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GLOBAL D&O CONCERNS: EXPORTING US LAW

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The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

The most hostile legal environment in the world for directors and officers has been the United States. The federal securities laws, sympathetic courts, liberal class action practices and aggressive plaintiff lawyers combined to create chilling legal precedents and staggering settlement amounts in US litigation against directors and officers. No other country in the world has come close to duplicating that hostile legal climate.

However, directors and officers of companies located in other countries are not immune from the same or similar liability exposures as exist under US law. Several recent legal developments in two contexts demonstrate this increasing vulnerability. First, many US courts are becoming more willing to allow investors in non-US companies to prosecute claims in US courts under US laws against directors and officers of those foreign companies. Second, some foreign countries with legal systems somewhat similar to the United States, such as Canada and Australia, are now embracing shareholder class action lawsuits against directors and officers as an appropriate method to deter wrongdoing and compensate damaged investors.

The exportation of US D&O jurisprudence has not been all negative for the directors and officers, though. For example, in recognition of the increased vulnerability of directors and officers, the United Kingdom recently enacted a new indemnification statute which allows companies to provide much broader indemnification protection for their directors and officers.

Each of these developments is summarized below. It seems likely that this trend towards greater globalization of D&O exposures will continue. Therefore, non-US companies should implement and follow the same types of comprehensive governance and D&O loss prevention practices that US companies have adopted in response to their increasing D&O exposures.

A. US Jurisdiction over Foreign D&Os and Investors

Two recent blockbuster US settlements by non-US companies serve as sobering evidence that foreign companies can incur catastrophic losses in US courts under US laws. In one case, Nortel Networks Corporation, a Canadian telecommunications company, and its directors and officers settled two independent securities class action lawsuits pending in a US district court for a total of \$2.7 billion. The settlement amount, which is the largest ever paid by a non-US company in a US securities class action lawsuit, included \$575 million cash from the company, \$228.5 million from insurers and 14.5% of the company's outstanding common shares.

In another case, Royal Ahold NV, a Dutch retailer, and its directors, officers and professionals settled a securities class action lawsuit for \$1.1 billion. The lawsuit arose out of accounting problems at Ahold's US Foodservice subsidiary. Even though a large percentage of the plaintiff class constituted shareholders outside the United States, the lawsuit was brought in a US district court and alleged violations of the US securities laws.

The Nortel and Ahold settlements are merely the largest in a series of recent securities class action settlements in US courts involving non-US companies. Other examples include:

Company	Headquarters	Settlement Date	Settlement Amount
DaimlerChrysler	Germany	February 2004	\$300 million
Deutsche Telekom	Germany	June 2005	\$120 million
Royal Dutch/Shell	Netherlands	July 2005	\$90 million
El An	Ireland	February 2005	\$75 million
MTC Electronic Teletechnologies	Canada	October 1998	\$70 million
Independent Energy Holdings	UK	September 2003	\$48 million
Laidlaw	Canada	December 2002	\$42.9 million
Cinar	Canada	November 2002	\$27.3 million
Vodafone	UK	March 2005	\$24.5 million

These settlements vividly demonstrate that non-US companies and their directors and officers have potentially catastrophic liability exposures under the US securities laws even if the liability environment in their own country is far more protective. US plaintiff lawyers are reportedly developing aggressive marketing programs to large institutional investors in Europe and other foreign countries in order to persuade them to bring securities fraud claims in the US. Those marketing efforts are proving successful. In the last couple of years, between 10-15% of the securities class action lawsuits filed in US courts were against foreign companies. As the quality of disclosures by US companies improves in response to the Sarbanes-Oxley Act and increased disclosure vigilance, plaintiffs' lawyers will likely continue to look outside the United States for their prey.

