

# Risk management for an enlarged EU

In cooperation with Economist Corporate Network and Economist Intelligence Unit

## Directors' and Officers' (D&O) liability

**THE BODY** of European legislation governing Directors' and Officers' liability is expanding significantly. It is incorporated in company law, as well as separate legislation governing such areas as environmental liability and employee protection. The European Commission is satisfied that current EU company law, including those sections relating to D&O liability, has been fully transposed in the new member states.

The scope of D&O liability throughout Europe has been expanded in recent years in the wake of scandals at Enron, Parmalat, Royal Ahold and elsewhere. The best known example of recent legislation, America's Sarbanes-Oxley Act of 2002, famously makes CEOs and CFOs sign declarations attesting to the truth of financial statements and holds them personally liable for misrepresentations.



# Executive summary

## What company directors need to know:

- Company law is not well established or adhered to in the new EU member states. Rights of minority shareholders are frequently ignored, many ownership structures are opaque and majority owners often obstruct the monitoring of board behaviour. Many poorly governed firms are likely to de-list from public exchanges rather than face the civil and criminal penalties established by corporate governance legislation.
- Having said that, weak enforcement mechanisms and a relatively small shareholder base, currently make the risk of lawsuits against company directors and officers low in the new EU member states. Strengthening enforcement bodies will change this.
- Liabilities faced by company directors and officers are being defined and formalised by EU lawmakers in three ways:
  - Existing European Union company law, which has expanded significantly in recent years, covers issues such as insider trading, misleading investment prospectuses and the transparency of financial statements.
  - Forthcoming European company law which will protect minority shareholder rights, rule on the disclosure of corporate governance rules and practices and delineate the responsibility of board members for misconduct.
  - Directives in other fields, such as the environment, employment law, health and safety and consumer protection, which also serve to define the responsibilities of company directors.
- Most of the new EU member states, or organisations within them such as stock exchanges, are also addressing corporate governance through the adoption of voluntary codes of behaviour. Although these entail no civil or criminal penalties for boards, they are likely to influence what regulators, courts and shareholder groups expect of directors and officers.
- D&O insurance is a relatively new line of insurance in the new EU member states and tends to be bought by multinationals and companies in highly regulated sectors.
- Between 2001 and 2003, the top seven judgements or settlements against directors and officers in EU companies totalled over US\$1bn.

## The EU action plan

 **THE EUROPEAN** Commission, having abandoned a 30-year-long attempt to establish a comprehensive body of company law (the Fifth Directive), has responded to financial scandals with action in a few selected areas. The Commission's Action Plan, *Modernising Company Law and Enhancing Corporate Governance*, issued in 2003, has resulted in a host of directives that directly or indirectly expand the personal liability of company officers. The most important of these are the following:

- **Directive on insider dealing and market manipulation** (to be transposed by October 2004), which outlaws such activity.
- **Directive on the prospectus to be published when securities are offered to the public or admitted to trading** (to be transposed by July 2005), which makes those responsible for prospectuses liable to administrative and civil sanction if they are incomplete or incorrect.
- **Directive on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market** (to be transposed by autumn 2006). The 'transparency directive' requires 'persons responsible within the issuer' to attest that each half-yearly and annual report presents 'to the best of their knowledge' an accurate description of the company's financial situation and performance as well as of relevant developments and risk. Unlike Sarbanes-Oxley, the transparency directive leaves the entire board open to administrative and civil liability if the reports are deemed to be misleading.

These directives are noteworthy for two reasons. Firstly, for some EU member states they are the first pieces of legislation of their kind. A few members, for example, have yet to prohibit insider dealing. Secondly, the directives' wording means that resulting national legislation may leave considerable room for broad interpretation. For example, despite the Commission's reassurance, the transparency directive's wording left the European Union Committee of the UK's House of Lords concerned that the measure could permit lawsuits not just by shareholders but by any potential investor anywhere in Europe.

More EU legislation is on the horizon:

- A directive, planned for 2005, to protect the rights of minority shareholder rights to receive necessary information, ask questions, produce table resolutions and vote in absentia or electronically
- A directive, planned for 2004 or early 2005, to require companies to disclose corporate governance rules and practices
- Most importantly, a directive, planned for between 2006 and 2008, on the responsibility of board members. Among other things, this directive would give minority shareholders rights to demand investigations of board conduct, prohibit continuance of corporate activity while insolvent and enact EU-wide disqualification of directors for serious misconduct.

