actions against the directors of that company, provided the following requirements are met: **(i)** that the action claims the full amount in favour of the company and not only the amount claimed by the respective shareholders exercising the action; and **(ii)** that the respective shareholders have not approved the resolution of the shareholders' meeting absolving the director in question from liability.

The New Securities Market Law also contains provisions concerning actions for liability that can be brought against directors, secretaries of the board and senior officers of public companies by: **(i)** the public company or subsidiary suffering damage to its business, or; **(ii)** the shareholders that, individually or together, hold shares with voting rights, or shares with limited or restricted voting rights, or shares with or without voting rights, representing 5 per cent or more of the company's stock.

These actions need not comply with the requirements of the General Commercial Company's Law. But they must be for the total amount of the liabilities in favour of the company, or its respective entities, and not only in the claimant's or claimants' personal interest.

The claimant may reach an agreement on the amount of the indemnification for any loss or damage, provided the respective amount and the terms and conditions of the agreement are submitted for the prior authorisation of the board.

The statute of limitations on these legal actions is five years, counted from the date on which the act or situation occurred. Any individuals or entities exercising an action in bad faith must the pay legal costs of any legal proceedings that result.

These actions will be enforceable, even where the shares of the public company are traded among public investors through negotiable instruments, issued by trustees, in which case the action may be exercised by the trustee or

Mexico

by the holders of the negotiable instruments.

The board members will not be held liable, jointly or severally, for any damage or loss caused to the company or its subsidiaries, resulting from any of the following acts/ decisions, provided that they are taken/made in good faith:

(1) If the board members approve matters which require board approval (or the approval of any of the committees of which they are a part)

(2) If the board members adopt resolutions or vote in board meetings (or in meetings of any of the committees of which they are a part), based on information provided by the relevant directors, the external auditor or the independent experts whose credibility and capacity are not subject to reasonable doubt

(3) If the board members choose, to the best of their knowledge, the most suitable course of action, or if no adverse effect could be foreseen, based on whatever information was available to them at the time

(4) If the board members comply with the resolutions of the shareholders' meeting, provided these do not violate the Law.

Alteration of registries

Under the New Securities Market Law, board members, general managers and other officers and representatives of public companies (and of companies promoting investment) can be subject to 3-12 years' imprisonment if they alter records relating to the company's assets and liabilities, or conditions of agreements, or register or cause to register inexistent transactions or expenses (or exaggerate that information), or willfully engage in any other act or prohibited transaction, causing prejudice to the business of the company or of its controlled entities, for their own benefit, whether directly or through a third party. If the perpetrator can demonstrate that any loss or damage has already been recompensed, he will be subject to 1-3 years' imprisonment.

Board members will not be held liable if they have acted in accordance with the instructions of a shareholders' meeting, or when they have acted in good faith based on information provided by the relevant company officers, or by the external auditor or any other independent experts hired by the company, or in compliance with the Law.

Prosecutions for alterations of company records can only be brought by parties holding a minimum 33 per cent of the company (or a company promoting investment), or by the Ministry of the Treasury and Public Finance, with the prior approval of the Commission, and at the request of parties holding a minimum 10 per cent of the company.

Provided that the damage caused to a company does not exceed an amount equivalent to 25,000 times the minimum daily wage applicable to the Federal District, and that it is repaired without the involvement of the authorities, or where the persons found liable had not previously participated in any illicit financially-related acts, or where no serious crime has been committed, the Commission may abstain from providing its approval to the Ministry of the Treasury.

The limitation period in a criminal action of this type is three years, counted from the date on which knowledge of the crime first arose, or if there is no such knowledge, five years from when the crime took place.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE PEOPLE'S REPUBLIC OF CHINA

SIMON MCCONNELL, PARTNER, AND MUN YEOW, SENIOR ASSOCIATE, ALLENS ARTHUR ROBINSON

Simon and Mun would like to thank Frank Voon and Maggie Ma (Senior Associates of Allens Arthur Robinson, Shanghai) for their contribution to the PRC chapter.

People's Republic of China

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 such 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.

Under the 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).

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 action, 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 the 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 over the past year. This matter is being carefully watched in China by both PRC and foreign interests. Kelon reported the largest loss of any publicly-traded mainland company – RMB3.7 billion, or approximately US$475 million. 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$47 million) and revenues by RMB1.2 billion (US$153 million).

The Regulator

Under the Securities Law, which came into effect on 1 January 2006, 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$75,000) for providing false information and other offences; and
- its former chairman was fined RMB300,000 (US$37,500) 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 put 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$41.5 million)
- 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 now 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.

Shareholder actions

On 6 July 2006, shareholders filed a lawsuit against Kelon seeking significant civil damages. Details available to the public are limited. However, it is known that the claim against Kelon at the Guangzhou Intermediate People's Court will be made on behalf of minority shareholders against Kelon and Kelon's former auditor.

It is not yet clear whether the claim against the former auditor (which has denied any failing on its part) will be permitted by the PRC courts to proceed. An earlier claim against the former auditor brought by an investor in Kelon was rejected by a Shanghai court in March 2006. The court declined to hear the matter 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 new laws designed to improve protection for small and minority shareholders.

Shareholder claims, under the PRC's new 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 which results in loss to investors.

Corporate governance in the PRC – new developments

The new PRC Company Law and new PRC Securities Law which came into effect on 1 January 2006, contain additional important revisions to the 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 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 shareholder's 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, which representation must be democratically elected by the employees.

Independent directors

The Securities Law tightens the insider trading rules on directors, supervisors and senior officers of listed companies. In addition to the express qualifications which 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 which owe the duty of 'loyalty and diligence' to the company (Article 148 of the Company Law) and the individuals 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.

Personal liability of directors and officers

The primary sources of personal liability in the context of recent developments – namely, the introduction of a new Company Law and Securities Law, effective 1 January 2006, include:

Specifically, Articles 150 and 153 of the Company Law:

- Article 150: 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 153: 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 69 of the Securities Law states:

- 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 he/she/it is able to establish that he/she/it was not at fault. If the issuer's or listed company's controlling shareholder or *de facto* controller is at fault, it 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 new 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

People's Republic of China

breach of directors' duties as now defined in the new 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).

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 the 'class action' present 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 which states the particulars of the case and invites 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 memorandum and 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?

There is not a developed D&O insurance market in PRC; the D&O insurance offered in PRC is similar to that in Western economies and can only be offered by authorised insurers and reinsurers (which now includes Lloyds' of London). There are complicated and lengthy processes associated with becoming authorised.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE RUSSIAN FEDERATION

HEIDI A LAWSON, INTERNATIONAL COUNSEL AND CLAIRE GRAHAM, ASSOCIATE, DEBEVOISE & PLIMPTON LLP

Russian Federation

Traditionally, directors' and officers' ('D&O') liability insurance is the last weapon in an executive's armoury. But what happens in circumstances in which corporate governance is a statutory misnomer and the legality of indemnification agreements is questionable? In such instances, the D&O insurance must be crafted to respond to the varied and expansive claims that an executive may face whilst occupying such a position.

Such are the circumstances in the Russian Federation. The key issue when considering a D&O policy is enforceability, which requires a thorough interrogation of policy wording to ensure that coverage will respond to executives' requirements. In this chapter we do not propose to provide a treatise on the substantive law of Russia, but rather to address key issues relating to enforceability, provide commentary, and suggest solutions.

Legal background

Insurance is regulated by the Civil Code and by the Law of the Russian Federation on Insurance adopted on 27 November 1992, as amended. Under the Civil Code, two types of insurance are recognised: personal and property. Insurance of civil responsibility is classified as a type of property insurance, although the Law of the Russian Federation on Insurance considers it to be an independent form of insurance.

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:

> '*The person, who by force of the law or of the legal entity's constituent documents comes out on its behalf, shall act in the interests of the legal entity it represents honestly and wisely. He shall be obliged, upon the demand of the founders (the participants) of the legal entity, to recompense the losses he has inflicted upon the legal entity, unless otherwise stipulated by the law or by the agreement.*'

Company directors may be held personally liable for any losses caused to the company through their wilful misconduct or negligent action or omission. 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.

Russian insurance company requirement

Under Russian law it is prohibited for an insurer that is not licensed in Russia (and an insurer can only be licensed if incorporated/registered in Russia as a legal entity) to provide any insurance services relating to Russian risks (Articles 4 and 6 of the Law of the Russian Federation on Insurance).

'Insurance services' and 'Russian risks' are understood very broadly and there is no clear definition of either term. In practice, most insurance companies and government agencies adhere to the most conservative approach ie that any involvement of a foreign insurer in a policy issued in Russia should be prohibited. The implications of conducting insurance services without a licence may be quite severe, including penalties and criminal liability of the executives of the company. Moreover, if a foreign insurer endorses the policy, it may bring the entire policy under threat, since the government authorities may try to invalidate it on the grounds of violation of the mandatory Russian law requirements.

Whilst the recent signing of a bilateral trade agreement between the US and Russia will allow US insurers to set up branches in Russia, it is too early to comment on the likely penetration of non-Russian insurers. In the meantime therefore,

Russian Federation

an executive of a Russian entity will need to take insurance from a Russian carrier.

Enforceability of English law

The compulsory execution of a policy by a Russian carrier will have an impact on the governing law of the contract. In most instances, an executive will wish to have the policy governed by English law. Whilst no criticism of the Russian legal system, the overwhelming body of statute and case law in England and Wales has led to a very sophisticated market with a highly developed interpretative body of knowledge. However, whilst Russian law allows the parties discretion to make an agreement subject to any foreign law, (Article 1210 of the Civil Code) this is subject to the following:

(a) the rule applies only if the agreement has a 'foreign factor' (Article 1186 of the Civil Code)

(b) the rule does not apply where any imperative norms of Russian law prescribe that the agreement is to be governed by Russian law (Article 1192 of the Civil Code)

(c) the rule does not apply where an international treaty of the Russian Federation contains 'substantive law norms' governing a relevant relation (Article 1186(3)); and

(d) the rule does not apply where it is evident from the circumstances that the agreement is in fact connected only with Russia regardless of the choice of law provisions (Article 1210(5) of the Civil Code).

Foreign factor

Russian law does not contain any explanations as to what can be considered a 'foreign factor', except for two examples, where **(a)** one of the parties to the agreement is a foreign citizen or foreign legal entity **(b)** the object of the agreement is situated abroad (Article 1186(1)). Article 1215 of the Civil Code in addition to the above-mentioned two foreign elements, adds a third foreign element where the juridical fact takes place abroad.

A juridical fact is understood to be an event or action which leads to the establishment, termination or change in the rights under an agreement. This includes the construction of the contract; the rights and duties of the parties to the contract; performance under the contract; the term of the contract; and consequences of invalidity of the contract. This may be relevant when the actions (or omissions) of executives resulting in an obligation to compensate losses takes place outside Russia. However, where executives will be discharging their obligations in connection with a company mainly in Russia, Russian courts may decide that there is no foreign juridical fact in the D&O insurance and/or indemnification agreement.

In D&O insurance, where the only parties to the agreement are Russian, the Russian courts are likely to reach a finding of no foreign factor. As regards the object of the agreement and the juridical fact, there are certain arguments in favour of construing a foreign factor where some of the parties to the insurance are non-Russian. In particular, the object of the agreement is the establishment, modification or termination of the rights of the parties to the agreement or third parties. It is hard to judge whether the object of the D&O insurance and/or indemnification agreement is situated outside Russia. The proprietary interest being insured under the D&O insurance, and the primary obligation undertaken under the indemnification agreement, is a liability to compensate damages to executives as a result of the discharge of their obligations as executives of the company. By extension therefore, if the executive is a foreign citizen, the obligation to compensate his damages may theoretically be considered a foreign factor of the agreement. However, since the compensation will be made by the Russian insurer (or Russian company) in connection with the discharge of the executives' obligations with regard to the Russian company, Russian courts may decide that the object of the D&O insurance and/or indemnification is situated in Russia.

