ROUNDTABLE

Risks facing directors and officers

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RISKS FACING DIRECTORS & OFFICERS

An ever-growing list of mandatory and non-mandatory rules is ramping up the risks faced by directors & officers. The general trend is toward raising the level of care expected of D&Os and expanding their existing duties. These higher standards increase the personal risks and liabilities for D&Os as they look to steer their organisations through the complexity of today's business challenges. As a consequence, at-risk senior executives are searching for more sophisticated D&O coverage.

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Snow: What factors are increasing the personal risks for D&Os in today's business world? In general, how are they responding to rising pressures?

Brunner: Corruption scandals, the financial crisis, large-scale cartel investigations, banks allegedly helping taxpayers to evade taxes – all of these have resulted in legislative action, rules set by courts, the enacting of new standards by private organisations as well as public attention. Such laws and private standards – which are treated as 'soft-law' – follow the tendency to introduce additional obligations, to broaden existing duties and to raise the level of care required from directors and officers (D&Os). Generally, the global focus on good corporate governance has led to more rigorous standards for D&Os, and an ever growing 'jungle' of mandatory and non-mandatory rules, on the national and international level, makes it increasingly difficult to manoeuvre and to keep a clear overview. All those factors expand the risk of claims against D&Os and require them, among other things, to look for more sophisticated D&O coverage.

Scott-Mackenzie: As Australian companies continue to seek new markets overseas, D&Os are not only faced with the jigsaw of Australian state and federal legislation, but also with foreign countries' legal requirements. For example, in some countries directors may be personally liable if a contract is not fulfilled, and we have seen extreme examples where a foreign court has imprisoned a director for the company not meeting its contractual obligations. We have seen an increasing focus on tackling foreign bribery and corruption in Australia. This is sparked, in part, by the criticism of Australia's enforcement and policing in the report by the OECD Working Group on Bribery in International Business Transactions in October 2012. Since this report, we have seen significant efforts made including the establishment of the Fraud and Anti-Corruption Centre between the Australian Federal Police and the Australian Securities & Investment Commission (ASIC) and a number of high profile investigations and prosecutions. Another such report issued in April this year identified that there was further work required by Australian authorities will likely see a further increase in enforcement efforts. This focus by Australian police and regulators mirrors the efforts that are being made by many of their global counterparts. Whilst the Australian business environment is generally perceived as lower risk for bribery and corruption, this is not necessarily the case in other jurisdictions in which Australian based corporations operate. This in turn has placed enormous pressure on such corporations' internal control environments to prevent foreign bribery and corruption, and there is anecdotal evidence to suggest that the internal control regimes of some companies have been unable to withstand this pressure. Many such organisations have been surprised by how difficult it can be to effectively police and manage the exposure to bribery and corruption, and how harsh the penalties are – not only to those that are involved, but the D&Os that the authorities believe should have detected and mitigated such a risk.

Goins: Increased regulatory scrutiny, a heightened focus by the US Securities & Exchange Commission (SEC) on enforcement of 'gatekeeper' duties, the increased globalisation of even smaller businesses, increased vulnerabilities to fraud, cyber risks, environmental issues, unanticipated vulnerability to geopolitical forces and other forms of business interruption, shareholder emphasis on short-term profits and increased outsourcing are some of the factors that put pressure on D&Os to meet higher standards and increase their personal risks. D&Os are responding to these pressures through increased attention to risk management, including the appointment of dedicated senior-level chief risk and chief compliance officers, better, interdisciplinary corporate planning for risk contingencies, and increased training on issues such as ethics, fraud and cyber risk for both directors and employees. Boards are also attempting to plug expertise gaps in the director mix through better succession planning and more focused talent searches, and are reviewing D&O liability coverage.

Activist investors, regulatory uncertainty, cyber insecurity and veritable mountains of compliance add pressure and unprecedented complexity to today's challenges.

ROB YELLEN

Godbey: In the US, the drop in oil prices which caused a downturn in the energy sector, coupled with slow growth in employment and consumer confidence, has sent some companies scrambling to avoid financial insolvency. Any threat of bankruptcy, debt restructuring, stock drops or financial restatements tends to increase risks for D&Os because investors have become much more aggressive about pursuing decision makers on the board, even when natural market fluctuations are responsible for the changes. Many D&Os, particularly independent directors, are demanding more comprehensive D&O insurance with larger policy limits, including Side A DIC and Independent Director Liability (IDL) coverage, to help mitigate this risk. Even the broadest indemnity agreement is virtually worthless if the company is unable or unwilling to reimburse the directors and officers, so good insurance is imperative.

Yellen: Keeping investors and other stakeholders happy in an environment with slow, or no, economic growth, cascading economic crises such as Greece and China, and intense pressure to live up to high expectations commonly reflected in near record share prices is no small task. Activist investors, regulatory uncertainty, cyber insecurity and veritable mountains of compliance add pressure and unprecedented complex- ▸▸

ity to today's challenges. For many of the risks they face, there is not much D&Os can do to avoid the suits. Stock drops – especially large drops – attract class action claims and today's relatively high valuations give stock prices more room to fall. Nearly 95 percent of US M&A transactions over $100m in 2014 with public targets experienced litigation while activist shareholders have never been more effective in pushing for change – leaving today's leaders caught in a classic Catch 22, finding themselves damned if they do or don't. Also, today's connectivity puts high-profile, highly-compensated directors and officers in the crosshairs of thieves and others who seek to profit from their private information, identity theft or personal brand.