Foreign defendants who are named as defendants in a US securities class action lawsuit obviously argue that the US court has no jurisdiction over them. In deciding whether a foreign defendant can be sued in the United States, US courts typically apply an "effects test" and a "conduct test." The "effects test" considers whether conduct by the foreign defendant had a substantial adverse effect on US investors or US securities markets. The "conduct test" looks at whether conduct by the defendant within the United States is alleged to have played some part in the perpetration of the securities fraud. If under either test the foreign defendant has a sufficient nexus with the US, a US court will have jurisdiction. In other words, if the foreign defendant committed wrongdoing in the

United States or committed wrongdoing that had a substantial adverse effect on US investors or the US securities market, then a US court will likely conclude it has jurisdiction with respect to the foreign D&O defendant. Although US courts have issued divergent opinions on how these rules apply to specific facts, there is a clear trend towards finding jurisdiction over the foreign defendants in a number of cases.

Historically, the most common basis for a foreign company and its D&Os to be subjected to securities litigation in the US arose when the foreign company raised capital in the US by selling American Depository Receipts (ADRs) in the US. Because ADRs are securities for purposes of the federal securities laws, misrepresentations which inflate the price of ADRs can give rise to a securities class action in the US. More recent cases are successfully asserting securities claims against foreign defendants for misrepresentations involving other types of securities even though the securities are traded on a foreign exchange, so long as US investors are harmed.

A similar and equally important issue in securities class action litigation relates to whether foreign shareholders can become members of a securities class action prosecuted in the United States. Courts apply the same “effects test” and “conduct test” to decide if foreign investors can be members of a class action in the US. Again, courts recently have evidenced a greater willingness to allow foreign investors to participate in the US securities class action. Obviously, this can result in dramatically larger damages and thus much larger settlement amounts than would exist if the class members consisted only of US shareholders. If the foreign investor purchased shares on a US stock exchange or relied on misrepresentations issued in the United States, those foreign investors will clearly be allowed to participate as class members. The more difficult case involves alleged wrongdoing outside the United States and no significant purchases or sales of securities occurred within the United States.

B. New Canadian Securities Class Action Law

Effective December 31, 2005, the Ontario Securities Act was amended to allow investors to bring a securities class action lawsuit against companies and their directors, officers, employees and agents for misrepresentations or omissions in the secondary securities market. In some respects, the new law, which is commonly known as Bill 198, is very similar to the US federal securities laws underlying the massive securities class action litigation exposures in the United States. However, in other respects, the Canadian statute is much different and more protective of defendants.

Like the US law, investors who buy or sell securities after an oral or written misrepresentation of material information and before a corrective disclosure occurs have recourse under the new law. The potential defendants include the company, its directors, officers, employees and accountants, as well as others who are involved in the wrongful disclosure on behalf of the company.

In the past, Canadian law prohibited misrepresentations or omissions in connection with securities transactions, but securities class action litigation was not viable because each plaintiff had to prove reliance upon the false information when

purchasing or selling the securities. Similar to US court decisions, the new Canadian law eliminates this reliance requirement, and allows any investor who purchased or sold securities while the false information was “alive” in the market to bring a claim whether or not the investor knew about or relied upon the false information in connection with their investment decisions.

The level of culpability required under the new Canadian law differs from US law. If the misrepresentation or omission occurs in a core document, such as a prospectus or annual report, the defendants are strictly liable under the new law unless the defendants can prove the due diligence defense summarized below. With respect to misrepresentations or omissions in any other communication, the defendant is liable only if he or she is guilty of gross misconduct. In contrast, the US securities laws generally impose liability if the defendant recklessly or intentionally misrepresented or omitted material information in any type of disclosure.

The primary defenses under the new statute include the following:

1. Due Diligence Defense. There is no liability if the defendant conducted a reasonable investigation and had no reasonable grounds to believe either the communication contained a misrepresentation or that failure to make a timely disclosure would occur.
2. Forward-Looking Statement Safe Harbor. Similar to US law, there is no liability for misrepresentations in a forward-looking statement if the defendant proves the statement contained both reasonable cautionary language and a description of the material facts or assumptions that were used in making the forward-looking statement, provided there was a reasonable basis for believing the forward-looking statement would be correct.
3. Reliance on Experts. There is no liability if the defendant relied upon experts to provide information within the scope of the expert’s expertise.