To resolve the issue and ensure that English law will govern the contract, it has been suggested that a non-Russian entity within the corporate structure of the Russian insurer could effect a guarantee as primary obligor of the insurer under the policy. However, this may be seen as a contravention given the non-Russian company's inability to obtain a licence to underwrite in Russia. Consequently the involvement of a foreign insurer may jeopardise the validity and enforceability of the policy, given that Russian courts would consider the policy void for breach of Russian law.

An alternative solution would be to insure a parent or subsidiary of the Russian company where such is located outside Russia and procure cover for the Russian entity under a global policy.

If neither of the above are suitable (and it is questionable whether a non-Russian insurance guarantee will ever be suitable), the policy language could be amended so as to specifically include non-Russian executives, as a way to arguably insert the requisite foreign factor.

Substantive law norms

If there is no foreign factor and the policy is therefore governed by Russian law, this could give rise to many issues in terms of compliance with and enforcement under Russian law, as the policy is usually drafted by English/US lawyers. If there is a foreign factor and the policy is made subject to foreign law, there may still be a remote risk that, when drafting the policy, the insurer will have to adhere to certain substantive law norms of Russian insurance law (Article 1186(3) of the Civil Code) which will not always be compliant with foreign law; for example, Russian law does not allow insurance for administrative or criminal penalties imposed on a director or officer.

Imperative norms

The Russian Civil Code (Article 1192 of the Civil Code) provides that, regardless of the choice of law provisions of the agreement, certain provisions of Russian law will continue to apply to the agreement (imperative norms). Imperative norms are considered to be provisions that, due to their nature or their special significance (including safeguarding the rights and law protected interests of participants in civil law relations). Russian law must govern the relevant relationships irrespective of the applicable law.

There is no list of such imperative norms and the court decides in each particular case at its discretion whether a provision is an imperative norm or not, which leaves much room for uncertainty. As a result, Russian courts may decide that irrespective of the choice of law provisions in the D&O insurance or indemnity, they are subject to certain provisions of Russian law (eg currency control provisions, tax provisions, certain civil law provisions etc).

Connection with Russia

Russian law provides that if the agreement is in fact connected only with one country, any choice of law provisions in the agreement shall not affect the imperative norms of the country with which the contract is actually connected. There is no test established in Russian law that could help determine when the agreement is connected only with Russia. Taking into account that the company and the insurer are Russian and most of the executives' obligations will be discharged in Russia, there are some arguments for a Russian court to decide that the D&O insurance and/or indemnification agreement is

Russian Federation

connected only with Russia and should thus be subject to all imperative norms of Russian law, irrespective of the choice of law provisions (See eg *Far East Okrug Arbitrazh Court Decision No. F03-A480/05-1/459* of April 15, 2005).

Forum

One method to make certain that English law will prevail is to amend the jurisdiction clause so as to provide for the referral of disputes to a centre of international arbitration, for example, the London Court of International Arbitration ('LCIA') or the International Council for Commercial Arbitration ('ICCA'). Whilst considered, in any event, to be a more practical forum for the resolution of commercial disputes given the composition of the tribunal, there is an additional benefit that Russian courts will not have the right to bring up the choice of law issue in connection with the enforceability of the foreign arbitration award in Russia unless such award contravenes Russian public policy (Article 244 of the Arbitration Code; Article 5 of the New York Convention (1958), to which Russia is a party).

Legal prohibition and presumptive indemnification

Certain control mechanisms exist to minimise corporate abuses with respect to joint-stock companies. The concept of an interested party transaction is set out in the Joint-Stock Company Law, as amended (Articles 81 to 84). As such, where the personal relationship between management personnel and those representing or benefiting from a transaction is deemed sufficiently proximate, the decision to conclude such transaction must be taken by the board of directors or general meeting of shareholders. Since the transaction is for the benefit of directors without an interest in the transaction to satisfy the quorum requirements. Effectively, all decisions relating to D&O insurance and/or indemnification will therefore have to gain the majority of the shareholders' approval (Articles 48(15) and 49(3)) in general meeting since it is clear that the executives have a self-interest in such transactions taking place. The decision to approve the D&O/ indemnification agreement shall include an indication of the person(s) being parties thereto, the beneficiary (beneficiaries), the price, subject matter of the deal and other significant terms and conditions thereof.

There is often a reluctance and general malaise evident in Russian companies towards seeking shareholder approval in relation to D&O insurance. Perhaps the concept of approving a product by which liability of its executives may be relieved is unfamiliar, or thought to be unpalatable, or is simply impractical in companies with a large body of shareholders. Without the approval, however, the policy is likely to be held void for illegality by the Russian courts due to contravening a provision of Russian law.

In certain cases, insurers have provided a waiver confirming that the absence of shareholder approval will not operate as a bar to coverage. This is unworkable, however, since it is not possible to ratify a contract which is void by operation of law.

An added complication to the enforceability of indemnification agreements is that there is no requirement under Russian law for a company to indemnify a director. Moreover, the law is silent in relation to indemnification both in general terms and specifically as applied to directors of a company. Russian law permits parties to enter into agreements which are not prohibited by law. 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.

There is, however, a risk that such an agreement, even if governed by

Russian Federation continued

English or other foreign law, would still be unenforceable as contrary to the basics of corporate law (Article 71 of the Joint-Stock Companies law) which states that it is the director or officer who can be held liable towards a company and not vice versa. By this logic, the company arguably cannot indemnify an executive for improper performance of his obligations. Until such time when an indemnification agreement is tested in the Russian courts, the enforceability issue remains unresolved. However, it is recommended that a director should seek to procure an indemnification agreement drafted in accordance with standard contractual requirements as evidence of the intention of the parties.

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 twofold. Firstly, in a traditional policy, this could mean that Side A coverage (for non-indemnifiable loss) is effectively defunct since the absence of legislation means that there is no limit to the amount a company can indemnify, 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.

To illustrate the point, both of the following examples attach the definition of non-indemnifiable loss to provisions under Russian law:

> *Example 1: Loss of an insured person that a company is unable to indemnify due to legislative prohibition or established insolvency.*

> *Example 2: Loss of an insured person that a company is unable to indemnify where not required to by the respective indemnity agreement and Russian law or due to insolvency.*

The effect upon a company and its respective executives 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 confines a company's inability to indemnify to, for example, legal prohibition which, as discussed above, has the effect of covering situations such as a failure to obtain shareholder approval where required by law.

A secondary effect of a poorly-worded policy is that in the event that a company does not indemnify the executive, 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 the intended coverage for individual executives. Ideally, it would be best to remove any such provision in the policy and to subrogate to the insurer the right to pursue the benefit of the corporate indemnity in the event it was not provided when it should have been.

Severability and non-invalidation

If a D&O policy does not include a severability clause, or where the insureds are not identified as composite, any fraud, non-disclosures or misrepresentations in the insurance application or elsewhere by one insured party may be imputed to all other insured parties, resulting in a complete loss of coverage for all parties, innocent and guilty alike. Under a severability provision, the insurer treats each covered party separately, such that the acts or omissions of one insured party do not impact the others, thereby mitigating the risk of rescission by the insurer. Insurers may attempt to eliminate or limit the severability clause, but it is important to ensure its inclusion together with a non-invalidation clause, the latter removing the right of the insurer to avoid, given that the policy could still be avoided for a non-disclosure of the company and/or placing broker. Such non-disclosure might not be capable of being tied to one executive only, or he may be acting as agent for all and consequently all will be tainted. A severability provision ought to be contained in the policy wording itself, as well as in the policy submission representations and warranties.

Conclusion

The issues concerning the enforceability of D&O insurance and indemnification agreements are complex and fraught with legal uncertainty. The role of a lawyer is therefore a critical one, not only to advise on the substantive issues of law, but also to modify policy language in order to provide innovative solutions ensuring broad and appropriate coverage for executives sitting on Russian company boards.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN SOUTH AFRICA

I A ESAT, PARTNER,

SHEPSTONE & WYLIE ATTORNEYS

South Africa

The regulatory environment in which corporate entities operate in South Africa has undergone significant alteration recently, becoming increasingly detailed and complex. These developments are the precursor to much broader, deeper and far-reaching changes that are set to occur in South Africa over the next two or more years.

The rapidly changing legal landscape has major ramifications for directors and for those concerned with their conduct. The trend is very heavily towards increasing director accountability and transparency and emphasising sound corporate governance. This is perhaps not wholly surprising in the light of recent corporate failures and the rapid growth of businesses operated by entities funded with public money.

The principal common law duty of directors is to act *bona fide* in the best interests of the company. This duty – and the fiduciary nature of the office which a director holds – is increasingly being reinforced not only in the application of the common law by judges, but also by legislators and through the statutes governing the workings of companies.

One major consequence of this trend is the heightening of the risk profile of directors and officers of companies. Appointees to boards face greater regulation, the enlargement of statutory duties, burgeoning shareholder activism, an energetic legal profession which is better prepared and equipped to take on directors and officers, an increasingly litigious environment and, in the case of corporate failure, more aggressive liquidators ready to conduct corporate post-mortems for the purpose of assigning blame and calling delinquent directors to account.

In this tough environment, directors' and officers' liability insurance stands out as an invaluable tool for managing the growing risk (for directors and companies) of becoming involved in costly litigation based on allegations, unfounded or otherwise, of director misconduct or default. The risk of incurring personal liability to the company, liquidators, creditors, the regulatory authorities, and even shareholders, is a daunting possibility that hangs over every director or officer, no matter how honest or diligent.

In the following sections we deal with recent legislative developments, updates on corporate governance and cases and litigation involving directors and officers flowing from corporate collapses.

Legislative developments

The Companies Bill

The current South African Companies Act was promulgated in 1973 and has been on the statute books now for over 30 years. Complementary legislation in the form of the Close Corporations Act has been in operation since 1984. In 2003 the Department of Trade & Industry began a review of these enactments with a view to a complete overhaul and rewrite of the legislation.

On 23 June 2004, the Department of Trade and Industry published a policy document entitled '*South African Company Law for the 21st Century: Guidelines for Corporate Law Reform*'. This document reviews, amongst other things, the history of corporate legislation, current weaknesses, the need for reform and the objectives of the review. The Department of Trade and Industry engaged in a process of public consultation in late 2004 and the process of drafting a new Companies Bill began in 2005. A draft Bill has been prepared and was published for public comment in February 2007.

The Companies Bill contains a non-exclusive code of director duties and obligations which, when enacted, will operate concurrently with the common law duties. In terms of the Bill a director must act with that degree of care, skill and diligence that would be exercised by 'a reasonably diligent individual' who had the knowledge, skill and experience of that particular director and also as may be expected of a person acting in that capacity. There is a secondary duty to 'act honestly and in good faith, and in a manner the director reasonably believes to be in the best interests of, and for the benefit of, the company'. A director will further have an obligation to communicate to the board any material information that comes to the director's attention other than information that is confidential and information already known to the board or which is in the public domain. Finally, there are duties relating to conflicts of interest including prohibitions against the making of secret profits, abusing the office of director and using confidential company information for personal profit. There is a prescribed procedure involving a declaration of conflicting personal financial interests to the board and the exclusion of the affected director from participating in the lobbying, approval or implementation of the transaction.

The Companies Bill effectively prohibits a director from being relieved from liability in any agreement, constitution, or resolution for false or misleading prospectuses or financial statements, recklessly carrying on of the company's business, participation in fraud by the company, gross negligence or breach of trust. The company may otherwise indemnify the director for any liability arising out of the director's service including, by implication, for ordinary negligence and may take out insurance for the director against any liability.

A new development in the Companies Bill that will see greater emphasis on compliance with corporate legislation is the proposed establishment of a Companies and Intellectual Property Commission. The Commission will have a mandate to encourage company formation and accountability through efficient and effective service delivery and through creating greater transparency in the market place. This mandate will be met through efficient registration of companies, education and awareness-raising, dissemination of information and enforcement of company law. Additional institutions include a Financial Reporting Standards Council, a Takeover Regulation Panel and a Companies Ombud.

