Directors under scrutiny

D&O: It’s getting personal

A Survey conducted by Allen & Overy and Willis – April 2013
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Introduction

Directors and high-ranking officers in public and privately-held corporations are under scrutiny like never before as they conduct business in an increasingly regulated and complex global business environment. As regulatory authorities have responded to public and shareholder pressure in the wake of the credit crisis with more rules, heightened vigilance and tougher enforcement powers, corporate leaders find themselves exposed to even greater risks on a daily basis as they go about their roles.

With directors and officers currently so concerned about their exposures, at the start of 2013 Allen & Overy and the global insurance broker Willis ran a joint survey of senior individuals at public and private companies asking their opinions on the risks they face, and the insurance and indemnification options available to them. This is our second annual survey, and once again looks at respondents’ experiences of claims and investigations to date, and their worries for the future.

We received over 120 completed questionnaires, from a sample that included directors, non-executive directors, in-house lawyers, risk experts and compliance professionals. Approximately half of those we questioned worked for public companies, and half for private organisations.

In the pages that follow, we have detailed the findings of our survey and addressed in some detail the trends that our respondents appear to fear the most, namely heightened regulatory scrutiny, increasing personal exposure, and the pressure to change corporate cultures and respond adequately and appropriately when the authorities come knocking.

We have gone on to consider how directors should protect themselves in this climate of increased risk. Against the current backdrop, the importance of directors’ and officers’ (D&O) liability insurance, and corporate director indemnification, has moved up the agenda. These mechanisms allow businesses to offer their leaders a degree of protection and assistance should they find themselves embroiled in civil, regulatory or criminal actions, and thereby help allay the fears of board members so that they can focus on performing their key functions.

The purchase of D&O insurance by companies gives individuals a promise of funding for their defence if any such litigation should arise. What’s more, many companies now supplement this with the provision of an indemnity against liabilities that their directors may incur in the course of their duties.

Should you require any further information on any of the issues raised here, please do not hesitate to get in touch with your usual contact at Allen & Overy or Willis.

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Executive summary

It’s getting personal – our key findings

When conducting our survey, we interviewed more than 120 individuals, comprising directors, in-house lawyers, risk experts and compliance professionals, about their experience of claims, their current levels of protection, and their concerns around liability risk going forward. The vast majority were UK-based.

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

- More than one in four respondents to our survey had experience of a claim or investigation involving a director of their company.

- Mirroring the 2012 result, regulatory and other investigations and enquiries are considered to be the greatest risks facing businesses and their directors (with 88.6% of respondents indicating this as a key risk – up from 83.9% last year) followed by criminal and regulatory fines and penalties (69.1%, up from 64.4%).

- More than a third of respondents were unaware of the personal exposure of directors to antitrust enforcement.

- Similarly, three out of ten respondents did not realise that directors face personal exposure to sanctions penalties, and nearly four out of ten non-executive directors questioned were unaware of sanctions risks.

- When it comes to D&O policy coverage, directors are concerned that there should be clear and easy-to-follow policy terms; that the cost of advice at the early stages of an investigation should be covered; and D&O policies should coordinate with and complement their company’s indemnification obligations.
Top five risks polled in the survey that respondents considered to pose the greatest significant risk to their directors and officers

- 49.6% Risk of being sued abroad
- 57.7% Anti Corruption Legislation (including the Bribery Act)
- 88.6% Regulatory and other investigations and enquiries
- 69.1% Criminal and regulatory fines and penalties
- 51.2% Securities/shareholder claims

Top five key D&O policy coverage issues polled in the survey that respondents considered to be of greatest importance to their business

- 52.0% Will your D&O policy and/or company indemnification be able to respond to claims in all jurisdictions
- 56.1% Whether there is cover for cost of advice at the early stages of an investigation prior to the main hearing
- 64.2% Clear and easy to follow policy terms
- 59.3% How claims against the directors and officers will be controlled and settled
- 52.0% The coordination of the D&O policy with your company’s indemnification obligations
Today’s regulatory environment

In the last five years, in part as a result of public and shareholder pressure and in part in the wake of a number of high-profile instances of wrongdoing, regulators the world over have turned their attention to company directors and officers.

