A Ticking Timebomb?
The Changing Liability Environment for European Directors and Officers

It has long been the case in the United States that lawsuits against corporate managers have been a significant source of liability. As such, Directors’ and Officers’ Liability insurance is certainly not new. It has been a standard coverage for US based corporations for decades. Until recently, Europe has lagged behind in this regard. Whereas ten years ago D&O insurance was considered unnecessary or even immoral, today it is practically indispensable.

Anyone reading European newspapers over the past few years couldn’t have helped but notice the increasing prevalence of articles addressing management negligence, stock market or stock price manipulation, manager criminal activity, or inappropriate financial reporting. Whereas in 1990 most underwriters may have been hard pressed to cite examples of claims, the past few years have seen the managers of some of Europe’s largest and most prestigious corporations facing lawsuits or investigations. These include the likes of DaimlerChrysler, Deutsche Telekom, Alcatel, Sotheby’s, Elf Aquitaine, Hoechst, and Swissair Group to name a few. The latest economic downturn has also hit European “New Economy” companies hard, with Metabox, Gigabell, EM.TV and Freedomland-ITN SpA among the many also facing the wrath of shareholders and prosecutors.
“Corporate governance” and the “liability of directors and officers” have become buzzwords throughout Europe. What is happening? There are a number of factors contributing to this phenomenon. The spread of “equity culture,” increased institutional investment, more and stricter legislation, cross-border mergers and acquisitions, and the rising exposure of European corporations to US securities laws can all be cited. Greater scrutiny on the part of shareholders and regulatory bodies can only lead one to conclude that European managers will be called upon increasingly to account for their actions before a court of law.

**The Rise of Equity Culture**

Stemming in part from the ravages experienced during the Second World War, Europeans, much like depression-era Americans, have generally had a more conservative approach to investing preferring to keep their money in the bank or invest in real estate as opposed to investing in the much “riskier” stock market. This has begun to change over the past decade as memories of the war have faded and it has become increasingly obvious that government pension schemes will be inadequate. Europeans faced with the possibility of financial insecurity during their golden years have begun to take investing for their retirement into their own hands, pumping billions of Euros into stocks and mutual funds. Others, simply not satisfied with the returns offered by traditional savings accounts, have been embracing US style investing in increasing numbers. In Germany, for example, the number of individuals owning shares of stock doubled between 1998 and 2000.¹

These “new” investors are becoming more and more concerned with the performance of their investments. Their emphasis is increasingly focused on short term results adding to the pressure put on managers to perform. They are both
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<th>Country</th>
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<td>European Union</td>
<td>EASD Principles and Recommendations</td>
<td>May 2000</td>
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<td>Corporate Governance Guidelines 2000</td>
<td>January 2000</td>
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<td>Austria</td>
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<td>Belgium</td>
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<td>German Code of Corporate Governance (GCCG)</td>
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<td>Corporate Governance Rules for German Quoted Companies</td>
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<td>DSW Guidelines</td>
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<td>Drittes Finanzmarktförderungsgesetz</td>
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*Table 1: European Corporate Governance Codes and Principles*
more critical and vocal. Shareholder rights groups exist and are active in virtually all EU countries. These groups are not just openly critical of corporations but have on a number of occasions taken matters into their own hands and filed suit themselves on behalf of their members. In Belgium, for example, shareholder activist group Deminor International SCRL is suing speech recognition company Lernout & Hauspie as well as its legal and accounting advisors on behalf of thousands of member shareholders for alleged fraud. Similarly, German shareholder protection association SdK sued the German multimedia company Metabox AG claiming the firm published misleading information relative to huge foreign orders made between April and November 2000 to boost the company’s stock price. These sales never materialized sending the company’s stock plummeting 99% from its high.

**New Legislation in Europe**

Governments have also done their part by commissioning studies relative to corporate governance and enacting new laws increasing director and officer liability. These new laws, addressing the duties of directors and officers, insider trading, mergers and acquisitions, minority shareholder rights, and reporting requirements have either been passed or are currently under discussion in a number of countries and at the EU level. These laws and corporate governance standards tend much more to closely resemble US securities laws.