The Corporate Laws Amendment Bill

The Corporate Laws Amendment Bill 2004 was passed by parliament in October 2006, but has not (at time of writing) been signed into law by the president. It contains extensive amendments to the Companies Act and the Close Corporations Act. These include, in particular, new provisions regarding the appointment and rotation of auditors and mandatory audit committees in respect of 'widely held' companies.

The amendment to Section 287 of the Companies Act provides that: 'If any financial statements of a company which are incomplete in any material particular or otherwise do not comply with the requirements of this Act, are issued, circulated or published, the company and every director or officer thereof who is a party to such issue, circulation or publication, shall be guilty of an offence.' Section 287A further provides that if any financial reports of a company are false or misleading in a material respect, then any person who is a party to the preparation, approval, publication, issue or supply of that report, and who knows or ought reasonably to have suspected that it is false or misleading, is guilty of an offence.

The Securities Services Act

The Securities Services Act 36 of 2004 came into effect on 1 February 2005 and creates various offences classified generically as 'market abuse'. These include:

- insider trading

- the disclosure of inside information
- engaging in a prohibited trading practice; and
- the making or publishing of false, misleading or deceptive statements, promises or forecasts relating to listed securities or public companies, where the person knows or ought reasonably to have known that they were false, misleading or deceptive.

The definition of an insider includes any person who has inside information such as a director. A prohibited trading practice is participation in the use of any trading practice relating to listed securities (including placement of buy or sell orders) which is manipulative, improper, false or deceptive and which might create a deceptive impression of the trading activity or an artificial price.

The Securities Services Act provides for stiff penalties of up to ZAR50 million and/or 10 years imprisonment. In addition, insider trading may result in civil liability of the insider to the board for any profit gained or loss which has been avoided by the insider and for the payment of a penalty up to three times such profit or loss.

Other legislation

The National Environmental Management Act, as amended in 2004, provides for co-operative environmental governance by establishing principles for decision-making on matters affecting the environment and providing for the administration and enforcement of environmental management laws. This Act means that directors of a company are deemed to be guilty of the same offence as the company that they are directors of, unless they can prove that they took reasonable steps to prevent the offence.

The Minerals and Petroleum Resources Development Act came into effect on 1 May 2004. This Act, which has significant implications for directors of mining and oil companies, imposes personal liability for any unacceptable negative impact which their companies might have on the environment, including damage, degradation or pollution advertently or inadvertently caused by the company.

Section 48(9) of the Value Added Tax Act provides that: 'Where a vendor is a company, every member, shareholder or director who controls or is regularly involved in the management of the company's overall financial affairs shall be personally liable for the tax, additional tax, penalty or interest for which the company is liable.' The effect of this is that directors who control or are regularly involved in the management of the company's financial affairs, are potentially personally liable for employees' tax, including any additional tax, penalty or interest for which the company is liable.

In appropriate circumstances directors may incur civil liability arising from contravention of statutory duties.

Corporate governance update

With effect from 1 September 2003, it became compulsory for all companies listed on the JSE Securities Exchange to comply with codes presented and recommended in March 2002 by the second King Report on Corporate Governance for South Africa (better known as the 'King II Report').

The codes deal with corporate governance issues and further require compliance with the Global Reporting Initiative (GRI), generally regarded internationally as the standard for sustainability reporting.

The objective of the Global Reporting Initiative is for organisations of all sizes worldwide to adopt periodic sustainability reporting ie reporting on economic, environmental, and social performance in the same way as financial reporting is regarded by corporates as routine and mandatory.

South Africa

The Global Reporting Initiative adopts a Sustainability Reporting Framework including Sustainability Reporting Guidelines and Sector Supplements and Protocols.

The King Committee, a private initiative of the Institute of Directors of Southern Africa, and inspired by the then UK Cadbury Committee, was formed to investigate aspects of corporate governance in South Africa and to formulate an ethical guide. Its first report, known as King I, was published in November 1994 – long before the WorldCom and Enron collapses.

The King II Report was prepared against the background of spectacular failures in South Africa of MacMed Group, Tigon, LeisureNet, Regal Bank and others and was therefore timely. Both King I and King II are highly regarded and have received acclaim internationally.

Recent cases

It has been held that directors stand in a fiduciary relationship with the company alone. Therefore, as such, they owe no fiduciary duties to the company's shareholders individually, nor to its creditors, its holding company or the group as a whole.

The derivative action gives any member of the company the right to initiate proceedings on behalf of the company where a company has suffered loss or damage and the company cannot seek redress because the wrongdoers themselves control the company. Whilst the statutory derivative action has been on the statute books for some time (in the form of s266(1) of the Companies Act), doubts have been expressed from time to time as to the existence of a common law derivative action.

In the recent case of *TWK Agriculture Ltd v NCT Forestry Co-Operative Ltd & Others 2006* (6) SA 20 (N), the court held that there was sufficient authority to support a finding that the derivative action is also a part of the South African common law. This development may well add another string to the shareholder's proverbial bow.

In the recent Supreme Court of Appeal decision of *Symington & Others v Pretoria-Oos Hospital* 2005 (5) SA 550 (SCA) a doctor who was a director of a hospital decided to let a section of the hospital – which was allocated to him by the company – for a rental. Although an action for disgorgement of profits was found to have lapsed in terms of the Prescription Act, the appeal court held that – in the event of a breach of a fiduciary duty – the company could claim both a disgorgement of the secret profit and any damages that it could prove it had suffered.

Cases involving s424 Companies Act

There have, in recent years, been a growing number of reported cases involving s424(1) of the Companies Act (which gives the courts the power to declare that any person who was knowingly a party to the carrying on of the business of a company recklessly or with intent to defraud creditors, or for any fraudulent purpose, should be personally liable without limitation for the debts or liabilities of the company).

The liquidation of MacMed Health Care Ltd, which led to the liquidation of all its subsidiary companies and the collapse of the Macmed Group, is generally regarded as one of the biggest corporate collapses yet experienced in South Africa (involving over ZAR1 billion in liabilities). Some of the litigation is reported in the case of *Nel and others NNO v McArthur and Others* 2003(4) SA 142 (T).

MacMed Health Care was involved in the business of manufacturing and distributing medical consumable products. It is reported that a consortium of banks was duped into lending money based on misstatements contained in the company's financial statements. The company subsequently went into liquidation. The joint liquidators of the company instituted an action against 16 former directors, officers and associates of the company alleging that they had knowingly been party to the carrying on of the business of the company in a reckless or fraudulent manner.

Two of the defendants initially took exception to the claim on the grounds that the allegations were vague and embarrassing. The exception was dismissed by the court. Importantly, it was held that a director who adopts 'a mere supine attitude in regard to a risk can be accused of recklessness whether he or she realises it involves the taking of a risk or not'. Consciousness of risk-taking is not a requirement. There is also no requirement for any causal link between the reckless or fraudulent conduct and the liability which the claimant seeks to impose on the directors.

It is reported that out-of-court settlements were reached with 14 of the defendants. The matter came before the court on 5 February 2004 in respect of the remaining two defendants (including the company secretary) and they were held jointly and severally liable in terms of s424 of the Companies Act for an amount in excess of ZAR647 million. The banks also took action against the auditors, but reached an out-of-court settlement in December 2006 with the PI insurer. Criminal proceedings may still be pending.

The other recent major corporate collapse spawning litigation involves LeisureNet, a company that operated the Health and Racquet Club in South Africa and Fitness Club in Germany, UK, Spain and Australia. LeisureNet was left with over R1 billion in liabilities. The liquidators of the company sued 12 former directors for payment of R1.2 billion, based on allegations of reckless or fraudulent trading in terms of s424 of the Companies Act, including an allegation that the financial statements were materially false and misleading.

The D&O insurer for 10 of the defendants has reached an out-of-court settlement with the liquidators in the sum of R18.5 million without admission of liability. Some of these directors are reported to have maintained their innocence, but agreed to the settlement to avoid protracted litigation, irrecoverable legal costs and the inevitable disruption to their professional, business and social lives. The case against the remaining two directors has yet to be decided.

An investigation by the Insider Trading Directorate has also resulted in an out-of-court settlement being reached with one of the directors of LeisureNet who divested himself and Sekunjalo Investments of their shares in LeisureNet before notice of the intention to apply for liquidation was released to the market.

Another recent corporate collapse that has received extensive media attention involves the business affairs of Tigon, Shawcell, PSC Guaranteed Growth Limited and Galahad Chartered Accountants Inc. The chairman of Tigon pleaded guilty in the Pretoria Magistrate's Court under s424(3) of the Companies Act as a result of his admitted failure to take appropriate corrective measures on ascertaining certain irregularities in Tigon and Shawcell. The chairman maintained that neither was he in any way personally dishonest, nor had he participated in any dishonest activity that had as its object a fraudulent purpose, or with the object of defrauding any creditors of the company. This statement was accepted by both the prosecuting authority and the court. He was sentenced to a fine of R50,000 or one-year's imprisonment – of which R25,000 or six-months' imprisonment was suspended for three years on condition he did not commit a similar offence. Prosecutions of other directors and officers involved in the management of these companies are ongoing and there are in addition likely to be civil claims.

Finally, the latest corporate collapse to make headlines involves the Fidentia group. On 27 March 2007 the companies in this group were

South Africa

placed under final curatorship and both the chairman and the auditor have been arrested on charges of fraud, theft and contraventions of statutory duties. Since assuming control and management of the business in terms of the earlier provisional curatorship order the curators believe they have established a multiplicity of wrongdoings, both criminal and civil, on the part of the directors and others and estimate that investors will suffer a shortfall of approximately ZAR1 billion.

Risk exposure

What emerges from these recent cases is that, by accepting appointments, directors of boards face substantial risks, with potential exposure to huge liabilities (even where they are non-executive directors not involved in the day-to-day running of their respective companies). Insurers have come to the rescue of some of these directors where suitable and adequate D&O insurance has been in place.

It is highly unlikely that the risk profile of directors will enjoy any diminution whether by the courts or by parliament. If anything, directors must be prepared to face additional challenges, the reinforcement of their fiduciary duties as well as the creation of new statutory ones, and a legal expectation that their governance will be more open, transparent and accountable.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN SPAIN

ALEJANDRO PLAZA FERRER,

ASSOCIATE LAWYER,

GÓMEZ-ACEBO & POMBO ABOGADOS

Spain

Spain is no stranger to the general trend of enhancing transparency in corporate governance, particularly (but not exclusively) where listed companies are concerned.

As part of this trend, important steps have been taken recently which significantly affect directors' duties and liabilities. The most important ones are **(i)** the Law 26/2003 (the so-called 'Transparency Law') and **(ii)** the Unified Good Governance Code (the 'Unified Code'), also known as 'Conthe's Code'.

The Transparency Law

In September 2002, the Spanish government created a Special Committee to enhance the transparency of listed companies, with the aim of improving investor protection. This committee was tasked with producing a report (published on 8 January 2003) that highlighted the crucial importance of transparency to the development of the capital markets. On the basis of this report, the Transparency Law incorporated, on a mandatory basis, some of the most important corporate governance international best practices and recommendations, thus providing **(i)** a new legal definition of the framework of directors' duties, especially with regard to conflicts of interest; and **(ii)** the need to implement a number of corporate governance tools including, among others, the Regulations of the Board and the General Shareholders Meeting ('GSM').

In line with the above goals, the Transparency Law included a number of amendments to the Spanish Stock Company's Law, some of which affect the definition of directors' duties.