Snow: What themes have underpinned recent claims filed against D&Os? What factors are driving these claims?

Godbey: The single most pervasive theme appears to be measuring the conduct of D&Os by an 'overall fairness' standard rather than strict adherence to corporate rules and regulations, which tend to exculpate D&Os. This trend in American law manifests itself in legal decisions that remove or reduce barriers to shareholder derivative actions, emasculate the business judgment rule, and shift the burden of establishing good faith and fairness from the claimant to D&Os. Although no one factor drives these decisions, some commentators postulate that D&Os should no longer be able to hide behind the opinions of their investment bankers or financial advisers, because these experts always declare a transaction 'fair'. After all, these experts have an incentive to close the transaction – they want to be paid.

Yellen: Residue from the 2008 financial crisis and a Main Street vs. Wall Street public sentiment have fuelled an unprecedented focus on business leaders' conduct and compensation. Fuelled, in part, by 'Fair Share' politics which pits 'haves' against the 'have nots', public outrage and mistrust of business leaders has never been higher. Disappointed, disenfranchised stakeholders lament sometimes tragic losses from fraud schemes laid bare during the crisis. Workforce rationalisation, a product of companies struggling to hit profitability targets in a slow-growth economy, has left many angry and frustrated over their disrupted lives and looking to blame the leaders forced to make tough calls.

Allegations of breach of directors' 'duty of oversight' have become the response to any and all negative events that may impact the company.

FRANCES FLORIANO GOINS

Goins: In the wake of enhanced pleading requirements for securities claims in US federal courts – such as the Private Securities Litigation Enforcement Act – the plaintiffs' bar is focusing on state law claims against directors and officers. Unfortunately, many state court judges do not have either the expertise or the experience to deal with complex issues of corporate governance. Allegations of breach of directors' 'duty of oversight' have become the response to any and all negative events that may impact the company – including not only the more traditional financial issues, but also data breaches, fraud and anti-bribery violations, and failure to comply with regulatory requirements. Factors such as the dependence of even smaller businesses on international trade and foreign markets and increased anti-corruption prosecutions not only domestically, but also in countries as diverse as the UK, China and Brazil, create fertile ground for follow-on litigation in the US.

Brunner: While earlier D&O claims largely focused on companies that had become insolvent and as a consequence were put into liquidation, we have seen a growing number of liability claims against directors where the company was far from being bankrupt and fully operational. One broader theme relates to shareholder disputes spilling over on the directors' level. In addition, some recent claims targeted intercompany loans that had been granted within the same group of companies, at favourable terms and without any security. One can discern from recent jurisprudence that corporate groups affected by financial distress must be careful when managing group liquidity on a consolidated level to avoid violating statutory laws in different jurisdictions applicable to the various group subsidiaries. A recent judgment of the Swiss Federal Supreme Court confirmed that cash-pooling schemes pose a considerable risk for D&Os in connection with capital protection rules, such as prohibition to repay stock capital and to grant hidden distributions to shareholders.

Scott-Mackenzie: We are seeing the last gasp of GFC related litigation. These include a number of Australian class actions that had been dormant up until recently. A number of these cases involve litigation against directors that may have retired from the board some years ago, only to be drawn back into the fray recently. We have also seen a significant increase in the number of newer entrant litigation funders, who are seeking class actions and other forms of litigation. Since IMF Bentham was listed in Australia in 2001, another dozen or so litigation funders have arrived. In addition, we have seen a number of attempts by law firms or their related entities to fund class actions. Where previously we were seeing it take many months for class actions lawyers and litigation funders to undertake due diligence on whether to pursue an action, we are now seeing a 'rush to file' as class action lawyers and funders want to be the first to lodge class actions. In many cases, this means that there are a number of Australian class actions and other claims against managers that are, in our opinion, poorly framed and that have been brought without sufficient understanding of how to run litigation.

Snow: How have the personal risks to D&Os changed over the past few years? What major new risks have emerged?

Goins: The major personal risk to D&Os is litigation itself, which has increased in severity over time. Even when terminated in its earliest stages, litigation causes personal reputational risk, expense, distraction and business disruption. In private civil litigation, the actual risk of a personal damage award against a director or officer has not changed significantly in recent years. However, to take full advantage of the business judgment rule, directors must be fully informed and act in good faith. Adequate indemnification and advancement provisions in corporate charters and bylaws and appropriate insurance coverage can also mitigate the degree of personal risk. In the wake of the Dodd-Frank Act and heightened attention by the SEC and other regulators to enforcement actions against individuals as corporate 'gatekeepers', regulatory penalties and criminal-side risks are increasing.

Scott-Mackenzie: The biggest emerging risk for directors is managing cyber and data related risks. Only a few years ago, cyber and data were seen as the domain of the IT team. Nowadays, most companies have recognised that data, including customer data, process maps or employee information, is one of their most valuable assets. With this insight, it is clear that the protection of this asset is important, and the loss of this data can be devastating to an organisation. Most boards have considered the impact of the mega data breaches in the US, such as the data breaches at Target and JP Morgan. However, many Australian directors continue to feel overwhelmed by the complexity required for an effective risk management framework for data protection and privacy. For example, is the ownership of a risk management strategy to protect employee data the domain of the HR or IT functions? The insurance industry has been quick to respond to the risks faced by directors arising from the loss of data and other cyber exposures. Specialised cyber insurance policies will provide a response team drawn from across the gamut of required professionals, including IT, accountants, public relations consultants and lawyers. In addition, the best such policies will meet the cost of business interruption as well as the defence and settlement of any regulatory or civil litigation against the directors and the company that may ensue.

