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Urgent D&O Risk Management Initiative: Protecting Directors and Officers of Foreign Subsidiaries

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Given the increasingly global nature of business, many US public and private companies find it advantageous to incorporate subsidiaries in jurisdictions outside of the United States. It has long been accepted as conventional wisdom that the officers and directors of these foreign subsidiaries face little risk of personal liability and that, if a problem were to arise, the parent company's director and officer liability insurance policy would respond.

Conventional wisdom is, in this case, unreliable. The severity and frequency of lawsuits against directors and officers has been increasing in a number of jurisdictions around the world. At the same time, parent companies may find it unexpectedly challenging under local laws to advance legal fees and indemnify the officers and directors of their foreign subsidiaries. Furthermore, many foreign jurisdictions may no longer be willing to give legal effect to D&O policies written on a worldwide basis, unless the policy was originally put in place according to local rules. Defendant directors and officers may have tax penalties imposed on them personally and could, at worst, be denied the ability to access D&O insurance coverage altogether in jurisdictions where the parent corporation or the insurance carrier has failed to comply with local insurance rules.

To avoid these pitfalls, US-headquartered companies should take a knowledge based, data-driven, systematic approach to protecting the officers and directors of their foreign subsidiaries. This systematic approach ideally involves accurately scoping the potential risks and then working within

the laws of relevant foreign jurisdictions to protect local officers and directors.

WHY THE SUDDEN NEED TO ADDRESS THE EXPOSURE OF DIRECTORS AND OFFICERS OF FOREIGN SUBSIDIARIES?

There are three reasons why directors and officers of well-run US companies are now proactively addressing the personal liability risk faced by directors and officers of foreign subsidiaries:

1. The number of suits and regulatory actions against directors and officers in non-US jurisdictions—once thought to be trivially low in both frequency and severity—is on the rise;
2. Now faced with actual suits against directors and officers of foreign subsidiaries, companies have begun to realize that US-style indemnification does not always work in non-US jurisdictions; and
3. Regulatory activity with respect to insurance matters is on the rise in non-US jurisdictions.

Taking these issues in turn, first consider the frequency and severity of actions against directors and officers of US companies. The litigation framework, not to mention the plaintiffs' bar, is so mature in the US that comprehensive statistics on litigation activities against US directors and officers are published annually. The result of this level of scrutiny is that litigation occurrences and outcomes are highly predictable in the US.

Unfortunately, there are no similarly comprehensive studies of non-US D&O litigation. However, there is a considerable amount of anecdotal evidence that suggests that litigation rates against directors and officers are rising. The three

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types of litigation that are the biggest threat to directors and officers of foreign subsidiaries² of US companies, as illustrated by the examples below, are:

- **Tax violations.** In October 2007 Brazilian authorities raided the office of a subsidiary of a large US technology company and arrested a number of employees in connection with an alleged tax avoidance scheme.
- **Corruption charges.** Of the 500,000 bribery cases investigated in China over the last 10 years, 64 percent involved non-Chinese companies.
- **Supervisory liability.** The managing director of the Indian subsidiary of a large US technology company is being sued personally by the family of an employee who was murdered by a car service driver. According to public record, attempts to have this case dismissed have failed, notwithstanding the fact that the driver did not work directly for the subsidiary but was instead an employee of a service engaged by the subsidiary.

Other related areas of concern include suits and prosecutions related to consumer protection concerns, product quality failures, environmental negligence and labor practices.

Next, consider the rules concerning the advancement of legal fees and indemnification. US companies typically expect that they will be allowed to advance legal fees to, and indemnify fully, the directors and officers of their foreign subsidiaries, just as they would for the directors and officers of the US parent company. Companies that are well capitalized can afford to offer these sorts of expansive benefits to the directors and officers of their foreign subsidiaries, and typically will choose to offer these benefits directly instead of providing insurance.

Unfortunately for the directors and officers of foreign subsidiaries, many non-US regimes do not provide the comfort

² *The developing data that does exist concerning shareholder suits against directors and officers of non-US companies is not relevant to this paper's scope of inquiry, which is focused instead on risks faced by directors and officers of foreign subsidiaries of US companies. To the extent that these subsidiaries are one hundred percent owned by the US parent company—which is typically the case—shareholder suits are not a concern.*

of the well-tested protections enjoyed by US directors and officers when it comes to the advancement of legal fees and indemnification. To the contrary, in many non-US jurisdictions, officers and directors accused of wrong-doing may not be able legally to obtain the advancement of legal fees at all, no matter how willing and well-capitalized the parent company might be. This can be an unpleasant surprise, especially for the non-US director or officer who now finds him or herself having to pay the legal bills being accrued to defend him or herself. France, for example, is one such jurisdiction. And consider Russia, a jurisdiction where the law is silent on the concept of the advancement of legal fees, and the practice seems not to have been tested before a court of law.

The third reason that companies are now addressing the issue of protecting the directors and officers of their foreign subsidiaries is recent challenges to the belief in the reliability of the "world wide coverage" clauses in most D&O policies. Certainly a well-written D&O policy will state that it is written on a world-wide basis and that the US D&O policy is intended to cover all directors and officers of the foreign subsidiaries of the parent company. The problem, however, is that the mere stating of this intention in the US D&O insurance policy contract does not necessarily mean that the US policy is in compliance with the local laws of the specific foreign jurisdictions where the policy is intended to apply.