Summarising directors' duties

Following the introduction of the Transparency Law, the legal definition of these duties can be summarised as follows:

- In performing their duties, directors must exercise the same degree of diligence as an orderly businessman and a faithful representative
- Each and every director must keep him/herself fully informed of the company's business
- Directors may not make use of their company's reputation to further their own particular businesses, or businesses on behalf of persons related to them
- Directors may not undertake business connected to the company's assets, unless the company has itself declined to enter such business
- Directors must notify the Board of any conflict of interest which may affect (directly or indirectly) the company's interests. If there is a conflict of interest, the director involved must cease involvement in any such activity, and the incident must be mentioned in the company's corporate governance report
- Directors must notify the company of any stake that they hold in any other companies with similar/comparable corporate purpose, as well as the posts or offices that they may hold in those companies. This information must be included in the financial report of the company's annual accounts
- For these purposes, 'related persons' are deemed to be:
  - The spouse (or equivalent) of the director
  - The relatives and siblings of the director, or of his/her spouse
  - The spouses/partners of the director's relatives and siblings
  - Any companies in which the director (directly or indirectly) controls the share-capital, under certain circumstances

Spain

- Directors must keep secret all the company's confidential information, even after having left their posts.

Summarising directors' liabilities

As far as the liability of directors is concerned, the Transparency Law makes some minor changes to the former legal framework. As things stand, the liability of directors is largely defined in Article 133 (and following) of the Stock Company's Law, as amended by the Transparency Law. Key points include:

- Directors shall be liable to the company, its shareholders and its creditors for any damage they cause by committing acts or omissions contrary to the law or the company's by-laws, or by any acts carried out which conflict with their duties
- Those acting as *de facto* directors of the company will be personally liable to the company, its shareholders and its creditors for the damage caused by acts or omissions contrary to the law or the company's by-laws, or by any acts carried out which conflict with their duties
- All the members of the board of directors which passed the resolution, or performed the act, which caused the damage shall be held jointly and severally liable, except for those who can show that they did not take part in its approval or performance and were unaware of its existence, or if aware, took steps to avoid the damage, or at least expressly opposed the resolution
- The authorisation or ratification of the wrongful act by the GSM will in no way serve to waive the directors' liability

An important cause of directors' liability is provided by Section 262 of the Stock Company's Law (as amended by Law 19/2005).

According to s262, a resolution of the GSM is required before a company can be dissolved (as a consequence of any sudden disruption to its net value, as defined by the law).

Directors must call a GSM within two months of any such disruption. Any shareholder can request that the directors call the meeting if, in their opinion, there are legal grounds for the dissolution.

Any legitimate person may file for judicial dissolution of the company **(i)** where the meeting is requested but not called, **(ii)** where no resolution was adopted, or **(iii)** where the resolution passed was against dissolution.

Directors are required to file for the judicial dissolution of the company where a resolution is passed against dissolution, or where no resolution was adopted.

Directors will be jointly and severally liable for all company obligations arising after the cause of legal dissolution has occurred, if they fail **(i)** to comply with the requirement to call, within two months, a GSM to pass a resolution dissolving the company, or **(ii)** if they either do not file for judicial dissolution of the corporation or, as the case may be, the bankruptcy, within two months of the date set for a meeting that was not held, or from the date of the meeting where a resolution against dissolution was passed.

In the above cases, the company's obligations will be deemed to have arisen after the cause of legal dissolution occurred, unless the directors provide evidence to the contrary.

Recent case law

A recent decision by the Spanish High Court casts some interesting light on directors' liabilities. STS of 28 April 2006 (RJ 2006/4087) sets out two important conclusions applying to cases where directors are sued for negligence in the performance of their duties, as well as where they are sued for liability in failing to promote the winding-up of a corporation. To sum up:

(a) the liability of directors for a company's debts (set out in s262 of the Stock Company's Law) is not automatic, at least not where a director can prove that s/he was only a director in name, was not involved in the management of the company, had no control over the company, and had not had sufficient time to acquire any real knowledge of the company's financial situation

(b) the liability set out in s262 cannot be claimed against *de facto* directors.

The Unified Code

In July 2005, the Spanish government created a Special Working Group tasked with driving forward the harmonisation of the two corporate governance codes then in existence (*Olivencia and Aldama*), as well as providing policy recommendations. The Group concluded its work in May 2006, producing a Unified Good Governance Code (the 'Unified Code', also known as 'Conthe's Code').

The Unified Code takes a number of international recommendations into account, including the latest OECD Principles of Corporate Governance, and various European Commission recommendations (dealing, *inter alia*, with the roles of supervisory directors and board committees, and the remuneration of directors of listed companies).

The main principles of the Unified Code can be summarised as follows:

'Comply or explain'

Article 116 of the Securities Market Law cites the principle known internationally as 'comply or explain' in requiring listed Spanish companies to specify their degree of compliance with corporate governance recommendations, justifying any failure to comply in their Annual Corporate Governance Reports. The Unified Code sets out the recommendations to be borne in mind by listed companies when fulfilling their disclosure requirements under this law.

In other words, Spanish legislation permits companies to decide whether or not to follow corporate governance recommendations, but requires them to give a reasoned explanation for any deviation, so that shareholders, investors and the markets in general can decide accordingly.

Binding definitions

Listed companies are free to decide whether or not to comply with the Unified Code's good governance recommendations, but their reporting on this issue must take account of its underlying concepts. Therefore, for instance, it is up to companies whether they decide to follow the recommendations on independent directors, but what they cannot do is to call a director 'independent', for the purposes of disclosure requirements, if the relevant person does not meet the minimum conditions stated in the Unified Code.

Evaluation by the market

It will be left to shareholders, investors and the markets in general to evaluate the explanations that companies give of their degree of compliance with the Unified Code recommendations. This means that neither the extent of compliance, nor the quality of explanations, will give rise to any actions by the CNMV (the Spanish stock market regulator), as this would directly invalidate the voluntary nature of the Code.

This is understood to be without prejudice to the CNMV's monitoring powers where the annual corporate governance reports of listed companies are concerned (provided for by article 116 of the Securities Market Law and Order 7 ECO/3722/2003 of 26 December, whereby the regulator may order companies to make good any omissions or false or misleading data).

Spain

Generality
The Unified Code applies to all listed companies, irrespective of their size and market capitalisation. As a consequence, some recommendations may be unsuitable or excessively burdensome for smaller-sized companies. In such cases, these companies will need to state clearly their reasons for non-fulfilment and any alternative routes chosen (ie their freedom of decision and organisational autonomy are guaranteed).

The main provisions of the Unified Code affecting directors are as follows (source, CNMV's web page):

The corporate interest
All directors, however and whenever appointed, must defend 'the corporate interest' (interpreted by the Unified Code as the common interests of a company's shareholders or, if preferred, the interests of the common shareholder). The Unified Code considers this to be the most appropriate focus for directors' responsibilities. For this reason, it urges that the ultimate goal of a company and, therefore, the principle guiding the board in all its actions, should be the maximising of the company's economic value over time. This seems preferable to other, broader, definitions of 'the corporate interest', because it gives the board and the executive bodies under it a straightforward driver for the adoption of resolutions and their subsequent evaluation.

This is, by no means, to say that shareholders' interests must be pursued at any price, without regard to other groups involved in the company or the community in which it operates. The interest of shareholders provides a touchstone for decisions which must nonetheless comply in full with the provisions of law (for instance, in tax or environmental matters), and enable the company to meet its contractual obligations, explicit or otherwise, with stakeholder groups such as employees, suppliers, creditors and customers and, in general, to adhere to any social responsibility principles taken on board.

The Unified Code recommends as follows:

> '*7. The Board of Directors should perform its duties with unity of purpose and independent judgement, providing to all shareholders the same treatment. It should be guided at all times by the company's best interest and, as such, strive to maximise its value over time.*
>
> *It should likewise ensure that the company abides by the laws and regulations in its dealings with stakeholders; fulfils its obligations and contracts in good faith; respects the customs and good practices of the sectors and territories where it does business; and upholds any additional social responsibility principles it has subscribed to voluntarily.*'

Competencies of the board
The Public Limited Companies Law assigns the Board of Directors full control over the company's strategy and management. At the same time, it allows it ample freedom in delegating powers within legally-established limits. This being so, companies can adopt widely divergent models of board organisation and procedures, especially where the board's involvement in day-to-day management is concerned. Although the Code does not line up behind a particular model, it does warn against excessive delegation (which can cause a board to underperform in its most basic and inalienable duty: the 'general oversight function'). This function splits into three key responsibilities: guiding and promoting company policy (strategic responsibility), controlling its management levels (stewardship) and liaising with shareholders (disclosure).

Ideally, the non-delegable powers at the heart of this oversight function should be closely defined. Although the list is a long one, some points are evident enough to need no explanation. That said, three issues in particular merit closer attention.

Concerning the ratification of management decisions, it seems reasonable that the board should approve the appointment or removal of senior officers at the proposal of the company's chief executive. No such proposal could be mandatory where a managing director is appointed to take on some of the duties of the executive chairman, or facilitate his/her succession.

At the same time, the board should pay special attention to the organisation of the corporate group, where possible avoiding artificial or overly complex structures, as urged in Principle 8 of the Recommendations of the Basel Committee on Banking Supervision for the corporate governance of banking organisations (know your structure).

Specifically, the board as a whole should be responsible for the creation of special purpose vehicles (SPVs) – entities which, despite having their own legal personality, are created solely for some intermediate purpose and are controlled by the group to which the listed company belongs, or companies resident in jurisdictions defined as tax havens, as well as any related transactions or operations. Such entities should respond in all cases to a legitimate purpose and should not unjustifiably impair the transparency of the group's structure and operations.

Finally, as an essential part of its oversight function, the board should be aware of any issues that could give rise to a conflict of interest and, specifically, control and authorise any company transactions with related parties that do not correspond to normal business flows.

The Code recommends the following:

'8. The board should see the core components of its mission as to approve the company's strategy and authorise the organisational resources to carry it forward, and to ensure that management meets the objectives set while pursuing the company's interests and corporate purpose. As such, the board in full should reserve the right to approve:

a) The company's general policies and strategies, and in particular:

- *i) The strategic or business plan, management targets and annual budgets;*
- *ii) Investment and financing policy;*
- *iii) Design of the structure of the corporate group;*
- *iv) Corporate governance policy;*
- *v) Corporate social responsibility policy;*
- *vi) Remuneration and evaluation of senior officers;*
- *vii) Risk control and management, and the periodic monitoring of internal information and control systems;*
- *viii) Dividend policy, as well as the policies and limits applying to treasury stock.*

b) The following decisions:

- *i) On the proposal of the company's chief executive, the appointment and removal of senior officers, and their compensation clauses.*
- *ii) Directors' remuneration and, in the case of executive directors, the*

Spain

additional consideration for their management duties and other contract conditions.

iii) The financial information listed companies must periodically disclose.

iv) Investments or operations considered strategic by virtue of their amount or special characteristics, unless their approval corresponds to the General Shareholders' Meeting;

v) The creation or acquisition of shares in special purpose entities resident in jurisdictions considered tax havens, and any other transactions or operations of a comparable nature whose complexity might impair the transparency of the group.

c) Transactions which the company conducts with directors, significant shareholders, shareholders with board representation or other persons related thereto ("related-party transactions").

However, board authorisation need not be required for related-party transactions that simultaneously meet the following three conditions:

1. They are governed by standard-form agreements applied on an across-the-board basis to a large number of clients.

2. They go through at market rates, generally set by the person supplying the goods or services;

3. Their amount is no more than 1% of the company's annual revenues.

It is advisable that related-party transactions should only be approved on the basis of a favourable report from the Audit Committee or committee handling the same function; and that the directors involved should neither exercise nor delegate their votes, and should withdraw from the meeting room while the board deliberates and votes.

Ideally the above powers should not be delegated with the exception of those mentioned in b) and c), which may be delegated to the Executive Committee in urgent cases and later ratified by the full board.'

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE UK

MICHAEL BROWN, CO-HEAD OF INSURANCE GROUP, ALLEN & OVERY LLP

UK

The period 2005 to 2008 is seeing significant changes in the legislative architecture for companies and their directors in the UK.