Godbey: New personal risks for D&Os can be found in some unusual places. For example, several states, including California, Illinois, Michigan and Oklahoma, have enacted statutes that make D&Os individually liable for the payment of sales, use, franchise and other business taxes if the company does not or cannot pay. In addition to paying the taxes, the states threaten liens on property and garnishment actions. Receipt of this type of tax notice can be terrifying because the amounts are huge, the company may be insolvent and unable to provide indemnification, and most D&O policies exclude taxes from the definition of 'loss'. A few D&O insurers now offer some coverage for tax liability in the event of insolvency, so prudent directors and officers should insist on this coverage. There are good defences to these tax actions, but coverage for defence costs to avoid this personal liability is essential.

Generally, we expect proceedings to become more and more complex and entail significant defence and procedural costs.

HANS-ULRICH BRUNNER

Yellen: The biggest, most impactful change has to be in the rise of US derivative claims. Once largely seen as throwaway claims, derivative settlements have reached new multi-hundred million dollar heights. With massive, non-indemnifiable loss a real threat, derivative claim exposure could be materially personal, if not insured. How bad is that risk now? Consider the top five derivative settlements: $275m for Activision Blizzard in 2014, $139m for News Corp. in 2013, $137.5m for Freeport-McMoRan in 2015, $122m for Oracle in 2005 and $118m for Broadcom Corp. in 2009. Not all of those settlements were fully funded by D&Os, or their insurers, but those amounts do set the bar for plaintiffs' expectations. Also, nothing is secret or sacred any longer. Social media has empowered anyone with a gripe to make a public spectacle of virtually any slight, real or perceived. Connectivity and cyber insecurity not only empowers crooks, competitors and others to steal personal information, money, intellectual property and other secrets, but hackers can interrupt service, hijack business process and cause real damage, too. Unlike litigation loss, reputation damage can be profound and immediate – with consequences exponentially worse.

Brunner: The regulatory environment has changed dramatically in recent years. Also, public opinion has changed significantly with respect to compliance issues and it has even led some politicians to express the opinion that managers should be held accountable for a company's bankruptcy. Moreover, recent actions have seen some banks – not only Swiss banks – forced to admit wrongdoing to achieve non-prosecution agreements or deferred prosecution agreements. These actions will no doubt have an impact on personal risks incurred by D&Os. Generally, we expect proceedings to become more and more complex and entail significant defence and procedural costs. These proceedings include not only civil and criminal litigation, but also defences in a variety of administrative proceedings, such as proceedings led by the Swiss Financial Market Supervisory Authority or by the Swiss Competition Commis- ▸▸

sion. Even in cases that appear relatively small, significant procedural and defence costs must be borne, in addition to a potential fine, by the company.

Snow: Have you observed any legal and regulatory changes that could have a significant impact on personal risks to D&Os?

Yellen: It seems like legal and regulatory change is the new constant. In the US, the Dodd-Frank Act mandated rulemaking that is far from over. While the UK and EU are also working to reinforce initiatives to reform and strengthen pan-European financial markets. Changes in enforcement, however, are more relevant game changers. In the post-2008 financial crisis world, global enforcement threats have reached new heights as the SEC and others seek to prove, in the face of continuing criticism, that they can effectively regulate and enforce. Armed with new, data sniffing, digital bloodhounds and a relatively new array of tools to foster 'cooperation', the SEC, for example, has continued to seek new ways to maximise the enforcement value of its resources. Enforcement activities have increased in the UK, Canada and the EU. Even innocent directors and officers are exposed to the cost and distraction of this new-age enforcement, and innocents can be punished too with the threat of compensation claw backs potentially leaving them punished for the mistakes of others.

Brunner: Recently, the Swiss Federal Supreme Court clarified its understanding of the business judgment rule and it has now become a general rule for the lower courts when examining ex-post D&O decisions. Accordingly, the courts must be careful in judging D&O decisions which later turned out to be wrong if these were taken in an impeccable decision-making process with appropriate information and free of any conflicts of interests. The most fundamental rule for D&Os is that they must seek out and utilise all reasonably available information, avoid any conflicts of interest and ensure their procedures follow current best practices. On the latter point, for example, a person who knows of the necessity of a decision by the board of directors but fails to call for a meeting of the board of directors allows for an improper decision making process and thus risks not benefitting from the Swiss version of the business judgment rule.

D&Os would be well-advised to make sure admissions are removed from the final adjudication language to preserve their D&O coverage.

BEVERLY BELL GODBEY

Goins: Federal regulation has appropriated governance roles that were once the exclusive provenance of state law. The SEC's recent aggressive enforcement plan produced a record number of actions in 2014, and the trend continues to seek disgorgement and penalties from individuals. Other regulators are likewise emphasising individual accountability as an enforcement tool. The SEC has pursued a policy of restricting 'neither admit nor deny' language in consent decrees, thus causing many defendants who would likely have settled to hold out for trial. Defence costs are predicted to remain at higher levels or increase. On the other hand, some states, particularly Delaware, have authorised corporate bylaws that can shield D&Os in litigation, including through forum selection or some form of fee-shifting. Case law has also developed favourably in a number of areas. For instance, some states now require, and most allow, advancement of defence costs to D&Os in appropriate situations.