If liability is established, damages are generally equal to the difference between the average price paid for the securities and the price of the securities within ten days following the corrective disclosure. However, unlike US law, the Canadian statute contains important limitations on the maximum damages recoverable from defendants. The applicable damage limitations are as follows:

- For the company, the greater of 5% of its market capitalization or \$1 million;
- For directors, officers and influential persons, the greater of \$25,000 or 50% of their aggregate compensation from the insurer and its affiliates; and

- For experts, the greater of \$1 million or the total revenue of the expert and its affiliates from the issuer and its affiliates for the twelve months preceding the misrepresentation.

These damage limitations are reduced by damages recovered in other Canadian jurisdictions resulting from the same misrepresentation or omission. However, these damage limitations do not apply to anyone who knowingly authorized, permitted or acquiesced in the misrepresentation or omission.

Although Bill 198 significantly expands the liability exposure for securities misrepresentations and omission under Ontario law, it is doubtful this legislation will result in liability exposures comparable to those existing under the US federal securities laws for the following reasons, among others:

- Fee Shifting. Under Canadian law, the plaintiff can be required to pay the defendants' fees and expenses if the defendants successfully defend the lawsuit.
- Damages Limitation. The damages limitation, which applies unless there is a knowing misrepresentation or omission, dramatically reduces the plaintiffs' potential recovery.
- No Jury Trial. Consistent with general Canadian law, a trial in a class action lawsuit under this legislation would be submitted to a judge, and not a jury.
- Leave of Court. Before prosecuting a suit under this legislation, a plaintiff must demonstrate to the court through affidavits that the lawsuit is brought in good faith and there is a reasonable possibility of success.

Based on these factors, plaintiffs will still prefer prosecuting their cases in the United States under the US federal securities laws if possible. However, it is likely that there will be a significant number of cases at least filed under the new Ontario legislation for at least three reasons. First, plaintiffs in a securities class action in the US cannot obtain any discovery while the motion to dismiss is pending. However, discovery could be available through a tandem lawsuit filed in Canada under Bill 198. Second, plaintiffs counsel who are not selected as the lead counsel in the US securities class action could file a tandem securities case under Bill 198 and use the existence of that Canadian lawsuit as leverage to participate in any large fee award in the US class action lawsuit. This increased potential for additional "parallel proceedings" further aggravates an already difficult challenge for defendants when multiple but independent proceedings arise out of a common problem. Third, with respect to some mid-sized public companies with no nexus to the US, the new legislation may be the only basis to file a class action on behalf of investors.

At a minimum, Bill 198 will likely result in a significant increase in defense costs incurred by defendants, and in some instances, significant settlements and/or judgments may result.

From a D&O insurance perspective, there are several initial observations:

1. In light of the damages limitations, the company has far greater exposure than its directors and officers. Therefore, the decision to include entity coverage for securities claims within the D&O policy becomes far more important.
2. If entity coverage is included, there is a far greater potential for the company consuming most or all of the D&O insurance proceeds, leaving the defendant directors and officers with little or no coverage. To address that concern, D&Os should consider including one or more Side-A policies in the insurance program, thereby dedicating a minimum amount of insurance protection for just the directors and officers.
3. Insurers will likely require higher deductibles at least with respect to securities claims.
4. Excess D&O policies are now more exposed as a result of the new legislation, and therefore premiums for excess D&O policies will likely increase.
5. Because there is a greater potential for catastrophic loss, Canadian companies should consider increasing the total size of their D&O insurance program limits.

In any event, D&O underwriters will undoubtedly be more vigilant in their underwriting analysis and decisions for companies exposed to this new legislation.

C. Australian Securities Class Actions

Over the last several years, Australia has emerged as the most likely jurisdiction outside the US in which a securities class action lawsuit will be filed. Although Australian law has authorized class actions since 1992, securities class actions became popular only after a landmark case against GIO and its directors in 1999. In that case, the GIO directors rejected a lucrative takeover proposal by another company, but GIO collapsed soon thereafter. Litigation on behalf of 68,000 shareholders eventually settled for a record \$120 million (Australian).