We will look first at what companies have been doing to take advantage of a 2005 relaxation to the statutory rules governing the scope of indemnities that companies have been able to give to their directors, and the ramifications of those changes on companies' D&O insurance arrangements (as well as the less well-understood extra-territorial consequence of this for UK-listed companies with non-UK subsidiaries).

We will then pick up some key consequences for directors of the wholesale re-writing of our UK companies' legislation via the Companies Act 2006: the largest single of legislation in Parliamentary history – some 1,300 sections long.

Lastly, we will comment on some other developments that have focused boardroom minds: lessons to learn from the collapse of the action against the former Equitable Life board, the extradition of a number of executives to the US under the Extradition Act 2003 and the forthcoming Corporate Manslaughter Act.

Director indemnities

Since 2005, companies incorporated under the Companies Act 1985 or its predecessors have been able to lend directors the cost of funding their 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; but in other cases the company may indemnify the director against his defence costs. Where the director is sued by third parties on their own account (as in a US shareholder class action), the company is also allowed to indemnify the director against any liability to the third party. The existence of any indemnity must be disclosed in the company's directors' report.

Companies do need to check that their individual constitutions permit them to implement loans and indemnities in this new form, and to understand that indemnity provisions within their Articles of Association are not in themselves enforceable by directors. Specific qualifying indemnity contracts are required.

Allen & Overy's experience is that the majority of UK public companies are taking advantage of the new rules to reassure their plc directors by promising to fund their defence of claims and other related expenses. Carefully drafted deeds can also clearly cover extradition defence costs and bail arrangements. By and large (with limited exceptions), we are not seeing directors of subsidiary companies (whose risk profile is different from that of plc directors) being offered equivalent indemnities.

The issue of whether/when it is in a company's interest to indemnify a director against his liability to a third party, where the director has been held to be liable after due process for a breach of a duty to a third party, has understandably caused more boardroom angst. No standard response has emerged. Each company has to consider its own boardroom risk profile and circumstances. In any event, successful shareholder litigants are unlikely to take kindly to the company funding the cost of a director's settlement if their complaint is that the director's actions have caused a diminution in their investment; so an indemnity may prove of illusory value.

UK-listed companies need to be aware that they 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 they were regulated by the UK Companies Act 1985. This is because the exemption in the Listing Rules for related party transactions applicable to director indemnities requires them to comply with the Companies Act, even where they are granted by overseas Group subsidiaries.

In general the scope of a permissible director indemnity remains narrower than the scope of available D&O cover, and certainly does not remove the need for robust insurance as a director's first port of call in the event of a claim against him.

The new director indemnity arrangements have some impact on D&O insurance cover. For instance, companies and directors will want to ensure that the policy will be available to repay a defence costs loan (where required) if the director opts to borrow his defence costs under an indemnity rather than implementing his D&O cover. Other policy wording changes may be required that do not necessarily appear in insurer standard D&O wordings.

The scope of non-indemnifiable loss for D&O policy purposes is now narrower, resulting in the company potentially being called on by D&O insurers to bear the first part of more claims within the company's side B retention.

New Companies Act 2006

This massive new Act will be the new legal framework governing companies incorporated in England & Wales and UK branches of overseas companies. The Act has significant direct ramifications for directors on a number of counts. Most of the new provisions discussed below come into force by October 2007, though the new director conflict of interest provisions will take effect from October 2008.

Directors' duties

The Act introduces, for the first time, a partial codification of directors' duties. The seven duties are: **(a)** a duty to act within powers; **(b)** a new duty to promote the success of the company; **(c)** a duty to exercise independent judgement; **(d)** a duty to exercise reasonable care, skill and diligence; **(e)** an expanded duty to avoid conflicts and possible conflicts; **(f)** a duty not to accept benefits from third parties; and **(g)** a new duty to declare an interest in a proposed transaction or arrangement.

A director will also be required to declare an interest in any transaction or arrangement entered into by the company; in future, failure to do so will be a criminal offence.

As now, the duties will be owed to the company (not other stakeholders) and will be enforceable by the company (and in certain circumstances, by a shareholder on behalf of the company – see below). Breach of a duty may, for example, give rise to damages or compensation being payable.

Commentary has focused on the newly-defined duty to promote the success of the company, in lieu of the old common law duty to act in the company's best interests. Lawyers are uncertain how this new duty will be interpreted by the courts, and what directors will have to do in practice to demonstrate that they have properly taken into account the factors listed in the Act as relevant to a board's consideration of what will serve to promote the company's success. That uncertainty is particularly acute in the case of a company in financial difficulty.

There is also concern that the expanded duty to avoid conflicts and possible conflicts will make multiple directorships much more difficult to manage.

Shareholder derivative claims

It has long been the law in the UK that directors owe their duties to the company as a whole and not to individual members, employees, creditors or other outsiders; and that a breach of a duty owed by a director which causes loss is actionable only by the company that suffered the loss, and not by shareholders etc (one key exception relates to directors' personal liability to investors for the accuracy of circulars and prospectuses promoting sal of company securities.) English law has only allowed shareholders to bring claims on behalf of the company and for the company's benefit – so-called shareholder derivative actions – in the narrowest of circumstances.

The Companies Act 2006 will lower the bar for shareholders to bring derivative claims from (effectively) a fraud test to a negligence test, where the company is not itself taking suitable action against a director. The court will have to give leave for the claim. In doing so, the court will need to be satisfied that the pursuit of a claim against one or more directors will promote the success of the company, and that the directors' conduct has not been authorised or ratified by the company. The court will consequently be in the position of being invited to second-guess a company's own decision not to pursue a claim against a director.

The Act does not oblige a shareholder to notify or consult with the board before bringing a claim. However, if a company establishes a system that encourages a shareholder to raise its grievances with the board, it will make it harder for the shareholder to demonstrate that it was acting in good faith. The change in a director's risk profile means that as soon as the company has notice of any (potential) claim, it may be forced to think more carefully about whether to bring an action itself so that it has control over the matter. Where the conduct on which the claim is based relates to the entire board, the board will probably need to appoint at least one independent director to decide whether the company should initiate proceedings itself, or oppose the pursuit of a derivative claim; the position of the remaining directors will be a difficult one. An informed and carefully-recorded board decision on whether to sue will be important under the new regime.

D&O 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 detailed policy terms. We would recommend a legal health check of the D&O policy.

A company cannot indemnify a director in respect of any damages awarded against the director in a successful derivative action, and can only indemnify him against his defence costs if the claim is dismissed. While the company could fund the director's defence (if the D&O policy fails to do so), this could only be done by way of a loan – which would have to be repaid immediately if the director is not exonerated.

Business reviews

One key change for UK-listed companies will be a requirement to include information in the business review accompanying a listed company's annual financial statements (to the extent necessary) on the trends and factors likely to affect the future development, performance and position of the business (ie forward-looking information), and information on environmental matters, the employees, social and community issues and persons with whom the company has key contractual or other arrangements.

UK

There has been concern over the implications for directors of, in particular, the predictive statements required to be included within the business reviews, given that this can potentially give rise to both civil and criminal liability. However, a director will not be liable for the contents of the directors' report (including the business review) unless he or she knew, or was reckless as to the fact, that the statement was untrue or misleading, or knew the omission to be a dishonest concealment of a material fact.

It should be noted that the safe harbour from civil liability for a directors' report will not extend to voluntary operational and financial reviews, nor to narrative reports published outside the statutory framework.

Transparency Directive

For a UK-listed company, another head of civil liability is introduced under the new transparency rules and will apply in relation to financial periods beginning on or after 20 January 2007. This relates to loss suffered by third parties as a result of false or misleading statements in certain reports or statements (eg annual and half-yearly reports, interim management statements and preliminary announcements replicated in the annual report). Safe harbours do exist, and their availability depends on the directors' knowledge or recklessness in relation to the false or misleading statement.

Director indemnities

The Companies Act 2006 will not materially change the rules described above regarding director indemnities. It will extend the new flexibility to directors of occupational pension scheme trustee subsidiaries in the Group.

Other developments

Equitable Life litigation against its directors

The Equitable Life Insurance Company debacle is well known: the company was driven to the brink of insolvency by misjudging the way that it was constitutionally entitled to allocate policyholder funds by way of differential bonus declarations between different classes of pension policyholders (some of them holding a right to a guaranteed level of annuity) as trends in interest rates changed to increase the value of those guaranteed annuities.

Equitable's financial travails led to the replacement of the entire Board and claims against the entire former board and auditors exceeding £3 billion. After protracted and very expensive litigation, the claims collapsed and were discontinued. The majority of the non-executive directors (represented by Allen & Overy) even recovered the whole of their costs.

The litigation was, of course, a nightmare for the individuals involved; but at the end of the day, the collapse of the claim is a 'good news' story for directors. Litigation of this kind and magnitude in the UK is very expensive and risky for the claimant, as well as for the defendant. The UK legal system does not allow US-style contingent fee litigation, and puts an unsuccessful claimant at risk of paying the defendants' costs. Companies are bound to be much more aware of the litigation risk of suing directors following Equitable.

One final lesson is the need for boards to have adequate limits of insurance to ensure that they can at least defend themselves adequately against unmeritorious claims. The Equitable litigation is reputed to have cost the defendant directors over £20 million – and this was not even US litigation. It is reported that they only had £5 million in D&O insurance. Other boards will not want to risk falling into a similar dilemma.

Extradition

The Extradition Act 2003 and the 2003 UK-USA Extradition Treaty have created new risks for UK directors. The new regime applies to extradition requests from a large number of countries, not just the US. It means that a request from one of these countries for a UK citizen to face justice in that country is no longer examined by the courts to see if there is a *prima facie* case. Now the courts simply ensure that procedures have been complied with and do not assess the merits of the claims.

An extraditable offence does not need to have been very serious. Rather, it must be one that could incur a minimum 12-month sentence in the UK, or the requesting state. Although the UK authorities may have decided not to investigate a particular case, that is not a barrier to extradition.

Businessmen can be extradited for something that is not an offence in the UK, and the US has been active in seeking extradition of British businessmen. The conduct leading to the request need not have take place in the US, but simply have affected a US party. The prosecuting authorities in the extraditing state may also add other charges once the businessman arrives in their jurisdiction.

The regime covers a wide range of countries, in some of which a serious problem has the potential to become a political problem that could result in extradition proceedings. Companies should examine such 'country risks', understand the criminal law regime and assess the stability of the government and volatility. Other strategies include: strengthening internal controls; ensuring robust anti-money laundering procedures, training staff, taking document measures and checking D&O insurance provisions.

The English courts have proved unwilling to accept any challenges to the new extradition regime, and the scope for a director to oppose his extradition is very limited. The US has also proved itself adept at arresting British businessmen wanted for alleged criminal offences whilst travelling in the US (as one or two online betting company directors have discovered), thereby circumventing the need for extradition.

From a D&O insurance perspective, most insurers now offer cover against extradition defence costs for what that may now be worth, and sub-limited cover for the cost of funding bail bonds and security bonds in countries where such bonds are acceptable bail security. Given that there could be an interval of a year or so before the actual trial, bail costs can be a material consideration. This aspect of the D&O cover, and the adequacy of the bail costs sub-limit, arguably takes on as much significance as the extradition defence costs cover.

Corporate manslaughter

A new offence of corporate manslaughter is to be introduced by the pending Corporate Manslaughter Bill. Whilst directors cannot themselves be convicted of this new offence, they should be aware that the proposed offence depends on proof that the way in which its activities are managed or organised by its senior management is a substantial element in the breach that caused a death. That increases the corporate governance burden on directors to ensure the suitability and enforcement of health and safety systems.

It is also predictable that attempts may be made in future, possibly using the new derivative shareholder action right, to recover the cost of what are likely to be swingeing fines on companies from the senior management whose failings led to that fine. As any such recovery action would be likely to be by way of a civil damages claim, the liability ought to be insurable so long as the 'insured vs insured' exclusion in the D&O policy does not bite and the director's actions were not deliberate.

