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Willis

2011 Directors' liability survey

Directors in peril – insurance and indemnity in risky times

December 2011/January 2012

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Introduction

Directors and high-ranking officers in public and privately-held corporations face risks on an almost daily basis as they conduct business in an increasingly regulated and sophisticated business environment. In the wake of the credit crisis, public and shareholder scrutiny of corporate leaders has never been more intense. The combination of a proliferation of powers and growing interaction between, regulators globally means the spotlight is on directors and officers like never before.

It is here that directors' and officers' liability insurance (D&O insurance) and corporate indemnification step in. These allow companies to provide protection to their directors against the consequences of becoming embroiled in civil, regulatory or criminal actions and thereby free those individuals to make decisions with the comfort of adequate protection behind them.

Given the current heightened levels of concern amongst directors and officers about their exposures, in the autumn of 2011 Allen & Overy LLP and Willis ran a joint survey

of senior individuals at public and private companies asking their opinions of insurance and indemnification arrangements. We asked about their experiences of claims and investigations to date, and their worries for the future.

In the following pages we have detailed the findings of our survey and attempted to highlight in response some of the key issues that directors and officers should consider when assessing packages of D&O insurance and indemnification.

As part of our series on directors liability Allen & Overy and Willis will be hosting a breakfast seminar on **Tuesday 31 January 2012** at One Bishops Square to provide a more in-depth analysis based on the survey results and to discuss current perspectives; your concerns and your priorities. To attend the seminar RSVP to directorsliability@allenoverly.com. Additionally, should you require any further information on any of the issues raised within this report, please do not hesitate to contact either Andrew Barton, Allen & Overy, or Francis Kean, Willis.



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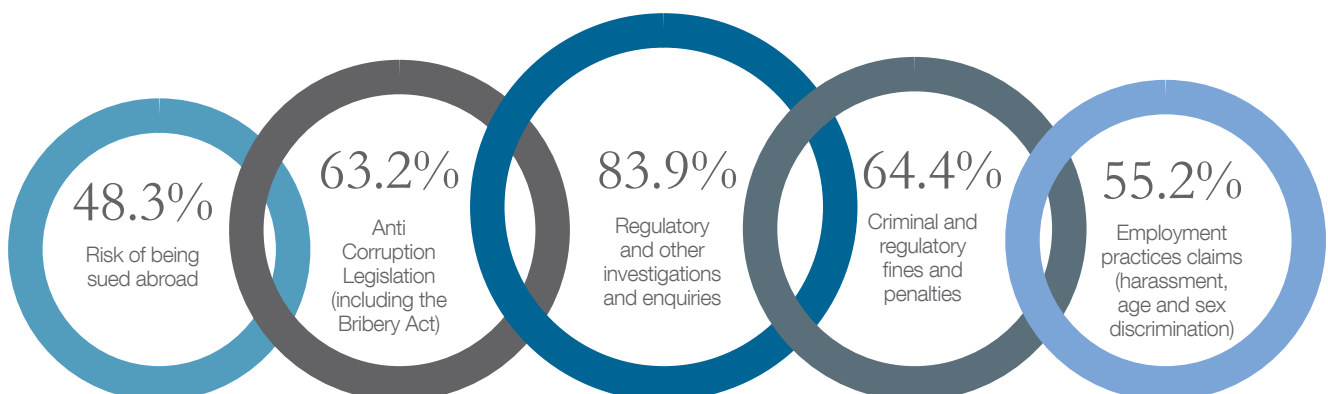
Executive summary

We surveyed more than 100 individuals, comprising directors, in-house lawyers, risk and compliance professionals, about their experience of claims, their current levels of protection and their concerns around risk going forward. Six out of every ten of our respondents worked in a public company and the vast majority were UK-based.