In many instances it is not the personal liabilities of directors that have changed, nor what constitute illegal acts, but rather the appetite of enforcement agencies to hold directors and officers accountable. Reprimanding senior executives is increasingly seen as the most effective means of changing behaviour and preventing criminal and civil offences going forward.

The trend of rigorous enforcement particularly holds true when it comes to international criminal acts, including crimes committed against antitrust legislation, against the UK Bribery Act or America’s Foreign and Corrupt Practices Act, or breaching international sanctions laws.

Our research shows that directors are alive to these concerns. And more than a quarter of our respondents have direct experience of claims or investigations involving directors of their companies.

In financial services in particular, the Financial Services Authority (FSA) moved last year to beef up personal liabilities when it asked banks and others to identify by name which senior executives were responsible for key regulatory or enforcement concerns, essentially those holding “significant influence functions” (SIFs).

Directors can find themselves liable for regulatory breaches; they might fall foul of civil lawsuits around their remuneration decisions; and they can be held responsible for notification failures. According to analysis by Nera Economic Consulting, the number of FSA fines against individuals rose by 45% from fiscal year 2008/9 to 2011/12. During that time, the number of fines against individuals for specifically failing to prevent misconduct increased from one in 2008/9 to four in 2011/12.

More detail about the personal liabilities of directors is outlined in the next section of this paper, but at the outset it is important to understand the political climate in which directors and officers now operate. Regulators have never been so keen to name and shame, fine, extradite and even imprison individuals whom they deem responsible for corporate crimes, and shareholders have never felt so empowered to challenge corporate decision-making through civil claims.
The climate for individual liabilities

The challenge for directors and non-executive directors in the face of growing personal liabilities is simply keeping abreast of the many activities performed by the increasingly multinational businesses they are charged with overseeing.

The pressures on their time are vast, not least for non-executives, who frequently spend as little as 30 days a year working in the business, and for the many directors who sit on the boards of four or five companies.

These directors tell us the information packs that they receive from the companies they run are either far too large, and make it difficult for board members to target the business-critical information, or that they tell directors far too little about the key issues.

Nevertheless, directors face sanctions that make them sit up and take notice, not least the threat of jail. Though probably the least likely outcome for corporate leaders, jail terms can be handed down for antitrust failings, insider trading, bribery and corruption, money laundering or sanctions violations. There is also the very real concern of regulatory fines and penalties. And these penalties can extend to being prohibited from sitting on boards in the future: the SIF regime now means that directors of banks that perform badly, though not necessarily personally liable, can find themselves excluded from directorships in regulated businesses going forward.

Then of course there is the growing threat of civil actions, and particularly shareholder class actions on both sides of the Atlantic.

We were particularly troubled to find that 35% of the directors we surveyed, and 31% of the non-executive directors, were not aware of their personal exposure to antitrust enforcement. For antitrust violations in the United States, the maximum jail term for executives is ten years, and there are instances where officers and directors have served four-year terms. These penalties apply equally to foreign nationals running companies with U.S. operations as they do to those businesses headquartered in the States, and antitrust authorities around the world are increasingly adopting similar approaches. There are now more than 120 regimes that pursue this conduct around the world, with around a dozen of those imposing criminal sanctions for breaches.

The number of antitrust cases being dealt with by the enforcement agencies has increased exponentially in recent years, not least because the incentives for reporting incidences of wrongdoing have increased, encouraging whistleblowers and pushing companies to approach the authorities when they are alerted to issues within their own organisations. This first-mover advantage can work to the detriment of directors, who may be implicated by the companies they work for when detailed investigations take place.
Worldwide, the result is record fines, with the U.S. Antitrust Division obtaining a record USD1.13bn in criminal fines in 2012, the highest amount in its history.