All in all, these remain challenging times in which to be a UK company director. Recent developments have done more to add to directors' burdens and risk, though the extent of the challenges faced by anyone seeking to sue a director in the English courts has been highlighted by the collapse of the case against the Equitable life directors.

LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN THE UNITED STATES

SARAH S GOLD, PARTNER AND RICHARD L SPINOGATTI, SENIOR COUNSEL, PROSKAUER ROSE LLP

Yona Lebovic, Sarah Reisman and William H Weisman, who are associates in the firm, assisted in the writing of this article.

US

In recent years, Congress and the courts of the United States have broadened the duties and responsibilities of corporate directors and officers in the wake of highly-publicised business scandals. Conduct that was once thought proper and innocent may now be grist to the mills of civil litigation, and behaviour that was merely 'aggressive' or 'hard-ball' has become magnetic, drawing the charged attention of government regulators, prosecutors, and plaintiffs.

Not surprisingly, there has been a responsive flood of advice from our colleagues at the Bar, certified public accountants, and business consultants about what directors and officers must do to conform with new and old laws and regulations, how they are to meet their obligations to shareholders with respect to the financial and operational management of their companies, and how they are to interact with employees and consumers. All would agree however, that 'climbing the corporate ladder' has become far more treacherous. There follow a number of key points to bear in mind in this challenging environment, highlighted by recent developments in law and practice.

As a member of management or board of directors, the honesty and strength of character of your colleagues is critical to fulfilment of your duties and responsibilities and to avoiding civil or criminal liability

For over a decade, directors of most United States corporations have been protected from liability by what has come to be known as 'the business judgement rule' (first established in the seminal *Caremark International* case (*Caremark Int'l Inc Deriv. Litig*, 698 A 2d 959 (Del Ch 1996)). The rationale of this case, decided in the Delaware Chancery Court, was quickly adopted in most other states. The business judgement rule protects directors from liability for decisions made on an informed basis, in good faith, and in the honest belief that any action taken is in the best interests of the company and its shareholders. Although the rule provides basic protection, increasing liabilities and oversight obligations, including those imposed by the Sarbanes-Oxley Act of 2002, are a deterrent to qualified persons accepting high-level positions at public companies.

Recently, the stringent *Caremark* standard for director liability and, in particular, for oversight liability, was confirmed by the Delaware Supreme Court (*Stone v Ritter*, 911 A 2d 362 (Del 2006)). The court held that, to be liable, a director must have intentionally failed to discharge fiduciary obligations. Then, adopting *Caremark*, the court explained that a director's oversight liability must be based upon the 'utter failure' to implement any reporting systems or controls, or the 'conscious failure' to monitor or oversee existing systems and controls. In addition to ensuring that reporting systems and controls are in place, to avoid liability directors should know corporate management and the 'tone at the top', know their fellow directors and ensure that there is a cooperative working group, document the steps taken to fulfil their fiduciary obligations, and utilise appropriate independent experts when problems arise.

What not to do

A case study in what **not** to do when a problem arises is the recent Hewlett-Packard debacle. Hewlett-Packard's board had a problem with leaks, apparently the result of lingering dissention over the corporation's future direction. When an internal inquiry undertaken by the former CEO failed to uncover the source of the leaks, the new CEO, Patricia Dunn, turned to outside investigators, who apparently used 'pretexting' (pretending to be various individuals) to obtain the phone records of board members and others, including journalists, in the hope of identifying the source. A board member, determined to be that source, was confronted by Dunn, but refused to resign. Instead, board member Thomas Perkins, outraged by the investigators' practices, resigned and contacted the Securities and Exchange Commission and the California Attorney General.

Hewlett-Packard's regular outside counsel investigated and advised that the methods used were 'not illegal'. The California Attorney General disagreed, and Dunn, the former general counsel, and others have been indicted. A civil case brought by the California Attorney General was recently settled by Hewlett-Packard for US$14.5 million. Seven lawsuits have also been filed against 10 board members and executives accusing them of wasting corporate funds and destroying Hewlett-Packard's reputation. The SEC is investigating Hewlett-Packard's failure to disclose corporate conflict as the basis for Perkins' resignation. The United States Attorney's Office, several federal agencies and the United States Congress, all have ongoing investigations.

Lessons learned

What went wrong at Hewlett-Packard? Former CEO Dunn has pleaded not guilty to the criminal charges, and has stated that she did not know the methods were illegal. And, she has offered no apologies. On the contrary, from her perspective, the leaks, arguably fiduciary breaches, had to be stopped. Clearly, the leaks represented a failure of the corporate governance structure. A board can only make effective decisions if provided with all pertinent information, which is often sensitive and may affect the corporation's reputation if disclosed. A board must work as a cohesive unit and freely discuss the information necessary to make decisions. If confidential information is being leaked, that vital trust is lost. Indeed, if a board member believes it is necessary to 'go public', then the leak is merely symptomatic of a greater problem. It is necessary, therefore, that procedures be adopted to prevent leaks and to contain damage if they occur. Every corporation should have **(1)** a code of ethics, including confidentiality provisions with specific consequences for their breach; **(2)** confidentiality agreements, signed by every board member, that include deterrents; and **(3)** clear policies and procedures for investigation of possible leaks.

Beyond these basics, dysfunctionality within the corporate hierarchy must be resolved firmly and quickly and cannot be allowed to fester. When problems arise, independent outside counsel (rather than the general counsel or regular outside counsel) should be hired immediately to conduct an investigation. Furthermore, in making corporate decisions, officers and directors should consider not just the law, but the policies and culture of the company. In this regard, Dunn's defence that the investigation was 'legal' may or may not prevail in court, but at the corporate level, a higher ethical standard, set down in a strong ethics policy, should have been employed. That ethical standard must be set by the top corporate executives, and directors should be attuned to the 'tone from the top'.

As a member of management or a board of directors of a business participating in a global economy, your actions will have consequences that may be unintended and unforeseen including exposure to foreign laws and regulations

The proper exercise of personal jurisdiction over a defendant is a threshold requirement in every court in the United States. Personal jurisdiction may extend to defendants who reside outside the United States. Officers and directors of foreign corporations may be subject to personal jurisdiction in United States courts under certain circumstances, even if they neither live nor work in the United States.

Personal jurisdiction extends to the limits of the Due Process Clause of the United States Constitution (*In re Royal Ahold*, 351 F Supp 2d 334, 349 (D Md 2004)). Under the due process analysis, a United States court may exercise personal jurisdiction over a foreign individual only if two conditions are met. First, the individual must have purposefully enjoyed the benefits and protections of the forum by having 'minimum contacts' with the United States. Second, the exercise of jurisdiction over that individual must comport with 'traditional notions of fair play and substantial justice' (*Id* at 349-50).

A foreign defendant has the requisite 'minimum contacts' with the United States if he either has engaged in 'systematic or continuous activities in the United States', or has purposefully directed his actions at the United States and the claim asserted against him arises from or is related to those actions. The former gives rise to 'general jurisdiction' and the latter creates 'specific jurisdiction' (*In re Royal Ahold*, 351 F Supp 2d at 350).

The distinction is critical because it determines the type of conduct for which a foreign defendant may be brought to court in the United States.

With general jurisdiction, a court may address any valid claim against that foreign defendant. In contrast, with specific jurisdiction, a court may determine only those claims that arise out of the foreign defendant's contacts with the forum.

Determining specific jurisdiction

In determining whether specific jurisdiction exists, courts typically apply a three-part test. First, the defendant must have purposefully availed himself of the forum's benefits by conducting activities in the forum state. Second, the claims must arise out of, or be related to, the activities in the forum state. Third, the forum's exercise of personal jurisdiction in the particular case must be 'constitutionally reasonable' (*Carefirst of Md Inc v Carefirst Pregnancy Ctrs* Inc 334 F 3d 390, 397 (4th Cir 2003)). In cases involving intentional torts, specific personal jurisdiction can arise from actions outside of the jurisdiction that are directed at, and have an effect within, the forum (see *Calder v Jones*, 465 US 783, 789-90 (1984); *Dole Food Co v Watts*, 303 F 3d 1104, 1111-12 (9th Cir 2002)).

The extension of personal jurisdiction over a foreign individual defendant must also satisfy traditional notions of fair play and substantial justice. Thus, courts balance: **(1)** the foreign defendant's burden from litigating in the forum; **(2)** the forum's interest in adjudicating the dispute; **(3)** the plaintiff's interest in obtaining convenient and effective relief; **(4)** the judicial system's interest in obtaining efficient resolution of controversies; and **(5)** the state's interests in furthering substantive social policies (see *World-Wide Volkswagen Corp v Woodson*, 444 US 286, 292 (1980)). The Supreme Court has recognised that 'unique burdens' are placed upon an individual required to defend himself in a foreign legal system, and has, therefore, cautioned courts to exercise additional 'care and reserve' before extending personal jurisdiction over foreign defendants (see *Asahi Metal Indus Co Ltd v Superior Ct of California*, 480 US 102, 114-15 (1987)).

As a member of management or a board of directors, you may not have absolute economic protection from the corporation against allegations of wrongdoing

Indemnification of an employee accused of wrongdoing arising from the scope of his employment is a well established concept of American

US

jurisprudence. Delaware provides a rather typical legislative archetype, permitting a corporation to advance legal costs and to indemnify employees accused of malfeasance. Delaware General Corporate Law (DGCL) s145 authorises a corporation to indemnify a corporate actor who incurs expenses, attorneys' fees, judgments, fines, or settlement costs stemming from actual or threatened civil or criminal litigation arising from the scope of employment. To be eligible for indemnification, the corporate actor must have proceeded in good faith, in a manner reasonably believed to be in the best interests of the corporation, and without reason to believe that the conduct in question was unlawful. Should a corporate director or officer successfully defend an action, either on the merits or otherwise, indemnification is mandatory. A corporation may choose to indemnify a corporate actor, irrespective of the outcome, if the individual acted in good faith and reasonably believed in the propriety of his or her conduct. Additionally, the statute explicitly authorises a corporation to advance litigation costs, provided the recipient undertakes to repay the advance should it ultimately be determined that indemnification is inappropriate.

D&O insurance – a crucial factor

Today, many corporations have enacted by-laws that adopt the substance of the indemnification and advancement procedures set forth in DGCL s145, or comparable statutes in other states. Those corporations usually indemnify their officers and directors to the fullest extent permitted by the law of their respective states of incorporation. Concomitantly, in the face of the increasing litigation costs and liabilities, Directors and Officers (D&O) insurance is now an economic necessity and a crucial factor in recruiting quality executives and directors. Coverage typically is provided under an Executive and Organisation Liability Insurance Policy that includes coverage for insured individuals (sometimes referred to as 'Side A' coverage), coverage for corporate indemnification of insured individuals (sometimes referred to as 'Side B' coverage), and coverage for claims asserted against the insured organisation (sometimes referred to as 'entity coverage' or 'Side C' coverage). Entity coverage, if offered, is often limited to securities claims. Some D&O policies include coverage for employment practices liability ('EPL Coverage') and ERISA claims ('fiduciary liability').

There is no standard D&O policy form, and insurance companies use policy forms that materially differ from one another. In addition, various coverage enhancements may be available by endorsement. Consequently, careful review of the policy form and coverage alternatives is crucial.

Among the more important D&O coverage terms and conditions to consider in reviewing policy forms are: severability provisions, which may prevent loss of coverage for insured persons based on the acts or knowledge of other insured persons; knowledge and conduct-based exclusions, such as fraud or dishonesty; exclusion for claims by one insured against another; provisions concerning 'presumptive indemnification', which may affect the application of policy retentions; and provisions regarding defence and settlement. Seemingly small differences in the wording of these provisions can make a big difference in coverage at the point of claim or settlement.

Additional coverage – the Thompson Memorandum

In addition to the traditional D&O policy, many companies purchase separate, stand-alone 'Side A' policies. These policies are designed solely to protect insured individuals, particularly officers and directors, through coverage that is non-rescindable by the insurance company. In addition, various forms of difference-in-conditions coverage are now available to provide gap-filling coverage if underlying D&O policies fail to respond due to insolvency, rescission or exclusionary provisions.