A number of key themes emerge from the statistics and analysis contained in this report:

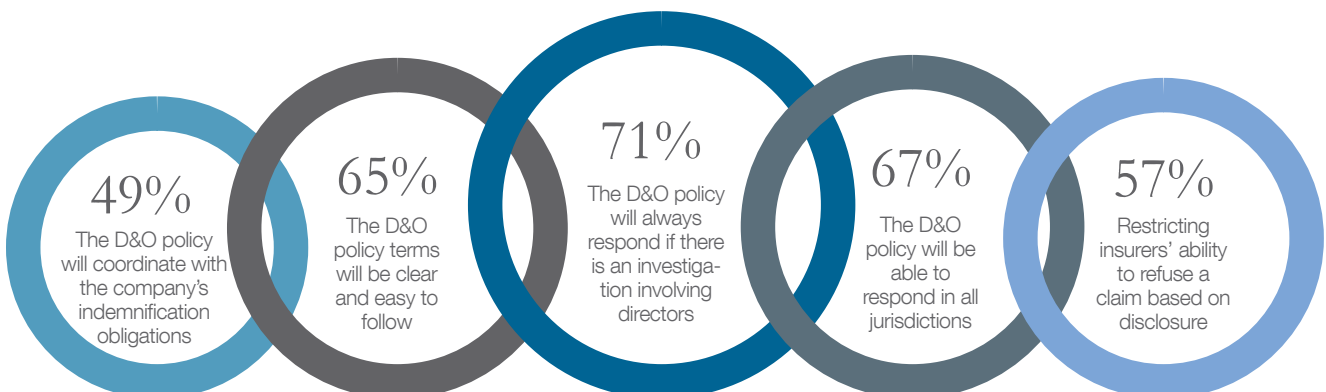
- Some **20% of respondents already had experience of a claim or investigation** involving a director of their company. This was perhaps surprising given the usual perception of the UK's relatively benign litigation environment.
- A third of those effected made a claim under their D&O insurance policy, and 35% sought indemnity from their company, suggesting **almost equal utilization of insurance and indemnity protection.**
- **Regulatory investigations and enquiries** were identified by 84% of our respondents as the risk that posed the greatest concern to their directors. Furthermore, 70% of those surveyed said that whether a D&O policy would always respond in the face of an investigation involving directors was their top concern with D&O policy coverage.
- **Criminal and regulatory fines and penalties** were the second biggest worry, identified by 64% of respondents as a significant risk to the business.

TOP FIVE RISKS POLLED IN THE SURVEY THAT RESPONDENTS CONSIDERED TO POSE THE GREATEST SIGNIFICANT RISK TO THEIR DIRECTORS AND OFFICERS



- Two-thirds of those surveyed called for **clear and easy-to-follow policy terms** when asked to name the most important aspects of D&O policies, while half said that **coordination of the D&O policy with the company's indemnification obligations** was a significant issue of policy coverage.
- Whether a D&O policy would be able to **respond to claims in all jurisdictions** was a worry for two-thirds of those surveyed, highlighting the increasingly international nature of both criminal and regulatory risk and the requisite insurance products.
- Our respondents showed little concern about coverage for **claims brought by the company against the directors**, despite the fact that duties are generally owed to the company, with the result that the company is most often the proper claimant in the case of a breach. This is a particular risk in insolvency situations where companies are taken over by liquidators and seek recourse from former board members. One of the most high-profile legal actions against directors and officers in the UK in recent times involved a claim by Equitable Life against its former directors, when the company pursued a GBP3.3 billion case alleging directors had failed in their duties.

TOP FIVE KEY D&O POLICY COVERAGE ISSUES POLLED IN THE SURVEY THAT RESPONDENTS CONSIDERED TO BE OF GREATEST IMPORTANCE TO THEIR BUSINESS



Preparing for regulatory investigations and enquiries

It is perhaps unsurprising that regulatory investigations and enquiries were identified as the risk that posed the greatest concern. From a director's point of view, there is a very real fear of being left without protection in the context of high-profile, expensive and time-consuming enquiries where they may urgently need advice and support.

84%

believe regulatory and other investigations and enquiries pose the greatest significant risk of director/officer liability

Evidence suggests regulatory investigations and enquiries are on the increase, and media coverage of scrutiny surrounding phone hacking cases, dawn raids conducted by the Financial Services Authority (FSA), and Office of Fair Trading (OFT) enquiries into price fixing, only serve to worry directors even more. Often these cases hinge on the evidence and culpability of senior individuals within the companies in question. Last year, for example, supermarket Safeway was given permission to bring a groundbreaking lawsuit against its former employees and directors to try and recover competition law fines from the individuals allegedly involved. The case followed an OFT investigation into collusion between shop chains and dairy companies in relation to retail prices for dairy products.