## Voluntary governance

**VOLUNTARY CORPORATE** codes of conduct, a recent development, have spread rapidly. A Commission report found 25 new codes appearing in the EU-15 between 1997 and 2001. After Enron, ten further codes appeared, along with three major amendments to earlier ones. All the new member states except Estonia have them, with the Budapest and Riga stock markets introducing new codes very recently. Finally, in April 2004 the Organisation for Economic Co-operation and Development (OECD) completed a post-Enron revision of its highly influential *Principles of Corporate Governance*. The Czech Republic, Hungary, Poland and Slovakia – all OECD members – have each introduced governance codes based on the *Principles*.

Such voluntary codes have little direct impact on D&O liability. Being voluntary, they lack enforcement mechanisms. The most demanding push companies to explain any failures to comply with their provisions. However, this 'soft' regulation could have two important legal effects:


- Company law in most European countries requires board members to act as reasonable, competent business people and to treat all shareholders fairly. The codes, although necessarily general, flesh out the meaning of such expectations more than legislation does. Courts may use these in assessing what is 'reasonable' behaviour for directors.
- The European Commission has indicated that it intends to promote the convergence of Europe's voluntary codes, and to encourage all member states to adopt one code that is mandatory for all resident companies. Should this effort succeed, the border between soft and hard law will blur.

### It's serious

Meanwhile, shareholders and prosecutors have used the legal weapons, already at their disposal, to alarming effect. Between 2001 and 2003, the top seven judgements or settlements against directors and officers in EU companies alone totalled over US\$1bn. The number of actual cases has declined, but that of suits by American shareholders against European corporations – usually the most costly – continues to rise. As a result, insurance premiums for D&O coverage in Europe have seen a steep increase and some price hikes of 500% have occurred, although, competitive market forces are now leading to a period of reducing premiums.



## Potential sources of D&O liability in CEE

 **INSTANCES OF** legal proceedings against company directors and officers have been rare in Central and Eastern Europe (CEE). This is mainly down to the fact that the region's market economies are still in adolescence, with a relatively weak culture of citizen and shareholder activism. Evasive action by listed companies and weak enforcement mechanisms (see below) mean that implementation of EU directives will not in the short term produce a wave of D&O proceedings. In the longer term, this situation will change.

### Abuse of shareholder rights

Once the new EU members strengthen enforcement mechanisms, issues relating to the widespread abuse of minority shareholder rights throughout the region will provide fertile ground for D&O liability actions. Governance mechanisms proved too weak to stop managers from pursuing their own benefit in the 1990s privatisation wave. Either such firms failed, or shares were amassed by block-holders, including foreign investors, banks, national investment funds and wealthy individuals. As a result, today CEE countries exhibit far more concentrated company ownership patterns than exist in Western Europe or America.

Such concentration has spawned a culture in which minority shareholder rights are frequently ignored. In many companies, ownership structures are often opaque, boards subsume the company's interests to that of the majority shareholder (who controls appointments), key information is not shared and obstacles are placed in the way of mechanisms to monitor the board – such as preventing proxies at annual meetings, or even moving such meetings at short notice.

Political interference also occurs in some countries, where the state remains a major corporate player by virtue of holding blocks of shares in some of the largest domestic companies (such as telecommunications providers and energy firms) and directly controlling large investment funds. It is common for civil servants to sit on corporate boards and frequently, as a matter of practice, to act and vote in unison with the other major shareholders.

Weak local capital markets exacerbate the problem. Efforts in the 1990s to create equity markets only partly succeeded. Aside from Poland, stock exchanges throughout the region are tiny: the Warsaw exchange is about the same size as those of the other new member states combined. Their small size and pervasive ownership concentration make these exchanges illiquid and vulnerable to manipulation. With little cash available from domestic markets, some majority owners have kept the value of their shares artificially low, allowing them to buy out minority shareholders at a discount. With a large enough block of shares, usually 75%, they can de-list the company, and thereby avoid the governance regulations of the exchange.

Shareholder organisations in CEE are currently weak and have little experience in challenging boards on issues of corporate governance. However, the aforementioned EU directives address shareholder rights and responsibilities explicitly and establish personal liability of directors for many of the types of violations which now commonly occur. Many of the companies interviewed for this report expect that the emergence of more aggressive shareholder activism is only a matter of time in the new member states. Boards can thus expect shareholder challenges in the form, for example, of demands for regulatory investigations or the filing of civil claims to counter what minority owners perceive as abuse of their rights.