Although once a well-settled employment practice, access to indemnification and advancement is no longer a foregone conclusion. Several years ago, United States Deputy Attorney General Larry D Thompson, acting in response to well-publicised corporate scandals that characterised the early part of this decade, authored a memorandum entitled '*Principles of Federal Prosecution of Business Organisations*' (the 'Thompson Memorandum') that outlined factors the Department of Justice would consider when determining whether to indict a company.

One factor identified in the Thompson Memorandum was the voluntary payment of an employee's legal fees, which might be viewed as evidence that a company was protecting culpable employees and purposely inhibiting the government's investigation. Thus, to be seen as truly 'cooperating' and thereby avoid indictment, a company faced overt pressure to withhold advancement of litigation expenses from its employees.

In December 2006, in response to scathing criticism from the bar and bench, the Department of Justice issued 'new guidance' in a memorandum authored by Deputy Attorney General Paul J McNulty (the 'McNulty Memorandum'). Prosecutors may no longer consider a company's advancement of attorneys' fees to employees when making a charging decision with respect to the company except in 'extremely rare cases' when 'the totality of circumstances show that it was intended to impede a criminal investigation'. In those cases, approval from the Deputy Attorney General must be obtained.

Stein examined

Stifling an employee's ability to access legal fees is contrary to longstanding employment practices permitted in most states. Additionally, as suggested in several rulings in *United States v Stein*, 440 F Supp 2d 315 (SDNY 2006), such a condition impermissibly interferes with an employee's ability to defend himself when confronted with government accusations of malfeasance.

In *Stein*, KPMG, a Delaware partnership, was under investigation for alleged violations of the federal tax code. KPMG's counsel pledged to cooperate fully with the government's investigation. Having been informed by the government, citing the Thompson Memorandum, that payment of an employee's legal fees might weigh heavily in the government's indictment decision, KPMG disregarded its longstanding liberal advancement practices. Instead, it instituted a policy whereby an individual's legal expenses were paid only up to a predetermined maximum amount. Furthermore, such payments would immediately cease if the recipient declined to speak with investigators, invoked the Fifth Amendment privilege against self-incrimination, or was charged with criminal wrongdoing.

In ruling on the constitutionality of the government's concerted effort to curtail KPMG's established legal fees policy, the court concluded that the government's conduct (pressuring KPMG to condition and withhold legal fees) constituted a violation of the employees' due process right to fairness in the criminal process and the Sixth Amendment right to counsel. As the court explained, a criminal defendant has a right to obtain and utilise resources lawfully available, free from government interference, to defend against allegations of wrongdoing. The Thompson Memorandum's provisions concerning the payment of legal fees, coupled with the overt pressure exerted by federal prosecutors, effectively prevented individual KPMG employees from accessing the financial means needed to exercise their constitutional rights. The court observed that KPMG, besieged by the threat of an impending indictment, refused to pay the legal costs solely because 'the government held the proverbial gun to its head'. The court acknowledged that advancement of legal fees might evidence a company's unwillingness to cooperate, but it found it wholly impermissible for the government to prosecute a defendant while simultaneously seeking to influence the manner in which he defends himself.

In a related opinion, Judge Kaplan ruled that certain incriminating statements, made to government investigators by KPMG employees, were obtained in violation of the Fifth Amendment privilege against self-incrimination. Those statements were garnered only after KPMG, spurred by government compulsion, repeatedly threatened its employees with termination and severance of legal fees payments in the event that uninhibited cooperation was not given to government investigators. The court ruled that the statements should be suppressed because they were not voluntarily offered, but were, instead, the product of government coercion.

The amelioration of the Department of Justice's position on these issues in the McNulty Memorandum and the propositions advanced in *Stein* will lead more companies to advance legal fees for their employees. Although this may cause an increase in insured defence costs, it may also encourage highly-qualified people to accept high-level positions despite the increased responsibilities and potential liabilities.

Conclusion

Despite the expanding regulatory environment in the United States and the attendant increased perils of serving as an officer or director of a public corporation, legal protections and insurance exist to protect careful, diligent and honest executives and directors. Ultimately, however, proper corporate controls, board oversight, and enforced ethics and compliance policies will lessen the need to rely upon those protections.

BIOGRAPHICAL INFORMATION FOR CONTRIBUTING AUTHORS

Author profiles

Allen & Overy LLP

One Bishops Square, London
E1 6AO, United Kingdom
Tel +44 20 3088 0000
Fax +44 20 3088 0088
Web www.allenovery.com

Michael Brown
Co-head, Insurance Group
Michael Brown, co-head of Allen & Overy's Insurance Group since its establishment in 1995, has worked at the heart of the insurance industry for over 30 years. Prior to joining A&O in 1995, he was Group Legal Adviser for a major international insurance broker, and ran their risk management function.

Michael is one of the insurance industry's leading commercial law practitioners (see Legal Media Group *Guide to the world's leading insurance and reinsurance lawyers*). He and his colleagues at A&O advise leading international and UK companies on their insurance programmes and problem claims. Advice to banks on using insurance to mitigate risk and enhance credit, and to the insurance industry on capital access and regulation is a core part of the team's practice.

Michael has a particular reputation in the directors' liability sector, where he advises widely on director liability risks, indemnities and insurance protection.

Michael edits Butterworths *Insurance Law Handbook,* the leading publication of its type; and is a CEDR trained and qualified mediator.

Allens Arthur Robinson

49/F One Exchange Square,
8 Connaught Place, Central,
Hong Kong
Tel +85 2 2840 1202
Fax +85 2 2840 0686
Web www.aar.com.au

Simon McConnell
Partner
Simon is a partner in the firm of Allens Arthur Robinson. He leads its Asian Insurance and Reinsurance practice, based out of Hong Kong.
He was rated as one of the world's leading insurance and reinsurance lawyers (Hong Kong) by Legal Media Group's *Expert Guide* in March 2006.

Simon is admitted as a solicitor in Hong Kong, Victoria and Western Australia. He has significant expertise in insurance and reinsurance matters, particularly in professional indemnity, directors and officers claims, medical malpractice and financial lines claims. He has been involved in numerous substantial claims involving accountants, lawyers, directors and officers, and medical practitioners. He represents a number of international brokers, insurers and reinsurers.

Simon's experience extends across the Asian region including Hong Kong, China, Singapore, Malaysia, Korea, Vietnam, Thailand and Indonesia.

Mun Yeow
Senior Associate
Mun Yeow is a senior associate in the Hong Kong office of Allens Arthur Robinson. She specialises in insurance and reinsurance, with an emphasis upon the Chinese market. She acts for a number of significant PRC underwriters and brokers.

Mun is fluent in English, Mandarin and Cantonese. She is admitted in Hong Kong and England and Wales.

Level 28, Deutsche Bank Place,
Corner of Hunter & Phillip Streets,
Sydney NSW 2000, Australia
Tel +61 2 9230 4000
Fax +61 2 9230 5333

Oscar Shub
Partner
Oscar Shub is a partner in the firm of Allens Arthur Robinson and the head of its Insurance and Reinsurance practice. He was recently placed in the top six insurance and reinsurance lawyers worldwide by a Euromoney Legal Media Group research study and in the top 10 in the 'Best of the Best' research study.

He is admitted as a solicitor in New South Wales, Western Australia, South Australia, England and Wales and South Africa.

He represents a large number of Australian and international insurers and reinsurers as well as a number of Lloyd's syndicates. He has had extensive experience in the field of insurance and reinsurance, professional indemnity, directors' and officers' liability, engineering, construction, plant and machinery and product liability at a significant level and involving complex and large claims.

Angela Martin
Senior Associate
Angela Martin is a senior associate in the firm of Allens Arthur Robinson in the litigation practice with a particular focus on insolvency, including insurance insolvency. Angela was recently placed in the restructuring/insolvency category of Chambers UK 2006.

She is admitted as a solicitor in New South Wales and England and Wales.

Baker & McKenzie, S.C.

Edificio Scotiabank Inverlat,
Suite 12, Blvd. M. Ávila Camacho 1
Col. Lomas de Chapultepec 11009
México, D.F.
Tel +52 55 5279 2939
Fax +52 55 5279 2999
Web www.bakernet.com

María Casas López
National Partner
María Casas' practice areas include general banking and finance, securities, cross-border lending transactions, asset-backed securitisation, structured financing, project financing, insurance regulatory matters, as well as foreign investment regulations in Mexico, with expertise in the acquisition and establishment of subsidiaries and representative offices of foreign financial entities, and companies in various fields of economic activity, including financial institutions, banks, management retirement savings companies and insurance companies. Mrs Casas has expertise advising foreign and domestic banks and financial institutions on the restructuring of credit facilities and insolvency issues, legal audits of Mexican entities, mergers and acquisitions and general corporate work.

María Casas received her law degree from the Universidad Nacional Autónoma de México, and has been admitted to practise law throughout the Mexican Republic since 1990.

Mrs Casas undertook post-graduate studies at Georgetown University and the University of California, UC Davis Extension. She has been a member of the firm since 1990 and a partner since 1995.

Mrs Casas speaks Spanish and English fluently.

Bouckaert Ormen Passemard Sportes - BOPS

47 rue Dumont d'Urville,
75116 Paris, France
Tel + 33 1 70 37 39 00
Fax +33 1 70 37 39 01
Web www.bopslaw.com

Rémi Passemard
Avocat
Rémi began his legal career in January 1991, practising commercial litigation and international arbitration for three years. He then specialised in banking litigation and insolvency proceedings. He advised major clients, particularly as counsel for directors and officers in liability claims.

Rémi joined Christian Bouckaert and Pascal Ormen at Norton Rose in 1999 and became a partner in 2002.

He developed his expertise in the insurance and reinsurance areas, providing assistance in liability cases (professional indemnity, general liability, EPL, D&O liability, product liability, financial institutions), property, industrial risks including the energy market, reinsurance litigation and arbitration, claims inspection, life insurance & reinsurance, regulatory issues and policy wording.

Through his strong expertise in insolvency law, he also assisted major clients, insurers and re-insurers, in dealing with complex cases arising from insolvency proceedings of insurance companies.

Author profiles

Rémi is also involved in high profile banking litigation cases and often acts as counsel for banks and financial institutions (enforcement of securities, liability cases, private banking litigation etc) before the French courts.

Memberships: Amrae (French association of risk managers); French Association of Insurance and Reinsurance Lawyers (AJAR); Committee J (creditors' rights), Business Law Section, International Bar Association; British Insurance Law Association.

Clyde & Co

51 Eastcheap, London, EC3M 1JP, United Kingdom
Tel +44 20 7623 1244
Fax +44 20 7623 5724
Web www.clydeco.com

Elizabeth Leonhardt
Solicitor
Elizabeth qualified as a Brazilian lawyer in 1992 and practised as an in-house lawyer for two of the largest Brazilian trading companies. She joined Clyde & Co in 2000 and is now a senior solicitor in Clyde & Co's Latin American department. The department provides a full service to insurance clients with an interest in Latin America, including advice in relation to compliance and regulation, policy wordings and coverage, as well as conducting and assisting clients in all types of dispute resolution.

Through Clyde & Co, Elizabeth has gained extensive experience in insurance and reinsurance matters, both in relation to marine and non-marine policies. Elizabeth has been involved in some of the largest reinsurance industrial/energy losses in the London market. Given her Brazilian law qualification, Elizabeth has also developed an expertise in Brazilian insurance and reinsurance law and the Brazilian insurance market practice generally.

She is also a Trade and Energy lawyer, having been involved in cases for major oil & gas and commodity clients in disputes relating to commodities trading, power and gas projects and carbon credits.