What's more, while the volume of cases continues to rise in the UK, there is a simultaneous ramping up of cross-border actions involving multiple regulators, sparked by the increasing cooperation between the UK's FSA and America's Securities and Exchange Commission, for example, and amongst European member states. This raises the very real spectre of investigations quickly escalating across several jurisdictions.

Should these situations arise, directors look to their companies for support, and yet their companies are not (unless specifically negotiated provisions are in place) obliged to indemnify them and, where they do, are unlikely to remove all risk. Crucially, investigations can often lead to a divergence of interests between the director and the company itself, at which point separate legal representation may become necessary.

What this means is that, especially in times of crisis, company directors would do well to consider whose lawyer they are seeking advice from and on whose behalf. Perhaps the safest assumption is that the company's lawyer is only ever there to advise the company and so, if necessary, independent legal advice should be considered. There may be a case for giving advance consideration to these issues as part of an emergency crisis response plan.

The question as to how any independent legal advice will be funded will also need to be addressed. Directors should establish in what circumstances the company will pay for it, and whether such costs would be met under the company's D&O insurance cover.

When it comes to D&O coverage for investigations and enquiries, it is worth being mindful of the policy small print, which will limit the insurer's exposure. For example, insurance often only applies with regard to investigations that are "formal and official", despite it often being possible to argue about both concepts. In truth, directors are frequently advised to engage with regulators and seek to resolve issues at an early, informal and unofficial stage.

Also, insurers will often foot the bill only where the director is the subject of a "requirement to attend", even though individuals may be better off speaking with investigators much sooner.

Therefore, if a company is under investigation and directors are worried about their personal exposure, while they may want to think about turning up at an investigation with their own lawyers early and voluntarily, getting insurance coverage to do so may not be easy. Directors may be right to be nervous.

But there is positive news. Good quality protection is possible and policies are available to cover most eventualities. Directors would be well advised to conduct regular reviews of their D&O policies and indemnification, and to understand how the two sets of protection fit together and interact on a practical level. An awareness of the depth and variety of coverage on offer, and the different approaches taken by different insurers, is the key to preparing properly for the prospect of regulatory investigations and enquiries.

Issues to consider

1_Who is my lawyer?

Directors should keep in mind the question of whose lawyer they are seeking advice from, and on whose behalf. It may be best to assume that the company's lawyer is only there to advise the company.

2_Who pays for my lawyer?

If an independent lawyer is needed, the question of who pays those legal costs will need to be addressed.

3_How good is my protection?

Regular legal reviews of D&O policies and indemnification, and interaction between the two, should be conducted.

4_What are my options?

Directors would be well advised to investigate the depth and variety of policies on offer, and make sure they get the best possible protection.

Spotlight on fines and penalties

When asked to consider the most significant risks faced by directors, nearly two-thirds of our respondents pointed to criminal and regulatory fines and penalties as a major concern.

64%

believe criminal and regulatory fines and penalties pose the greatest significant risk to directors and officers

Perhaps compounding this worry is the fact that these criminal and regulatory fines cannot be indemnified by UK companies on behalf of their directors and officers, because the Companies Act prohibits them from doing so. In addition, for reasons of public policy, insurance cover is not available to protect against them if the fines or penalties flow from a dishonest or intentional act by the insured.

Furthermore, while defence costs will usually be covered off by a D&O policy in the event of a negative judgment, if a director is found guilty in circumstances where defence costs were met under the company indemnity, the director will typically then have to repay those defence costs as well as paying any fines imposed.

This is particularly relevant in light of legislation, such as the UK Bribery Act, which allows for personal liability in the case of directors. The Act allows for the prosecution of individuals if, with their “consent or connivance”, a bribery offence was carried out by the company. So even if an individual isn't prosecuted for actually bribing or being bribed, he or she can nevertheless be punished.

Similar personal exposures exist in a variety of other legislations, with the Office of Fair Trading also making clear on various occasions that it sees sanctions against individuals as having a key role to play in encouraging compliance with competition law. The UK's Health and Safety Executive has similarly been seen as keen to pursue individuals where possible, and America's extra-territorial Foreign and Corrupt Practices Act allows for the prosecution of directors and officers where wrongdoing is found.