As a result of the publicity and success of that case, securities class action litigation erupted. Today, 7 out of 10 new class action lawsuits filed in Australia are reportedly shareholder related. Most of those cases relate to erroneous forecast of financial performance.

Another development which has caused an increase in securities class action exposures is the increasingly high levels of stock ownership by Australians. Fueled in large part by privatization of various state-owned companies and the demutualization of several large insurance companies, approximately 55% of all adult Australians reportedly now own shares of stock in a company, which is reportedly the highest percentage of any country in the world. This large pool of investors, when combined with a heightened sensitivity to corporate governance and disclosure reforms in today's post-Enron world, create a volatile litigation environment for directors and officers.

Unlike US law, two dynamics have prevented an explosion in the severity of Australian securities class actions. First, Australian courts do not award to the plaintiffs law firm a large percentage of the settlement amount as a fee award. Second, consistent with general Australian law, the loser in a securities class action can be liable for the legal costs incurred by the prevailing party. However, these dynamics have been mitigated recently as a result of the emergence of financiers (other than the plaintiffs' lawyers) who fund the expense of prosecuting class actions in exchange for a large percentage of any recovery. For example, IMF (Australian), which is believed to be the only company of its kind in the world listed on a stock exchange, bankrolls securities class actions and typically takes 30% of any settlement in the lawsuit. The Australian High Court is expected to rule in late 2006 on whether this practice of funding litigation by companies such as IMF is proper or should be restricted.

D. UK Indemnification

In response to the perceived increase in director liability exposures, the UK Companies Act 1985 was amended in 2005 to authorize broader director and officer indemnification by companies organized in the UK. Previously, UK law generally prohibited a company from indemnifying its directors and officers with respect to claims for negligence, breach of duty or similar misconduct unless the D&O successfully defeated the claim. The new legislation, embodied in Sections 309A and 309B of the Act, allows companies to provide broad indemnification protection for their directors and officers even if the D&O is adjudged to be liable, as long as the indemnification is authorized by an indemnity provision contained within the company's constitution, articles of association or bylaws. However, a director or officer has no enforceable right to indemnification under such a provision unless the indemnification right is conveyed by a separate agreement between the D&O and the company. The separate indemnity agreement can take a number of forms, ranging from a letter to a formal agreement or deed of indemnification. The most protective type of agreement requires the company to indemnify the director or officer to the fullest extent permitted by law. If the company only has the indemnity provision in its constitution, articles or bylaws, or if the additional agreement with the D&O does not mandate indemnification or contains limitations on the company's obligation to indemnify, then less than full and certain financial protection is achieved.

The scope of indemnification authorized by the new legislation is somewhat similar to the indemnification authorized under state indemnification statutes in the United States. For example, a UK company is not permitted to indemnify directors and

officers for settlements or judgments in connection with suits by or on behalf of the company. The most significant difference between the UK and US statutes (other than the need for a separate indemnity agreement under the UK statute) is that the UK statute does not condition indemnification upon the director or officer satisfying any standard of conduct. Therefore, even a director or officer who commits rather egregious wrongdoing can be indemnified under certain circumstances. In contrast, the US indemnification statutes generally limit indemnification only to directors or officers who acted in good faith and in the reasonable belief their conduct was in or at least not opposed to the best interests of the company.

All companies organized under UK law, including UK subsidiaries of companies organized under the laws of other countries, should evaluate their desired scope of D&O indemnification protection in light of this new legislation. To assist in that important analysis and drafting process, qualified counsel experienced in indemnification issues should be retained since many of the issues that need to be considered are not obvious or easily understood.

In addition, Side A D&O insurance policies, which provide extraordinarily broad coverage only for non-indemnified D&O losses, are now available for the first time in the UK for companies that adopt protective indemnity provisions pursuant to this new legislation. As evidenced by the dramatic popularity of Side A D&O policies with US companies, those policies can afford valuable protection for D&Os beyond what is available through standard D&O insurance policies.