The UK, for example, recently passed the Financial Services Market Act 2000 (FSMA2000), a comprehensive set of revisions to the old law which among other things creates a watchdog agency similar to the US Securities and Exchange Commission. Germany passed sweeping legislation in 1998 entitled “Gesetz zur Kontrolle und Transparenz im Unternehmensbereich” (KonTraG) which clearly spells out various duties and obligations on the part of directors. The German Parliament is also currently discussing a new law known as “Viertes Finanzmarktförderungsgesetz” aimed at further enhancing transparency. The proposed law seeks to create an independent cause of action against corporations for false or misleading information released to shareholders. Shareholder activist groups are pushing hard for the law to create a direct cause of action for shareholders against managers as well. In May 2001, the French Parliament passed a law making it compulsory for companies to disclose the salaries of their top management. It is also worth mentioning that in a number of non-EU member states, laws have been passed and codes adopted aimed at corporate governance and transparency in anticipation of their eventual acceptance into the European Union. The fallout of these laws upon directors and officers remains to be seen but at the very least they set

**Increased Institutional Investment**

Investors seeking higher returns – and diversification of risk – have also been looking beyond their own borders. For example, US mutual funds, driven by their desire to provide adequate returns to investors, have been pouring money into European stocks throughout the 1990s. Along the way, they have also introduced expectations of transparency and greater influence in company affairs to Europe’s traditionally cozy boardroom structures. CALPERS, the Californian pension fund, has actively sought to introduce corporate governance standards in a number of European countries. That is not to say that European fund managers are not also asserting their rights. In the UK fund managers, preferring to see Abbey National PLC taken over by Lloyds Bank PLC, helped push Abbey National to break off takeover talks with The Bank of Scotland. In Italy, fund managers mobilized ordinary shareholders in an attempt to block plans by Telecom Italia CEO, Roberto Colaninno to convert non-voting shares to voting shares requiring holders of non-voting shares to pay a 48% premium. The action eventually forced Telecom Italia to reduce the premium amount making the conversion more attractive to shareholders.

Thanks to globalization and international mergers and acquisitions, corporations previously operating in a single country find themselves exposed to a multitude of legal systems.
the stage for further discussion, debate and potential liability. (For an overview of various laws and corporate governance principles in EU member states please see table 1.)

Cross-Border Mergers and Acquisitions

Cross-border liabilities, once considered virtually unthinkable, are increasingly becoming a reality for corporate managers. Thanks to globalization and international mergers and acquisitions, corporations previously operating in a single country find themselves exposed to the laws and regulations of many other lands. A striking example can be found in the case of Italian luxury goods maker Gucci, which is listed on the Italian, Amsterdam, and New York stock exchanges. In 1999 Gucci, had sold 42% of its shares to French retailer Pinault-Printemps-Redoute (PPR) for USD 3bn in order to avoid acquisition by luxury goods rival Louis Vuitton Moët Hennessy (LVMH). At that point in time LVMH had owned a 34% stake in Gucci and had plans to buy more. LVMH chief executive Bernard Arnault claimed that Gucci had broken Dutch (not Italian) corporate laws by not insisting on a general offer to benefit all shareholders. He also accused Domenico De Sole, head of Gucci, of personally benefiting from the PPR placement. A petition by LVMH before a Dutch court to void the Gucci sale of shares to PPR was denied, but the French fashion maker appealed the decision and in September 2000 the Dutch High Court in The Hague remanded the case back to the lower court with instructions to consider it further12.

Another highly publicized case was that of Deutsche Telekom. In December 2000 a class action lawsuit was filed against Deutsche Telekom (DT) as well as chief executive officer Ron Sommer in various New York federal courts in connection with its take-over of the US cellular phone service provider Voicestream. DT management was accused of having deceived shareholders prior to a secondary offering in the United States by failing to inform them in a timely fashion of the already advanced take-over negotiations.
Following announcement of the takeover DT’s stock fell by almost 7%\textsuperscript{13}.

Not to be underestimated when discussing cross border activity is the whole area of Employment Practices Liability. Corporations and managers making acquisitions especially in the US and UK are often surprised by the exposures associated with Employment Practices. One such claim filed in the United States against Mitsubishi of Japan resulted in a settlement in excess of USD 30m.\textsuperscript{14} On the European continent EPL claims have not to date been a major issue but managers need to be aware. In June 2000 and December 2000 the EU Council passed directives designed to combat discrimination and harassment in EU member states\textsuperscript{15}. By no later than December 2003 EU member countries need to have appropriate laws in place conforming to these directives. Although the outcome of this legislation remains to be seen, it is likely that managers will be facing increased liabilities to employees after 2003.