The position in relation to the insurability of fines remains an uncertain area and directors should ensure their cover is as broad as possible as it is not universally the case that fines and penalties cannot be covered. There is no public policy reason why an insured cannot claim under an insurance policy in respect of a fine where the fine is imposed against an individual through no fault of their own, for example in the case of a strict liability offence where there is no argument that the director is personally culpable. It is fair to say that the question of what fines and penalties can be insured remains a developing area of law and continues to attract legal argument.

Issues to consider

1_ Indemnity versus insurance?

Make sure that there is the correct level of interaction between your D&O insurance cover and your company indemnities, particularly in the area of repayment of defence costs in the event of a guilty verdict.

2_ What is covered?

Read the small print of policies to be clear on exclusions that apply in the case of fines and penalties.



D&O insurance meets company indemnities

As we have seen there are two types of protection available to directors: indemnities provided by the company and D&O insurance provided by an insurer.

50%

believe that coordination of D&O policy with the company's indemnification obligations is a significant issue of policy coverage

D&O insurance and company indemnities overlap, but they are not co-extensive and each have their advantages and limitations.

Where directors find themselves in need of support and are on good terms with their company, it is often easiest to turn to an indemnity, which will usually be simply drafted and easier to claim against than an insurance policy.

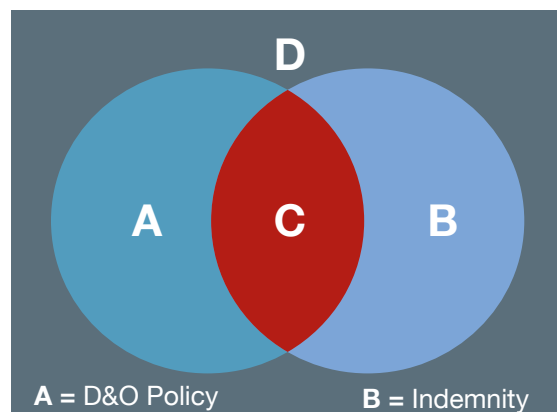
However, indemnities are more tightly regulated under the law in terms of what can be covered. Certainly, if the company is awarded damages against one of its directors or officers (which is not unlikely given directors' duties are owed *to* the company), there will be no option but to turn

to D&O insurance. This will have limits in place and necessarily requires dealing directly with an insurer, who may well be able to rely on exclusions and be looking to minimise its exposure, which can be challenging in times of stress.

Well-advised directors will therefore have both protections in place and will pay careful attention to the crossovers and interaction between the two. It is important, for example, to make sure that the repayment of any defence costs incurred in the event of an unsuccessful defence is picked up by a D&O policy, even if those costs are initially footed under the indemnity.

HOW D&O INSURANCE POLICY AND DIRECTOR INDEMNITY INTER-RELATE

The diagram below illustrates the way in which a typical D&O insurance policy and director indemnity inter-relate in terms of the scope of protection that each offers.



A_What only a D&O insurance policy can do for you

Only a D&O insurance policy, subject to its terms, can provide protection in the form of:

- defence costs cover (civil, regulatory and criminal proceedings), with no repayment risk in the event of the director being found to have acted wrongfully unless they are found to have acted dishonestly or fraudulently;
- cover for director/officer liability to the company or an associated company. The law precludes a company from providing a director with indemnity protection in respect of liability to the company itself, so a D&O insurance policy can provide a broader range of indemnity protection than a company indemnity can do;

- a source of indemnity protection that is independent of the company, thus removing the conflict problems that arise when the company is involved in the claim against the director; and
- a source of indemnity that is available even if the company has become insolvent (rendering any corporate indemnity valueless).

But a D&O insurance policy will be subject to policy exclusions and other coverage restrictions and an aggregate policy limit that does not appear in typical indemnity arrangements, and a D&O policy is subject to an annual renewal and renegotiation process.

B_What only an indemnity contract with the company can do for you

Only an indemnity agreement can, subject to its terms, provide protection in the form of:

- an uncapped indemnity;
- no policy exclusions (though most indemnities do include a number of conditions);
- no insurer payment refusal/default/insolvency risk; and

- a long-term indemnity assurance, which is not subject to annual renegotiation, and thus to the risk of change or cancellation.