Sanctions are another threat overlooked by many of the respondents to our survey, with 31% of directors and 39% of non-executive directors unaware of their personal exposure to penalties should their companies fall foul of sanctions regimes. High profile countries currently subject to different sanctions regimes include Iran, Syria, Sudan, Zimbabwe and Cuba, but there are more than 20 regimes in place at the moment, including some in Egypt.

The penalties of a breach can be severe, exposing individuals to the real possibility of criminal prosecution and reputational harm. Here there is strict liability, meaning simply not knowing that something was illegal is not enough of a defence.
Changing corporate behaviour

Directors can no longer afford to hope for the best when it comes to regulatory best-practice, and must instead take the lead in instituting a culture of compliance across the organisations for which they are responsible.

It is increasingly important for directors and officers to work hard to set the compliance tone for the organisation from the top, by making it clear to employees what is expected of them, by setting an example and by ensuring that the messages are communicated across, and become part of, the company. The guidance published with the Bribery Act 2010 is just one example of express reference to the importance of “tone at the top”.

Business leaders need to design and implement systems and controls that are appropriate to their organisation, and regularly review and test those systems to ensure they are delivering results. At the same time, compliance requires a bottom-up approach, such that the system ensures that regular requests for information are made of all levels of the business, and frequent enquiries are initiated and followed up. Directors need to ensure that the information that they receive is both timely and appropriately prioritised, so that they know they have done their best to be on top of what is going on.

In today’s environment, directors and officers also need to look out for themselves, which means that if they have questions they must not only raise them, but also pursue answers, and record the fact that they have done so.

Directors need to be assertive with their colleagues across the business. If they find themselves dealing with topics with which they are not comfortable, they should seek external advice. There were countless examples of directors of financial institutions telling Congressional hearings in the US— that they didn’t understand the collateralised debt obligation products that their banks were trading, but ignorance is not an excuse that will find favour with regulators.

The key message is that devoting time, resources and effort to the compliance programme is the best guarantee of success, and that the companies that have successfully introduced effective cultures have done so only as a result of sustained commitment. Directors must take responsibility for introducing and maintaining a culture of compliance across their organisation, which means building the right structures; delivering regular training to employees, and particularly those in high-risk areas; setting up proper audit procedures that allow for deep-dive checks on a regular basis; and acting on discoveries in a timely and effective way.

And should the regulator come calling, and an investigation get underway, we recommend that directors and officers respond as openly and honestly as possible to enquiries and immediately consider taking independent advice where it is possible their personal position may put them at odds with the interests of the company. If a crime has been committed, a robust and efficient response by directors is most likely to ensure individuals emerge from the process with credit and their reputations intact.

“The key message is that devoting time, resources and effort to the compliance programme is the best guarantee of success”
What directors should be doing – a five-point plan

- Set the compliance tone from the top down
- Introduce and enforce appropriate systems and controls
- Conduct regular bottom-up enquiries and deep-dive audits
- Ask questions and record answers
- Seek external advice if dealing with a specialist topic you don’t understand
Protecting directors and officers

With directors and officers in the spotlight like never before, it is no surprise that D&O policy coverage and related company indemnities are likewise commanding attention.

We asked our survey respondents what they felt to be the most significant issues arising out of D&O, and a significant number – 64.2% – pointed to clear and easy-to-follow policy terms as a key concern. Next up came worries about how claims against directors and officers will be pursued and settled, and whether policies will cover the costs of advice at the early stages of an investigation, prior to any main hearing (and here we are talking about dawn raids, regulatory visits and notification obligations, for example).

One issue that did not appear to trouble our survey respondents, however, was the sharing and hence rapid depletion of an aggregate limit, which only 19% of those questioned identified as a worry. We fear this may be the result of a lack of appreciation of the issue: it is important to understand that many policies for amounts in the tens of millions of pounds which might appear large represent an aggregate sum covering all directors. Therefore, if there are either a number of claims against the board members or one claim against many individuals (or even in some situations the company), that limit can be quickly exhausted.