**Increased Exposure of European Corporations to US Securities Laws**

The last and probably most important factor contributing to the rise in litigiousness against European managers has been the increasing tendency on the part of European companies to raise capital or simply list their shares in the United States. The United States remains by far the most litigious country in the world when it comes to suits against directors and officers with over 500 securities claims currently awaiting disposition, 250 new securities claims filed every year, and average settlements over USD 12m.\textsuperscript{16}

Listing in the United States exposes managers to US securities laws and has already resulted in numerous lawsuits and some very significant settlements. One such settlement came in the case of French telecommunications equipment supplier Alcatel. In September 1998 US investors filed a class action lawsuit in New York against Alcatel. The action was brought on behalf of shareholders who had acquired securities of Alcatel in the merger of Net Acquisition, Inc., a wholly owned subsidiary of Alcatel, with DSC Communications Corporation. The complaint charged that management violated securities laws by engaging in a scheme to artificially inflate the market price of Alcatel securities, and then using the securities to purchase DSC, thereby defrauding former DSC shareholders.\textsuperscript{17} The case was settled in October 2001 for USD 75m.\textsuperscript{18} Other significant cases against DaimlerChrysler, Deutsche Telekom and others are still pending.

Although the situation in Europe is obviously changing, we do not necessarily expect Europe to turn into another US as respects to suits against directors and officers. European plaintiffs are essentially fighting with one hand tied behind their backs when compared to their US counterparts. Unlike the US, most European countries do not provide civil plaintiffs with a right to discover documents once a lawsuit has been commenced. This seriously hampers the plaintiff’s ability to prove their case. In Germany, for example, only the state can require document production in criminal cases. This formidable weapon is used by the plaintiff’s bar in the US with extreme effectiveness. Managers faced with a lawsuit and the tedious time consuming task of responding to plaintiff’s innumerable document requests have a strong incentive to settle so they may focus on the day to day running of their companies. In addition, with the exception of the UK, European countries generally do not allow for shareholders to sue as a class. This forces shareholders to sue individually and does not allow them to join forces against their corporate adversary.\textsuperscript{19} Furthermore, contingency fees are typically not possible and the loser is often forced to pay the winner’s legal fees creating a further disincentive to bring suit.\textsuperscript{20}

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<tr>
<th>Industry Sector</th>
<th>Frequency</th>
<th>%</th>
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<tr>
<td>Financial Services (Banking and Non-Banking)</td>
<td>71</td>
<td>35.1%</td>
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<td>Internet/Information Technology/PR</td>
<td>43</td>
<td>21.3%</td>
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<tr>
<td>Construction/Engineering/Real Estate</td>
<td>20</td>
<td>9.9%</td>
</tr>
<tr>
<td>Retailing/Food/Household/Garden</td>
<td>16</td>
<td>7.9%</td>
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<tr>
<td>Manufacturing</td>
<td>16</td>
<td>7.9%</td>
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<tr>
<td>Service Industry</td>
<td>12</td>
<td>5.9%</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>9</td>
<td>4.5%</td>
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<td>Transportation/Travel</td>
<td>6</td>
<td>3.0%</td>
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<tr>
<td>Natural Resources</td>
<td>4</td>
<td>2.0%</td>
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<tr>
<td>Health</td>
<td>2</td>
<td>1.0%</td>
</tr>
<tr>
<td>Sport/Entertainment</td>
<td>2</td>
<td>1.0%</td>
</tr>
<tr>
<td>Nonprofit</td>
<td>1</td>
<td>0.5%</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>202</strong></td>
<td><strong>100%</strong></td>
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*Table 2: Number of incidents per industry group*\textsuperscript{26}
**European Claims Overview**

If it is indeed true, based on the above discussion, that claims against European managers are on the rise and that a number of underlying factors are causing this, one should ask: where are the claims coming from? Who is filing the suits? Which types of business are more intensely scrutinized? A 2001 GeneralCologne Re study of the press from the 1990’s uncovered a total of 202 separate examples of suits or criticism against European managers. 53.2% of the articles found public authorities either bringing suit or criticizing management. In 28.8% of the reports shareholders were either suing or expressing dissatisfaction, 9.3% were independent parties, 8.3% by the companies’ own management and once a single manager (0.5%) complained against the rest of the board. In various cases, both public prosecutors as well as private entities filed a complaint or voiced criticism.