Even earnest participation in these markets holds D&O and reputational risks. In a rare example of Polish shareholder activism, alleged improprieties in Michelin's behaviour as majority owner of Stomil Olsztyn sparked three audits. Although exonerated, the episode cost the company US\$50m. Pernod Ricard, Bayerische Hypo Vereinsbank and Goodyear have also faced unsubstantiated allegations of abusing majority holdings in local firms.

### **Domestic law**

D&O liability is also affected by domestic law in the new EU states' governing environmental protection, employment, employee health and safety, fair trading and consumer protection. While Brussels has required the new member states to transpose EU law in these areas as part of the accession process, it leaves the countries themselves to decide on the imposition of personal liability for corporate actions.

EU law, in these areas, will necessarily have D&O impact. Businesses will need to adopt significantly higher standards and often undertake deep cultural changes as well as extensive equipment and infrastructure upgrades. Management and boards will be held responsible for the success of these transformations. One Czech utility recently arranged D&O insurance for board members, given concerns of inadvertently contravening new EU environmental liability regulations.

D&O liability also exists in aspects of domestic company law in the new EU member states. Examples which apply broadly to all of them include the following:

- Directors and officers are liable for damage to a corporation arising from gross incompetence, unauthorised or illegal actions (including fraudulent misrepresentation of a company's financial position) or negligence. Usually, only the company itself can sue directors but, if the company refuses, minority shareholders may initiate cases. Plaintiffs have the difficult task of showing that board members failed to exercise due care, although in Latvia the burden of proof falls on defendants.
- Directors and officers are liable for unpaid taxes or other company debts if they continue operations after they should have initiated bankruptcy proceedings.
- Ordinarily, civil suits and regulatory claims arising out of employment, health and safety, consumer protection and environmental issues must be filed against companies rather than directors and officers. Exceptions occur where these individuals fail to execute court or administrative orders against the company. The firm may in turn sue responsible individuals to recover costs of adverse judgements.
- Board members are liable jointly and independently for board actions, although individuals can sometimes avoid liability if they voted against the policy occasioning the complaint, or in the event of an adverse judgement, group together to sue their fellows who are most responsible. Joint liability is a particular risk in some smaller states, where there often are not enough qualified individuals to fill supervisory boards.

- Individual directors and officers are liable for criminal acts they knowingly undertake. In some countries, such as Slovakia, criminal charges cannot be brought against a corporation, so board members might be charged for any such corporate wrongdoing, whatever their individual conduct.

The differences amongst CEE countries in local D&O liability are often as stark as the similarities. Some examples illustrate this:

- It is a crime in Estonia to disclose business secrets, and in Slovakia to utter untrue negative statements about a competitor's product.
- Legislation in Poland and Hungary does not recognise punitive damages, while it does in the Czech Republic.
- Czech, Latvian and Slovak laws ban agreements to limit director liability, while they are allowed in other new EU member states.
- Hungarian law provides greater protection against civil D&O suits than most, but it also imposes some stiff criminal penalties, including up to eight years imprisonment for trading while insolvent.
- Under Slovak law someone not on the board, whose instructions directors are accustomed to obeying such as a majority owner, may be deemed a shadow director bearing full liability.
- Poland's Labour Code does not mention sexual harassment, but management board members can be jailed for five years for simply acting to the company's detriment. How judges will interpret this is uncertain, since separate legislation covers directors who abuse their positions for personal benefit.

Given the widespread abuse of minority shareholder rights, where the expanded bodies of CEE company law applied immediately to all corporations in the new member states, they would leave boards wide open to lawsuits. The new legislation's collective board responsibility would expose even unwitting directors.

In practice, the impact will be less because:

- The directives only cover companies listed on regulated markets. Many majority investors, wary of oversight, will simply acquire more shares and delist their companies.
- Of the few local companies who need access to sizeable capital markets, many are already cross-listed on American or European exchanges, with tougher scrutiny and higher D&O risk. Half the WIG20 – Warsaw's premier shares and CEE's most liquid – and 60% of the top-tier Baltic companies are listed in New York alone.

Thus, the new directives will apply primarily to large listed companies which are already well-behaved. However, they should have a beneficial impact on the corporate governance of CEE's growth-oriented mid-sized firms who aspire to go public. For CEE corporate governance to change as a result, though, enforcement bodies will need to make vast gains in resources and aggressiveness.