But restrictions imposed by law on the scope of what is permitted by way of indemnification to a director mean that an indemnity contract for a director is likely to be more limited in its scope, and that defence costs are only available as incurred on the basis of a loan, which could potentially have to be repaid if the director's defence fails.

C_What both a D&O insurance policy and a company indemnity can do for you

Both a D&O insurance policy and a corporate indemnity have the ability to provide protection for directors and officers against:

- liability arising from civil proceedings brought against the individual by third parties (ie by parties other than the company or an associated company); and

- defence costs payments for which the director or officer is entitled to be indemnified eg by reason of his being exonerated from wrongdoing. However, in the case of a company indemnity to a director, unlike the D&O insurance protection, this protection is, in most cases, only available once the outcome of the proceedings is known and is dependent on a successful outcome.

D_What neither D&O insurance nor a company indemnity can do for you

Neither a D&O insurance policy nor a corporate indemnity will provide a director or officer with indemnity protection against:

- liability arising by reason of the director's dishonest, fraudulent or criminal conduct; or

- most criminal fines or regulatory penalties (please see page 6, 'Spotlight on fines and penalties').

Shaping international policies

It is perhaps inevitable that one of the principal concerns of those we surveyed about D&O insurance was a worry about whether their policy would be able to respond to claims in all jurisdictions.

67%

worry whether their D&O policy will be able to respond in all jurisdictions

Two-thirds of our respondents when they were asked about important issues for their insurance cover point to this issue as being one of the biggest challenges for both insurers and purchasers of D&O insurance. As companies become increasingly global and as international regulators turn their attentions across borders, getting worldwide coverage right has never been more crucial.

Sadly, however, it is not as simple as purchasing one D&O policy for the parent company and hoping that it provides global coverage for all the subsidiaries wherever they may be located. A UK-headquartered plc with operations around the world may purchase its D&O policy in London with insurers licensed in the UK, but find that this is no guarantee of international coverage since these insurers do not meet the requirements of an admitted insurance policy in the overseas jurisdictions where the subsidiaries are located. An admitted insurance policy is one that is issued by a licensed insurer in the country where the policy is purchased. A great number of countries have tough laws requiring risks in that country be covered by a policy issued by an insurer licensed in that country, and that includes D&O risks. In some countries, admitted insurance is mandatory and companies can face fines and taxes to stop insurance purchased outside that country from paying D&O claims that originate in that specific country.

So a UK-headquartered company with subsidiaries in Brazil, Italy and Russia, for example, could easily find that its global D&O policy purchased in London cannot pay out for D&O claims incurred in Russia and Brazil where admitted insurance is mandatory, although Italian claims would be covered because of Italy's membership of the European Union (Freedom of Services for EU countries).

The key point for purchasers of global policies is not to assume that buying a programme in London guarantees international coverage, and instead take great care to ensure the coverage can respond to the payment of legal costs and other obligations in all of the relevant jurisdictions.

Furthermore, it is important to make sure that the international D&O policy keeps up with a business's global expansion, and is regularly reviewed to guarantee relevant markets are covered. When a company enters a new jurisdiction, directors and officers should ask themselves whether they will be properly insured and/or indemnified in the event of a claim against them being brought in that country. And while this primarily applies to the directors and officers of the subsidiary overseas, it is often the case that a main board director will sit on the board of that foreign subsidiary, in which case it is necessary to make sure claims against the parent are also covered by the policies.

“A global D&O programme is fraught with many complexities in order to secure local legal compliance in a given jurisdiction.”

JULIAN P MARTIN, EXECUTIVE DIRECTOR, WILLIS

Issues to consider

1_ Is coverage international?

It is always necessary to take care that your global D&O policy can respond to D&O claims that arise from all of the jurisdictions where your business has operations.

2_ Does the local law where my subsidiaries are based require admitted insurance?

So that a D&O claim in that local jurisdiction can be paid legally by an admitted insurer.

3_ Keeping up-to-date?

As your business expands internationally, directors and officers should review insurance and indemnity coverage for each jurisdiction entered, and ensure that they are protected against any claims in that market.

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