**D&O cover – issues for directors to consider**

01._ Is the policy truly “severable”, ie does it deliver personal protection irrespective of the conduct or knowledge of others?

02._ Is your coverage international, and are all the jurisdictions where your business operates included?

03._ Has your D&O policy (both as to terms and limits) kept up to date with expansion of the business and developments in the market?

04._ Neither D&O insurance nor company indemnity can protect you for liability arising from a director’s dishonest, fraudulent or criminal conduct, or criminal or regulatory penalties but be wary of blanket exclusions.

05._ Do you need your own lawyer to protect you if your interests diverge from those of the company?

06._ Under which law and how will disputes between you and insurers be addressed?
D&O insurers understand that investigations pre-date legal claims and, in many cases, do not lead to prosecutions or proceedings. The costs can nevertheless be substantial.

It is noteworthy that from insurers’ perspective, that investigations are treated entirely differently from civil and criminal claims. Most policies are really designed to deal with claims for legal liability, and the defence costs associated with responding to those claims. Investigations fall for different treatment.

Insurers will not cover all investigation costs believing it is not their job to pick up the routine costs of a company in the normal run of its business. What they will do is pick up investigation costs when it appears that there may be more serious issues on the horizon for directors, but this does little to calm director concerns that their policy will respond as soon as the regulator starts asking questions.

It is important to understand the point at which a D&O policy offers cover for individuals, which is typically the point at which a director is singled out by regulators.

This is a controversial area of D&O coverage, with some insurers covering only formal or official investigations, while others will cover requests for documents or interviews, but often only in the case of dawn raids or mandatory investigations that they deem to be non-routine.

Directors need also give consideration to the interests of the company on whose board they sit, and particularly whether the company dealing with an investigation will assume the burden of paying separately for them. Issues can arise where the interests of the company and individual directors diverge. The company’s lawyers may be willing to represent directors at the outset but this may change in the longer term. Where an actual or potential conflict of interest has arisen, a company may decide it cannot justify spending shareholder money protecting an individual.

Internal investigations are also often a source of concern for directors, as companies increasingly take the initiative and conduct their own enquiries, either on the recommendation of regulators or as a result of whistleblowers. These may be conducted by third parties, and may speak formally to individual directors and officers, again raising the question of who pays for independent legal representation if it is deemed necessary.
In addition to the D&O policies, the other main way in which directors and officers can obtain cover against the costs of legal representation is if their company chooses to indemnify them. There are legal restrictions governing what businesses are allowed to indemnify their directors and officers against, but indemnities covering the costs of legal representation at regulatory investigations are permissible. Where such indemnities exist, however, questions of who pays legal expenses may in practice arise in situations where directors find themselves adverse to the company. A well-advised director will want to see what is covered spelt out clearly so that the indemnity will provide an effective additional layer of protection to complement D&O insurance.
What only a D&O insurance policy can do for you

Only a D&O insurance policy can provide protection in the form of:

- defence costs cover (civil, regulatory and criminal proceedings), with no repayment risk.
- 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.
- 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 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.

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. Defence costs could potentially have to be repaid if the director’s defence fails.

What neither D&O insurance nor 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. (Some limited cover may be available under a D&O policy, but not a company indemnity)
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.

Under a D&O policy, where a judgement against a director or officer, whether criminal, civil or regulatory, is based on any finding of dishonesty, fines and penalties will not be recoverable.

If, however, directors have a fine imposed against them through no fault of their own, for instance in the case of a strict liability where there is no argument that they are personally dishonest, they may be entitled to cover under a D&O insurance policy, depending on its terms (sometimes they are simply excluded altogether). It is also fair to say that the question of what fines and penalties can be indemnified remains a developing area of law, and continues to attract legal argument.

69%
cited criminal and regulatory fines and penalties as a key concern
GLOBAL PRESENCE

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