Godbey: The SEC has announced that it intends to eschew its 'no admit or deny' policy for settling enforcement actions, and instead encourage individual D&Os to admit liability and publicly accept responsibility for their actions. In addition to the negative collateral consequences for those individuals in the enforcement action, an admission of liability can lead to a loss of D&O coverage. Most D&O policies have personal conduct exclusions which preclude coverage for fraud, criminal acts and intentional wrongdoing, among other things. As an enhancement to coverage, many D&O insurers append 'final adjudication' language to the exclusion, which means that it doesn't apply until there has been a final adjudication of the wrongful personal conduct. In some policies, 'final adjudication' includes an admission. D&Os would be well-advised to make sure admissions are removed from the final adjudication language to preserve their D&O coverage.

Scott-Mackenzie: We are seeing a significant increase in the number of Royal Commission and Senate Inquiries calling upon directors to provide evidence. These are particularly personal and difficult for directors. The terms of these inquiries will often allow evidence to be led that may not otherwise be admissible in other litigation, and handling these inquiries requires particularly adept legal advice and litigation management. Unfortunately, some directors are finding that it can be more difficult to have their D&O insurer fully engaged in these matters. Part of the issue is that some D&O insurers will pay for and mount an effective defence to ameliorate the threat of a significant fine or damages, but may not be inclined to pay for top tier defence lawyers when the immediate risk to the director in an inquiry is the cost of the directors being criticised. For those directors involved in such inquiries, they are often having to deal with not only the scrutiny of the Inquiry, but dealing with a less sophisticated insurer that has not got the experience of assisting directors during these matters.

Snow: In your opinion, what more could D&Os be doing to manage potential risks and liabilities that threaten

both their company's value and their own reputation? Are D&Os as aware of the risks they face as they should be?

Scott-Mackenzie: Many directors continue to join boards without necessarily undertaking the requisite due diligence. Prospective directors need to recognise that, whilst there may be prestige associated with taking a board position, it should inherently be a 'two way' street. Not only should the company be comfortable with the director, but the director must be comfortable with the company after due enquiry. As an extension, I advocate that such due diligence should be an ongoing process. Directors should take time each year to review what the corporate foundations were that they initially drew comfort from to join the board, and whether those foundations are still present. We have had occasion where a director drew comfort because there was a particularly strong executive team with a focus on a structured risk management framework. However, when there were changes in that team, the directors did not necessarily reflect on whether that should occasion a change to their continued directorship. If a director's view is that they would not join the board at this time, then this should be a 'red flag' that either they should be working for change, or, in the absence of change, consider resigning their directorship.

Directors should take time each year to review what the corporate foundations were that they initially drew comfort from to join the board, and whether those foundations are still present.

JEREMY SCOTT-MACKENZIE

Brunner: There is not a single, unified appropriate risk management system. Each company faces its own particular risks, whether operating internationally or domestically, or depending on the regulatory environment that applies to its particular business. Hence, a permanent objective is to ensure that D&Os are not only aware of their legal obligations under company law, but also under any other regulations that might apply. Abiding by a certain formalism and the simple, but basic requirements for applying the business judgment rule is actually an important starting point. In addition, proper records should be maintained to avoid potential evidentiary difficulties in the event a dispute arises. Last but not least, internal processes should be reviewed periodically and amended if necessary to reflect the current regulatory environment. Also, as D&Os may become personally liable for taxes and social security contributions, they have a self-interest to know the risks as well as also regularly supervise and actively avoid such debts remaining unpaid.

Yellen: In addition to the basics of staying informed, setting the tone at the top and seeking independent advice, savvy D&Os buy D&O liability insurance and they make sure their 'Side-A' coverage will respond when there is a failure or refusal to advance or indemnify loss. D&O coverage really pays, and it may be the only buffer between a robust litigation industry and personal assets. D&Os should also make sure their coverage is up to date. D&O insurance quality and features vary, and with a competitive market driving innovation, your D&O policy may not be keeping up with new opportunities to transfer today's new or heightened risks. New features, like enhanced investigation coverage, express advancement, reputation protection and claims cooperation severability are essential in today's heightened enforcement world. Also, D&Os should make sure to share their troubles, directly or via their company's risk manager, with their broker and legal advisers who can help assess the situation and how insurance may factor in. To illustrate, with activist investors demanding reform now more than ever, a broker can help you assess whether D&O insurance may respond, and, perhaps more importantly, whether a demand for reform may trigger a policy's duties to notify provisions. For most D&O insurance, a mere written demand for monetary or non-monetary relief will likely trigger that duty and potentially trigger coverage, too.

Godbey: Recent opinions from the Delaware Chancery Court shed light on actions D&Os should take to avoid potential risks and liabilities. In one case, minority shareholders sued to challenge a recapitalisation by majority shareholders and investors. Although the court ultimately found that the recapitalisation was fair, it found a breach of fiduciary duty because the 'process' was not fair. The court criticised the board for failing to hire an independent financial adviser, relying on a 'back of the envelope' company valuation, and failing to consult with the one independent director for advice and input. In another case, the court criticised the board for approving credit agreements entitling lenders to accelerate the debt in the event of a change of control. This action can be a breach of fiduciary duty when a proxy fight is foreseeable. D&Os should evaluate the process for transactions, demand transparency and stop rubber-stamping.