It comes as no surprise to US residents that insurance placed in the US for US companies must be done in a way that respects and complies with US rules and regulations concerning insurance. In the last few years, more and more foreign governments have become increasingly demanding and sophisticated in their oversight of insurance-related compliance in their own jurisdictions. This includes imposing rules that are specific to their jurisdictions. A driver for this increase in insurance regulation and the scrutiny of insurance is the revenue opportunity associated with premium taxes, i.e. taxes imposed on the premium paid for an insurance policy covering risk in the local jurisdiction. Companies that fail to adhere to these rules run the risk of not being able to access their D&O insurance when it is needed in these non-US jurisdictions. Insurers that fail to adhere to these rules run the risk of fines, penalties and/or the revocation of their corporate business license.

WHAT IS THE SOLUTION?

To address these issues, companies need to work with a D&O insurance broker who can bring to bear a systematic process to:

1. Scope the potential risk faced by directors and officers in non-US jurisdictions;
2. Calibrate the ability of a parent company in the US to support directors and officers facing prosecution; and
3. Identify the local requirements with respect to using insurance to protect local directors and officers.

Scoping the Potential Risk. As a first step to scoping the risk, a company must decide which countries to analyze. This is easier when a company has only a few subsidiaries; such a company will likely decide to analyze all the countries where the company has any exposure. More difficult are the decisions that have to be made for companies that have a large number of subsidiaries. Given the complexity of the analysis that the risk management department is proposing to undertake, these companies will likely choose a subset of subsidiaries when initially approaching the issue. Common elements for this decision making process include data such as total revenue, employee count, strategic importance to the parent company, and cultural norms for legal compliance in the local country in question.

This process may also result in refining a company's understanding of which persons at the foreign subsidiary will be treated as directors and officers, i.e. could be held liable for the management of the foreign subsidiary and responsible for the acts of others. The range of persons who may be treated in this way in some foreign jurisdictions can be far broader than in the US, where director and officer titles are normally controlling.

The next step is to gather available frequency and severity data with respect to the countries a company has decided to analyze. This is a difficult process as the data are not readily available outside of the US. To avoid having this part of the process devolve into little more than gossipy anecdotes, consider analyzing the potential exposures faced by directors and officers as driven by the legal framework of the country in question.

Calibrating the Ability to Support Local Directors and Officers. To the extent that a jurisdiction has a very similar advancement of legal fees/indemnification regime as the United States, the decision of whether to purchase

D&O insurance to support directors and officers of foreign subsidiaries will resemble the decision the parent company makes for itself. Many jurisdictions, however, have regimes that are far less officer and director-friendly than the US. In these jurisdictions, the availability of cash and the willingness of a parent to use this cash to support local directors and officers may not be relevant. It may well be the case that the only party legally permitted to advance legal fees is an insurance company (through its insurance policy). The right way to handle this issue is to conduct a legal analysis that considers on a country-by-country basis what is and is not allowed when it comes to advancing legal fees to and indemnifying local directors and officers. This is another area of tremendous complexity, and it is critical to work with experts in this particular field. Finding a local expert can be challenging. Very often a foreign subsidiary's local counsel may not have previously considered issues of advancement of legal fees and indemnification as those terms are used in the US.

The result of the country-by-country analysis described above will often be the realization that certain steps must be taken in order to accommodate local rules regarding the advancement of legal fees and indemnification. Be it through modifying local charter documents, the execution of one-off indemnification letters, or other processes, a plan should be developed to execute on these needed steps so that the parent company is able to execute on its desire to support its local directors and officers with the advancement of legal fees and indemnification.

Clarifying Local Insurance Requirements. Some companies will decide to place local D&O insurance only in jurisdictions where the parent company cannot reliably advance legal fees and indemnify. Others will take a broader approach in order to provide some protection to their balance sheet against the possibility of needing to make indemnification payments to directors and officers. In either case, a country-by-country analysis is required to ensure that D&O insurance will indeed respond when needed. The issues include answering questions like:

- Is a locally admitted insurance policy required (i.e. one deemed acceptable before-the-fact by local insurance regulators)?
- Is the use of a local broker required to place the insurance?

The penalties for ignoring these questions range from minimal to serious. For example, in Brazil, the consequence to a director or officer who receives money from an improperly placed insurance policy is punitively large tax penalties imposed on the monies received. Another possible consequence in other jurisdictions is the complete inability of a local director or officer to obtain money for his legal fees or for indemnification. There are even some jurisdictions, such as Malaysia, in which participating in the placement of illegal insurance can result in jail time. In other words, the stakes are high.

SYSTEMATIC, KNOWLEDGE DRIVEN APPROACH

In light of the globalization of US companies and the developing litigation risk in non-US jurisdictions, it is increasingly untenable to ignore international D&O insurance issues. The systematic approach outlined in this article, when coupled with a database³ of knowledge that bridges the disciplines of foreign law and insurance, will allow companies to analyze and address properly the issue of liability exposure for the directors and officers of their foreign subsidiaries.

³ Woodruff-Sawyer & Co.'s proprietary Foreign Exposure, Indemnification & Insurance (FEIITM) Database is considered among the most complete in the world.

Woodruff-Sawyer & Co. D&O liability insurance practice's whole-risk approach to mitigating the personal, unlimited liability faced by directors and officers of public and private companies is characterized by our dual focus on both insurance and corporate governance solutions. To learn more about how we provide Complete Solutions to Complex Risks™, please contact Woodruff-Sawyer & Co.

Questions? Comments? Your feedback and insights on the issues raised in this article are welcome and appreciated. Please send an email to Priya Cherian Huskins (phuskins@wsandco.com) or call 415.402.6527.