Al.Franca 1050, Conj 44, 01422-001, Sao Paulo, Brazil
Tel +55 11 30820885
Fax +55 11 30830500

Richard Hawkins
Solicitor
Richard qualified as an English solicitor in 1997 and is based in São Paulo, where he represents Clyde & Co. He is fluent in Portuguese, and specialises in insurance and reinsurance, international arbitration and international trade matters.

Debevoise & Plimpton LLP

Tower 42, Old Broad Street, London EC2N 1HQ, United Kingdom
Tel +44 20 7786 9000
Fax +44 20 7588 4180
Web www.debevoise.com

Heidi A. Lawson
International Counsel
Heidi Lawson is international counsel in the firm's Corporate department with extensive experience in management and director liability and insurance issues, corporate governance, and regulatory and general insurance matters. Ms Lawson has over 20 years' experience in the insurance industry and risk management, including a six-month secondment to the Financial Services Authority in London and a number of years working in the insurance industry prior to practising law. Ms Lawson is a Chartered Property and Casualty Underwriter (CPCU) and is admitted to practise law in both New York and England.

Claire Graham
Associate
Claire Graham is an associate in the Corporate department. She advises a wide range of clients in various jurisdictions worldwide. Ms Graham is experienced in directors' liability and insurance issues, corporate governance, regulation and general non-contentious insurance matters. Ms Graham was formerly a Group Risks Underwriter for Canada Life UK Division and Munich Re (Life Branch)

for six years and is an Associate of the Chartered Insurance Institute and a Chartered Insurance Practitioner.

Gómez-Acebo & Pombo Abogados, S.L.

Castellana 216, 28046 Madrid, Spain
Tel +34 91 582 91 00
Fax +34 91 582 91 21
Web www.gomezacebo-pombo.com

Alejandro Plaza Ferrer
Associate Lawyer

Alejandro Plaza Ferrer advises clients in a wide array of matters and has expertise in mergers and acquisitions of national and international companies, from the wording of the preparatory offer documentation to the due diligence procedure, and negotiation and preparation of all contractual documentation. He is vice-secretary to the board and a founding member of Instituto de Consejeros-Administradores (IC-A), which represents the directors of the main Spanish companies.

Mr Plaza speaks Spanish and English fluently.

Matheson Ormsby Prentice

70 Sir John Rogerson's Quay, Dublin 2, Ireland
Tel +353 1 232 2000
Fax +353 1 232 3333
Web www.mop.ie

Sharon Daly
Partner

Sharon is a partner in the Commercial Litigation and Dispute Resolution department and co-chair, alongside Liam Flynn, of the Insurance Law Group. The Group provides a full service to insurance clients, advising on setting up insurance companies in Ireland, mergers & acquisitions, compliance and regulations, schemes of arrangement, policy wordings, coverage, advice and claims handling.

Sharon has extensive experience in financial lines policies including E&O, D&O and bankers' blanket bond policies.

Sharon and her group provide crisis management advice for clients dealing with investigations and enquiries from the Financial Regulator, the ODCE and the Gardaí. The group provides a risk management and risk assessment service.

She is also an intellectual property practitioner, mainly in the area of entertainment law. Sharon has extensive experience in copyright disputes and represents IMRO, MCPS and BSKYB and FIFA.

Sharon is a recommended practitioner by Euromoney's *Guide to the World's Leading Insurance & Reinsurance Lawyers 2006* and her group was ranked number one by the *Legal 500* in 2004 and 2005.

Naschitz, Brandes & Co

5 Tuval Street, Tel-Aviv 67897, Israel
Tel +972 3 623 5000
Fax +972 3 623 5005
Web www.nblaw.com

Yoav Daniel Razin
Partner

Yoav Razin is a partner located in the Tel-Aviv office of Naschitz Brandes. He specialises in corporate, securities and antitrust law. He regularly advises clients on multinational corporate transactions. In addition to advising private companies, Mr Razin represents some of Israel's largest government companies, and is currently involved in privatisation efforts relating to some of these companies. As an adjunct to his corporate practice, Mr Razin represents corporate clients in litigation, arbitration and alternative dispute resolution matters.

From 1992 to 1994, Mr Razin was a lecturer in Administrative Law at the Tel-Aviv University Ramot College of Law. During 1997 he was special counsel to the US law firm Fulbright & Jaworski LLP.

Mr Razin received an LL.B. degree from Tel-Aviv University in 1990 and was admitted to practise law in Israel in 1991.

Author profiles

Orrick, Herrington & Sutcliffe

**Via Visconti di Modrone, 12,
20122 Milan, Italy**
Tel +39 02 45 41 38 00
Fax +39 02 45 41 38 01
Web www.orrick.com

Diego Rigatti
Partner
Diego Rigatti, a partner in Orrick's Milan office, is a member of the Corporate and Intellectual Property Groups. Mr Rigatti has extensive experience in intellectual property, privacy and e-commerce services.

Mr Rigatti is a frequent lecturer in various congresses on intellectual property, e-commerce and related matters and he was selected as an external expert to review the reports issued during the U.E. START Program (a program on e-commerce development within European companies).

Before joining Orrick, Mr Rigatti was a member of Studio Legale e Tributario in Milan, a law firm associated with Ernst & Young International. He is admitted to the Italian Bar Association in Milan and has authored numerous publications.

Claudio Cucinotta
Associate
Claudio Cucinotta, an associate in Orrick's Milan office, is a member of the Corporate Group. Mr Cucinotta has experience in corporate law and international law.

Before joining Orrick, Mr Cucinotta was a member of KStudio Associato (KLegal) in Milan, a law firm associated with KPMG International. He also worked in the legal department of H3G Italia S.p.A. and cooperated as a consultant with the Italian Foreign Office and with 'Fondazione Ducci' in Rome.

Proskauer Rose LLP

**1585 Broadway, New York, NY
10036-8299, United States**
Tel +1 212 969 3000
Fax +1 212 969 2900
Web www.proskauer.com

Sarah S Gold
Partner
Sarah S Gold is a partner in the Litigation and Dispute Resolution department, and is co-chair of the Securities Litigation and Enforcement Practice Group.

Ms Gold has represented clients in numerous securities matters including defending class action and derivative lawsuits, and in internal, SEC and other regulatory, and federal criminal investigations. Ms Gold has also handled a wide variety of other civil and criminal matters, including various commercial litigations for large public companies.

Currently, Ms Gold is representing several underwriters in the IPO securities litigation, and clients in multiple options backdating cases, and in internal, regulatory, and criminal investigations.

Ms Gold served as an Assistant United States Attorney in the Criminal Division of the United States Attorney's Office for the Southern District of New York, including in the securities frauds unit, for six years prior to entering private practice.

Ms Gold received her law degree with honors in 1974 from Rutgers University School of Law, where she was Notes and Comments Editor of the Rutgers Law Review.

Seth B Schafler
Partner
Seth B Schafler is a partner in the Litigation and Dispute Resolution department, and is chair of the Insurance Practice Group.

Mr Schafler has extensive experience representing policyholders in coverage negotiations and disputes with their insurance companies, and litigating coverage issues in federal and state courts across the country. His experience covers a wide variety of insurance products including commercial general liability, directors' and officers', professional liability, errors and omissions, fiduciary liability, property, business interruption, and fidelity and marine and credit risk insurance, among others.

Mr Schafler represents the lessees of the World Trade Center in the litigation involving their insurance claims for property and business interruption resulting from the September 11, 2001 terrorist attacks.

Author profiles continued

He also represents two of Wall Street's leading investment banks regarding coverage and recovery issues related to high-profile settlement agreements made with the SEC, NY State's Attorney General and other entities.

Mr Schafler earned his BA from the University of Chicago and his JD, cum laude, from Benjamin N. Cardozo School of Law, where he served as Articles Editor of the Law Review. After graduating from law school, Mr Schafler served as a judicial clerk in the United States District Court for the Western District of Missouri.

Richard Spinogatti
Senior Counsel
Richard Spinogatti is a senior counsel in Proskauer Rose LLP's Litigation and Dispute Resolution department. Rich has more than 30 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, Rich 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. He has also consulted with clients on a wide variety of risk management issues.

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. He has particular expertise in litigating accounting and auditing issues in the context of securities class actions and governmental investigations.

Rich authors a monthly column on securities litigation and corporate governance in the New York Law Journal and is a frequent contributor to published articles relating to the securities laws, corporate governance and the accounting profession. Rich also lectures on commercial litigation, regulation of the accounting profession and securities law.

Shepstone & Wylie

35 Aliwal Street, Durban 4000, South Africa
Tel +2731 3020111
Fax +2731 3011185
Web www.wylie.co.za

Cabby Esat
Partner
Intikab Esat (aka Cabby Esat) is a senior commercial partner in the Corporate and Commercial Law department of Shepstone & Wylie, a leading South African law firm with offices in Durban, Johannesburg, Cape Town, Richards Bay, Pietermaritzburg and London.

Intikab holds a Masters degree from the University of Cape Town in commercial law (with distinction) and is a fully qualified attorney and legal practitioner in South Africa and Zimbabwe. His specialisations include company law, corporate structuring, mergers and acquisitions and issues surrounding directors and officers.

Intikab is a fellow of the Institute of Directors of Southern Africa and an associate member of the Association of Arbitrators (Southern Africa). He also heads up the firm's corporate structures and formations section and has over 22 years of legal experience.

Taylor Wessing

Isartorplatz 8, 80331 Munich, Germany
Tel +49 89 2 10 38 0
Fax +49 89 2 10 38 300
Web www.taylorwessing.com

Wolfgang Schaller
Partner
Wolfgang Schaller is a specialist in insurance and reinsurance law and he advises and represents well-known and internationally operating insurance and reinsurance companies. Disputes handled by Wolfgang include disputes relating to liability insurances (in particular to directors' and officers' liability, accident, disability and life insurances), disputes concerning profit loss indemnity insurances and reinsurance disputes. Wolfgang also advises on insurance policy wordings and on regulatory issues.

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). He joined Taylor Wessing as a partner in 2006.

Wolfgang has been regularly quoted by the *Legal 500* and *European Legal Experts* as an expert. A native German speaker, he is also fluent in English.

Dr Dirk Lorenz
Partner
Dirk advises clients on corporate and tax law issues. His main areas of work are the structuring of M&A-transactions and private equity and other funds.

Dirk studied law in Munich and Paris and took his doctor of laws degree in international commercial law with Prof. Bruno Simma. He holds a special degree in tax law. Dirk joined our office in Munich in 1999 and became a partner in 2003.

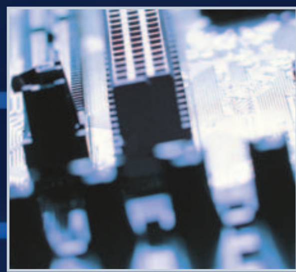
Dirk is a member of the International Fiscal Association and of the German Corporate Law Association. He is co-author of the manual *Mezzanine Finanzierungsinstrumente* (Erich Schmidt Verlag, 2004). A native German speaker, he is fluent in English and French.

Willis Limited

Web www.willis.com

Willis Limited is part of the Willis Group of companies and its ultimate parent company is Willis Group Holdings Limited. Willis is a leading global insurance broker, developing and delivering professional insurance, reinsurance, risk management, financial and human resource consulting and actuarial services to corporations, public entities and institutions around the world. Including our Associates, we have over 300 offices in some 100 countries, with a global team of approximately 16,000 employees serving clients in some 190 countries. Additional information on Willis may be found on its web site.

Willis is one of the world's leading risk management and insurance intermediaries, with over 15,000 professionals in over 300 offices around the world.



Winner of StrategicRISK magazine's European Commercial Broker of the Year 2006 for the second consecutive year.

Winner of Reactions magazine's Best and Most Innovative Insurance Broker of the Year 2006 for the second consecutive year.

Winner of Insurance Times' National Broker of the Year 2006 for the second consecutive year.

FINEX
Willis Limited
One Camomile Street
London EC3A 7LA
Tel: +44 (0)20 7488 8111
Email: D&O@willis.com

www.willis.com