Goins: D&Os are generally aware of the need for broad-based enterprise risk management. In recent surveys, directors mentioned cyber security, for instance, as among their top concerns. Most large public companies are at least considering appropriate programs to manage risks, but smaller entities may not view such risks as vendor management or international fraud enforcement as significant enough to justify the investment of time and corporate resources necessary to identify and manage them, although issues such as these can create devastating corporate losses. Directors may not simply abdicate risk management because they deem the problem to be beyond the resources of the entity. Traditional lower-level risk management departments are not generally equipped to assess the cost-to-benefit impact of current risks. Effective risk management requires an interdisciplinary approach, drawing on ▸▸

the collective expertise of the enterprise to identify, quantify and control risk. Education, advance planning, oversight and tracking are crucial.

Snow: With mergers and acquisitions presenting a wide array of potential pitfalls, what advice can you give to D&Os undertaking M&A in terms of protecting themselves from the personal liabilities associated with a transaction?

Godbey: By far, conflicts of interest remain the predominant risk factor in M&A transactions. In many cases, the courts focus on whether the director or officer has or will obtain a benefit from the transaction – even a subtle benefit. For example, directors who also serve as investors or consultants to the company need to evaluate the potential for a conflict between the two entities. Similarly, directors who may receive bonuses or compensation in the event of a change of control face increased risk of a conflict. Even current officers or directors who want to serve on the board of the new entity may have a conflict in supporting the transaction. Use of special committees of independent directors to objectively evaluate the transaction can help reduce the risk of a conflict, as can a vote of the minority shareholders if there is a potential conflict between majority and minority interests.

Scott-Mackenzie: Many directors, and their advisers, continue to get caught in the hype of the deal and fail to consider not only the risk to the business, but the personal risk. The personal risk directors' face in M&A transactions continues to grow. Of late, plaintiffs are naming directors and officers in civil litigation as a tactic to press for early settlement. In essence, the directors face the spectre of personal litigation if the company does not settle. Often, the pleading against the D&Os will use the Australian Competition and Consumer Act 2010 (Cth) as an alternate pleading to draw in the individuals, and may also be used to bypass contractual limits that are in place from the sale and purchase agreement.

Yellen: M&A is a critical insurance juncture. In addition to risks from that transaction, there are also risks that the transaction will result in coverage traps, like gaps in coverage for future claims that may relate to both pre-close and post-close acts, errors or omissions. Most M&A objection litigation is addressed before the deal becomes effective through adjustments to consideration and deal terms. Typically, the costs of those adjustments, while not covered under D&O insurance, would be borne by the acquiring entity rather than personally by directors or officers. However, if those claims are not resolved before the deal closes or if the deal fails, personal risks increase substantially as the character of loss potentially shifts from mere additional consideration to potential damages for breach of fiduciary duty by the directors.

Goins: Recent reports say 94 to 97 percent of M&A transactions generate shareholder lawsuits. This is more than twice the number calculated in 2005. While most suits are resolved prior to the deal closing and some are withdrawn or dismissed, such claims remain an issue for D&Os. The Delaware Supreme Court recently upheld exculpatory charter provisions that eliminate an outside director's personal liability to shareholders for monetary damages for breach of fiduciary duty where the director has acted in good faith and is not conflicted. That opinion, *In re Cornerstone Therapeutics, Inc.*, may have broader application in other contexts to protect at least independent directors by requiring individualised allegations of non-exculpated misconduct to survive a director's motion to dismiss. Most state corporate laws also protect directors who reasonably rely on good faith on reports of corporate management or certain outside experts.

Brunner: We have not yet seen – and would not expect to see – a flood of US style M&A litigation of disgruntled shareholders of a company in Switzerland, that either has been or is about to be acquired, based on the allegation that the board of directors breached its fiduciary duties by conducting a sales process that did not maximise shareholder value. Accordingly, our advice would be simple: do whatever is necessary to obtain the protection of the business judgment rule. In the M&A context, this means, for example, undertaking thorough and proper due diligence, using independent external advice and, eventually, fairness opinions, to obtain all information necessary to understand what risks are associated with the transaction and the pricing, then act accordingly to minimise such risks. With regard to D&O insurance, the acquirer should ensure that there is coverage for the kind of deal contemplated, and from the perspective of the acquired, the D&O should be aware that coverage might expire upon completion of the transaction.

Snow: What has been the impact of increased regulations, penalties and settlement figures on the costs associated with defending claims filed against D&Os?

Scott-Mackenzie: The cost of settlements in securities actions continue to skyrocket, with the high water mark in Australia of the Centro securities class action a few years ago. Whilst the increasing costs of settlements and increased regulation makes headlines, some directors are surprised at the cost of defending such proceedings, and that, even if successful, these costs are seldom fully recoverable. In many cases, we are seeing the legal defence costs of complex D&O litigation exceeding $10m, and on occasion in excess of $25m. Quite simply, without the benefit of D&O insurance, many directors would not get their day in court. Given the rising cost and complexity of D&O litigation, the need for both capable legal expertise and an experienced claims manager is needed now more than ever.