## Enforcement

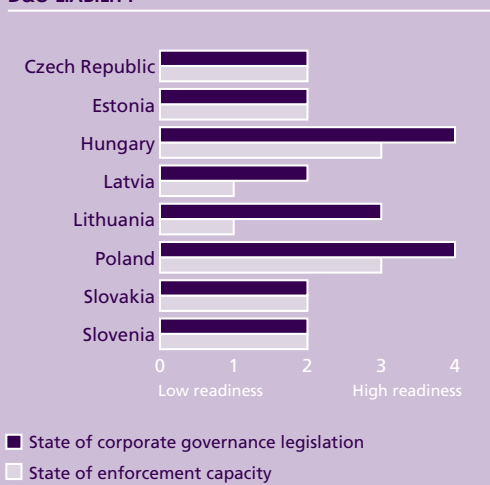
**ALTHOUGH THE** European Commission has stated that local administrative bodies are capable of enforcing company law, other commentators invariably describe regulatory capacity as weak. Polish and Hungarian institutions are more stringent than most and financial institutions are notably well regulated across the region. (A large Czech bank interviewed for this report remarked on the 'high expert standard' of country's financial regulators.)

The weakness of enforcement bodies results mainly from inexperience. The market economy here is only about a decade old and legislation has been in constant flux, with major accession-related changes completed only this year. Regulators, learning their jobs from scratch, have faced ever-changing rules written with different corporate governance norms than local ones in mind.

CEE courts also have little experience of determining personal liability in commercial matters. Most of the new D&O legislation requires interpretation of terms such as 'reasonable', 'willful breach' or 'gross negligence'. Little or no local case law exists to guide judgements on these freshly-minted laws.


As mentioned above, shareholder organisations are weak and ineffective. Poland's two small shareholder groups are still rarities in the region. Moreover, because of impediments to asserting minority shareholder rights, activists have tended to cause embarrassment at annual meetings rather than vote shares or use the courts. Investment funds and financial institutions have not assumed any important monitoring role. Lenders have also had little impact, although banks such as Bank Pekao, one of Poland's largest, have been active in the spread of national corporate governance codes.

ACCESSION COUNTRIES' READINESS FOR D&O LIABILITY



Source: ECN (Estimates based on research and interviews)

## Risk awareness and insurance strategies

 **ALTHOUGH D&O** liability is not a current priority for corporate boards in CEE, companies interviewed for this report expect this situation to change. They predict D&O liability cases will be pursued more vigorously in the medium term.

- Many have reservations about the quality of enforcement bodies, but all believe that they are improving with experience and expect them to reach European levels in the next two-four years.
- An increasing number of CEE companies will need to access foreign equity markets, and will thus face monitoring by American and increasingly litigious French and German shareholders.
- Local shareholder activism is beginning to stir – most interviewed companies saw its influence in corporate governance growing; they expect increasingly sophisticated shareholders to force companies to sue directors and officers where they are personally liable, or they will simply do this themselves.

Given the region's opaque corporate governance, company activities that would incur personal penalties against directors almost certainly occur. The first successful D&O lawsuits will spark more. It is worth remembering that D&O liability in Western Europe was transformed from a niche area of insurance to an important risk in under a decade, partly through EU legal reforms enacted in the 1980s.

D&O liability insurance is available in most CEE countries. Major multinational corporations typically include local boards and managers in their group D&O coverage which, given current conditions, does not greatly affect premiums.

Local firms in highly regulated industries, such as finance, pharmaceuticals and utilities, also tend to seek insurance. Several companies interviewed for the report complain of a lack of appropriate insurance products locally; those available are frequently the result of a repackaging, by national firms, of coverage underwritten by foreign partners.

Companies in other fields often do no more than monitor developments and rely on compliance with good behaviour codes. For example, the senior executives of a large Lithuanian IT firm review new EU directives, obey local legislation, follow International Accounting Standards and provide such contract protection for directors and officers as they legally can. On the other hand, management knows of no D&O liability case in Lithuania, and worry that insurance might cost them more than reimbursing any potential adverse judgements against directors.

In environments where companies are prohibited from indemnifying their directors or limited in the circumstances in which they are legally permitted to indemnify their directors, D&O insurance can be the last line of protection from personal bankruptcy. It is better to have some good cover in place and sleep well at night than realise too late that impending litigation will bankrupt you long before you can clear your name.

In the UK, there are directors of major companies facing personal financial pain as they face years of litigation – and it could have been avoided through the purchase of adequate D&O insurance.

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This paper is the fifth in a series of five published by Marsh in co-operation with the Economist Corporate Network and the Economist Intelligence Unit. The papers address the risk management implications of EU enlargement for businesses operating in the eight accession countries of Central and Eastern Europe. After the introductory paper to the series, the second paper focused on consumer protection, the third on employee protection and the fourth on environmental liability.

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