Goins: The cost associated with defending claims against D&Os have been spiralling upward steadily over the last few years. Although many observers believe the raw number of suits filed has declined of late, their severity is at record levels, and there have been more jumbo settlements across the board, with fewer cases disposed of through initial motion practice. State courts, where much of the recent activity has occurred, are particularly reluctant to grant early dismissals without a factual record. When an initial motion fails and litigation enters the discovery phase, costs skyrocket. Increased regulation in industries such as financial services and healthcare also drives up costs, since the revelation of a regulatory investigation usually triggers tag-along shareholder litigation. Regulatory enforcement actions and attendant penalties only exacerbate the problem.

Yellen: Naturally when more is at stake, settlement values increase, and defence costs are likely to be higher, too. No matter how well written new rules or regulations may be, uncertainty ▸▸

over how they should be interpreted is likely to result in litigation. Some of the more controversial rules, like the US Department of Labor's proposed 'Definition of the Term Fiduciary: Conflict of Interest Rule-Retirement Investment Advice' rule, faces scathing criticism by financial industry opponents who assail its complexity and lack of clarity, and warn that it could inspire a wave of litigation and enormous compliance challenges. In addition, as regulations grow, so can the frequency of enforcement – sometimes overlapping enforcement within or across jurisdictions. With global enforcement authorities cooperating like never before, the potential for significant, multi-front defence has increased. As a result, defence cost burn rates and total spends can increase exponentially as with the need for local lawyers driving much higher burn rates and inflating the overall defence spend.

Brunner: Every new regulation creates a further potential claim that needs to be insured. But costs will not only increase for obtaining insurance coverage, they also increase due to new complexities and the need for implementing and maintaining an adequate compliance system.

Godbey: Major brokers in the US report that securities class action filings have been flat over the past year, overall settlement values have decreased and the number of settlements also has gone down. Nevertheless, the $275m Activision settlement and the $137.5m Freeport-McMoRan settlement, among others, suggest that 2014 was the year of the shareholder derivative settlement. Chubb reports that the "average total costs to the company of a D&O event, including judgments, settlements, fines and legal fees" was $697,902 last year. These figures suggest that companies need to aggressively pursue risk management strategies as well as strengthen their D&O insurance programs to effectively curtail these rising costs.

Snow: How important a role does D&O liability insurance play in mitigating the breadth of personal risks to board members and senior executives?

Brunner: In certain instances, the company will assume – and already advance – legal costs in connection with claims against D&Os and even indemnify them. This level of protection in the form of hold-harmless agreements, however, finds its limits on the one hand in cases where the company itself commences litigation against the director or officer or on the other hand, where the director or officer is in 'substantial' – not 'wilful' – breach of the duties owed to the company. Most importantly, when the company has gone bankrupt, such arrangements are of no value. Hence, D&O insurance is an important tool to mitigate personal risks, in particular with its coverage of defence costs. Again, D&Os should be careful in securing coverage beyond the termination of their mandate, as in many cases D&O policies follow the claims-made principle. Yet, D&O insurance is only one of many tools mitigating risks. D&Os – actually, the entire company – should follow a risk awareness culture and should continuously reflect on their actions. Targeted, ongoing education in compliance issues, for example, is an important cornerstone of risk mitigation.

Godbey: A comprehensive and effective D&O liability insurance program is crucial to protecting officers, directors and independent directors from personal risks associated with board service. In today's market, savvy individuals routinely decline board service if top quality D&O insurance is not in place in sufficient amounts to cover a catastrophic loss. Potential board members, particularly independent directors, frequently demand to read the policies and have them evaluated by coverage counsel or personal brokers. They want Side A DIC layers, as well as IDL policies, to make sure coverage is available to protect their interests apart from the company's interests and those of senior executives. A well-crafted and structured D&O program benefits the company, protects individual D&Os and offers an incentive for the company to attract the most well-qualified new board members – all good reasons to spend the time and money to get the best coverage.

Scott-Mackenzie: The role of D&O insurance goes beyond that of mitigating the risk. It allows directors to focus upon the business without compromising their decisions for fear of personal liability. In the absence of D&O insurance, many directors could simply not meet the cost of this complex litigation, and would likely have to settle civil litigation, or accept banning orders and other sanctions imposed by ASIC and other regulators.

Goins: D&O liability insurance is critical to mitigate exposure to personal risk for board members and senior executives. D&Os need to take steps to be sure that their companies provide them with adequate indemnification for such expenses, as well as appropriate provision for advancement of defence costs, which are frequently the most expensive element of such claims. Often the actual costs of advancement and indemnification must be funded through liability insurance. While such insurance rarely covers fraud or intentional actions by the insured D&Os and it is unlikely to cover a liability verdict, D&Os need to know that they will be funded in mounting the best possible defence to avoid such a result. Moreover, an aggressive and well-constructed defence is the best leverage in settlement negotiations.

Yellen: Because there are circumstances when even well funded companies cannot or will not protect their D&Os, effective D&O liability coverage is a must have proposition. D&O policies may provide protection long after the company no longer can. While D&O insurance can provide critical resources to ensure directors and officers can defend themselves, some D&O carriers also bring expertise and influence that can help get tough situations resolved. Having the right carrier and broker can make a world of difference in outcome.

Snow: With the scope and nature of D&O risks having increased exponentially in recent years, how have D&O insurance policies evolved to satisfy today's needs?

Scott-Mackenzie: D&O policies continue to evolve to address a range of exposures, such as the impact of multinational risk and the imposition of fines and penalties. In addition, modern D&O litigation requires more than a good lawyer, but also requires a litigation management team, including an experienced claims manager that can call upon accountants, public relations and their overseas counterparts. As an addition, leading D&O policies should provide access to claims managers prior to any such litigation. These claims managers have a wealth of experience in litigation management and are able to provide feedback on common pitfalls when dealing with regulators or in other complex D&O litigation, which the board can then use ▸▸

to review and bolster their risk management framework.

Brunner: Some 20 years ago, D&O policies in Switzerland were a matter of a few publicly traded large companies, and it was a speciality business carried out by only a small number of insurance companies. This has changed considerably. Nowadays, even small and medium size enterprises are purchasing D&O policies and such policies are no longer a speciality business, but are sold by many, which led to a market environment that has become more competitive and fast-paced. Improved insurance parameters now comprise a larger and more diversified risk pool in combination with a larger premium volume, more competition and high insurance capacities due to a difficult investment environment with negative interest rates. This has effectively resulted in lower premiums and more flexibility. Accordingly, these aspects have neutralised, to a certain extent, any contrary effect from more regulation, at least for the moment. Following a public vote on executive salaries, new rules have been implemented entailing criminal liability in case of breach. Executives will likely be under scrutiny, which may also lead to more D&O cases in Switzerland. Overall, we would not be surprised if heightened scrutiny of executive action, potential obstacles in international business through a veritable regulatory boom and a more litigious shareholder society in Switzerland could result in an increased demand for more sophisticated D&O insurance products. As we have seen in the past, such circumstances have resulted in a significant increase of insurance premiums and reduced individual risk coverage.

Yellen: The good news is D&O insurance solutions have never been better suited to mitigate the risks associated with serving on a board or as an executive. Coverage is available not just for traditional claims-based loss, including defence costs, but also to loss from informal investigations and inquiries – even if no claim has been made and no wrongful act has been alleged. Side-A coverage, which largely responds to non-indemnified exposures of board members and executives, has never been broader and may include multiple reinstatements of limits. Global risks call for global solutions, and today's D&O coverage addresses global better than ever before. More traditional D&O coverage can now benefit from 'Side-A Liberalisation' that not only upgrades traditional D&O to match the exceptionally broad terms of Side-A excess, but can enhance the entire program to improve mitigation of counterparty and contract risk. A critical enhancement not uniformly offered is protection that will not dissipate when one or more insureds cooperate with authorities, rather than the insurer, in the context of an investigation.

Goins: D&O insurers have paid attention to the increasing and evolving risks to D&Os, and have created new products to address the increased risks. For instance, there are currently available in the US a number of different cyber security coverage policies, most of which did not exist three years ago. It is important for companies and their D&Os to stay ahead of the curve with respect to insurance risk coverage, since once claims begin to accumulate under a particular policy, insurers may be more reluctant to issue similar coverage at cost effective rates to new insureds. Insurers have likewise responded to the market for expanded Side A coverage and the market for such policies is now quite competitive. To the extent coverage needs to evolve, the industry will continue to develop new products to respond to those needs.

Godbey: Luckily for corporate D&Os, D&O insurers have listened and responded with expanded and novel coverages, like coverage to defend against subpoenas and document requests received before a claim arises. This coverage for pre-claim inquiry costs is just one of many changes to the definition of 'loss' or 'damages', which now can include derivative investigation costs, liberty protection costs, SOX 304 costs, extradition costs, UK Corporate Manslaughter Act defence costs, personal reputation expenses, asset protection costs and Dodd-Frank 954 costs. Newer D&O policies also offer coverage for certain civil penalties assessed pursuant to the Foreign Corrupt Practices Act, some HIPAA liabilities and even cyber liability. Unfortunately, the insurers have not yet addressed coverage for, or at least a defence against, the proliferation of aiding and abetting claims arising out of 'merger and acquisition objection' cases, but D&Os look forward to the day this coverage is available, as well.

Snow: What advice would you give to companies and their D&Os when they are assessing the merits of a D&O policy? Which elements should be considered of paramount importance?

Goins: Companies and their D&Os should consult experienced coverage counsel when assessing the merits of D&O insurance. Too frequently, companies rely upon internal risk management employees or insurance brokers to interpret policies for them and to tell them what coverage they need. But internal risk management may not be sophisticated enough and brokers may not be entirely independent. Moreover, the interpretation of policy provisions is constantly evolving in case law, and experienced coverage counsel may be better positioned to correctly match up the particularised risks faced by the entity and its D&Os with available products, and to interpret and assess the insurance products under consideration.

Brunner: As D&O policies are on a claims-made basis, the most important aspects are related to time – D&Os should be covered beyond *functus officio* and beyond the 'life' of the entity; hence, there should be a run-off period of five years at least. In addition, we would recommend including the possibility of triggering coverage by notifying circumstances, and there should be an extended reporting period after termination of the policy. With regard to coverage, defence costs for criminal prosecution and proceedings become more and more important. Finally, coverage for D&Os' personal liability for tax claims and social security contributions should be sought.

Godbey: D&O policies vary greatly from insurer to insurer, so it is wise to read and compare the actual language to find the broadest and most comprehensive coverage. Brokers and coverage attorneys regularly provide these evaluations and comparisons. Depending on the size of the policyholder, D&O policies can be highly negotiable. If shopping the market is an option, ask the broker to obtain two or three quotes, along with policy specimen forms and all proposed endorsements. Use competing quotes as leverage to negotiate not only the lowest premium, but also superior coverage. Brokers also can provide 'peer reviews' to compare potential policies with those issued to other insureds in the same industry or insureds of approximately the same size. Analyse specific company risks then employ all of these negotiations and tools to purchase the coverage that best protects the company and the D&Os from these potential risks.

Yellen: At the end of the day, selecting the right partners and building relationships is critical to getting protection that can be relied upon. Also, while cost always matters, in today's competitive market, broad coverage should be first priority since it is available for reasonable cost. Start by finding a broker you can trust with multinational reach and influence. Brokers can not only get best-in-class features tailored to your situation, but they have information and relationships that often make the difference between resolution and litigation. When claims happen, a strong broker will serve a critical function pulling potentially diverse stakeholders, like primary and excess carriers and defence and coverage counsel, together.

Scott-Mackenzie: While obtaining a broad coverage and sufficient limits are often focused upon, we would suggest that if a director really wants to see the quality of their D&O insurance, they should meet with the insurer's claims manager. Whilst the insurer's and the broker's sales team are important to the placement of the D&O, it is the insurer's claims manager that will assist them should they face litigation or an investigation. In addition, consider whether you want your D&O insurance to cover just the D&Os, or whether you want the policy, including its limit, to be shared with the company. Some policies continue to provide cover to the company in the event of securities class actions or employment practices disputes. These may lead to the policy being depleted by claims against the company, and the directors being left without the protection they thought they had purchased.

Snow: What risk management measures can directors adopt to mitigate against potential legal battles and costly settlements?

Yellen: D&O coverage is not a commodity. Likewise, D&O risk is dynamic, shifting with myriad factors like stock price, enforcement trends, M&A and IPO trends, and the fluid priorities of the plaintiffs bar. Enterprise risk management has become a more significant agenda item for boards lately – not just for D&O exposures, but those D&O exposures can fall within and be impacted by the larger risk management efforts. To stay ahead of the curve, companies and their D&Os should keep a sharp eye on the SEC, its rulemaking and enforcement. In particular, watch how regulators look at cyber security and related disclosures, and track how enforcement authorities use evolving analytical tools to increase its efficiency and effectiveness. On the civil litigation front, while cyber security breaches have made headlines, and they have, thus far, not resulted in a successful securities class action or derivative claim, it is just a matter of time. When that first successful suit becomes the template for success, we could see a torrent of similar litigation follow.

Scott-Mackenzie: First and foremost, good risk management for the company is often good risk management for the directors. Directors are often investigated by regulators, or lawyers look to litigate against directors, where the company has had perceived difficulties – whether a worksite death causing an investigation under Work Health & Safety legislation, or a securities action arising from the company's failure to meet its continuous disclosure obligations. Secondly, when faced by an investigation or civil litigation, obtaining good legal advice as quickly as possible is essential. With early intervention, the matter may be dealt with at a preliminary stage which is obviously advantageous. Our experience is that once a regulator has a head of steam up, they can often be difficult to stop. This often requires that the company's risk management framework include not only the preventative measures to reduce the likelihood of a breach that may cause a litigation or investigation, but developing and testing processes to effectively respond should a regulator like ASIC call upon them.

Godbey: The most effective way to avoid D&O litigation is to prepare, implement and enforce specific written corporate governance, compliance and ethics programs. Within these programs, companies should strengthen internal controls, including financial and reporting procedures, engage in comprehensive risk assessment, create employee handbooks and conduct regular inside and outside audits. Companies need to make sure these programs are adequately staffed and funded, and with board oversight, they should periodically review and update the programs to make sure they remain viable and relevant. In addition, companies need specific policies and training on how to prevent, detect and remediate misconduct, should it occur. Some companies have implemented bonuses and rewards for managers and employees who diligently follow compliance policies. All of these measures tend to reduce litigation and prevent negative regulatory scrutiny and activity.

Goins: The best defence for directors to potential legal battles and costly settlements is to be proactive. This means demanding full analysis of potential risks from management, putting in place effective and thorough accountability and reporting systems, effectively monitoring the implementation of such systems through regular reporting and review, promptly rectifying any deviations or violations, and adjusting the systems as needed. The protections of the business judgment rule only apply when directors make informed decisions in good faith, based on adequate investigation, and applying a well thought-out and well executed strategy. Simply 'doing nothing' nullifies the business judgment rule, increases the risk of litigation, and potentially exposes directors to liability for damages. Directors should also consider new strategies, such as forum selection bylaws, recently approved in Delaware, and some form of fee-shifting, which can, if properly implemented, reduce risk of personal liability.

Brunner: There are – in essence – two sets of risk mitigating measures a director should adopt. On the one hand, they should ensure proper decision-making processes and take decisions on the basis of appropriate and timely information after due discussion of the pros and cons, by considering alternatives and their respective risks, by consulting experts in areas where they lack sufficient expertise as well as acting solely in the interest of the company. Also, they should maintain an orderly file of all relevant decisions and acts that may give rise to potential claims. On the other hand, they should follow best industry practices as these may likely be regarded as certain minimum standards and could be used by courts to determine whether a breach of duty occurred. ■