In 45% of the examples a lawsuit was actually filed, while in 39% it was still being contemplated and in 16% legal action was neither taken nor being contemplated. 43% of incidents were more or less related to fraud while in 57% other allegations were made.

The GeneralCologne Re study also found an increasing prevalence of press articles dealing with D&O related incidents in recent years. Only 29% of the incidents took place between 1995 and 1998 whereas the great majority (144 cases or 71%) took place between 1998 and 2001. The results were also extremely interesting when looking at which industry groups were most often in the spotlight. The majority of incidents occurred in two major industry groups. More than one third of all complaints arose in connection with the financial sector (35.1%). This includes banking and non-banking enterprises. Together with the information technology branch (including Internet firms and media and public relations companies), in which 21.3% of the instances took place, these two industry groups accounted for 56.4% of the sample (see table 2).

**The Market for Directors and Officers Liability in Europe**

What has this new spotlight on directors and officers done for the D & O insurance market in Europe? The market has changed dramatically over the past few years going from a relatively claims-free environment where coverage enhancements and premium reductions on renewals were the norm to an industry far more concerned with the potential for enormous loss ratios. Underwriting has taken on a whole new meaning as many carriers pushed by their own negative experience are starting to realize that this is a very volatile exposure which needs to be controlled and carefully underwritten. Gone are multi-year policies and aggregate reinstatements. Employment
practices liability, at least for US exposed risks, is being written as a separate cover and not simply endorsed onto the D & O policies for virtually no additional premium. The implications associated with providing securities entity cover are also being seriously considered. Premium increases at least on US exposed business have become the norm as underwriters realize that the prestige accounts they were so willing to write at any price can indeed have claims. The increasing claims activity has of course not affected all carriers equally. Many are still somewhat complacent as they have not experienced as much of this activity themselves. It is likely these carriers will receive the rudest wake-up call of them all for failing to heed the warning signs popping up all around them.

1 Business Week Online, 19.03.2001.
2 Wall Street Journal Online, 11.06.2001.
3 Dow Jones Newswire, 08.08.2001.
4 www.calpers-governance.org.
5 Business Week Online, 19.03.2001.
6 Europe’s Shareholders: To the Barricades, Investor Activism Comes of Age; Business Week, 19.03.2001.
8 According to this draft bill shareholders are entitled to compensation in the case of either omitted or untimely or false ad hoc statements by the company that had a negative influence on the trend of exchange rates (§§ 37 b and 37 c WpHG).
11 In Bulgaria, for instance, a Corporate Governance Initiative exists. It is a coalition of Bulgarian non-governmental organizations for facilitating the adoption of relevant corporate governance standards and procedures that would ensure accountability and control in the economy (see Corporate Governance Initiative for Bulgaria: www.csd.bg/cgi/). In Romania a Corporate Governance Initiative for Economic Democracy was established, and Russia issued a Draft Code of Corporate Conduct (see European Corporate Governance Institute: www.ecgi.org/codes/menu_europe.htm).
12 South China Morning Post, 09.04.2001; Scotman, 09.03.2001; Dow Jones International News, 08.03.2001; 26.01.2001.
14 Business Insurance, 15.06.1998.
18 Class Action America.com.
19 According to Foris AG, Berlin, however, in Germany a contrary trend recently became apparent. Efforts to bundle individual interests are undertaken by means of a so called “Klagehäufung” where only one complaint is being filed on behalf of several individuals. These individuals either give one single plaintiff the authority to file suit by assignment (this way only one person is named plaintiff) or are all named as plaintiffs in the proceedings. Every person must agree on equal terms beforehand and it is not possible to become a member of the group after the complaint has been filed.
20 It should be mentioned that at least in Germany there are some firms which are attempting to get around contingency fee rules. They offer to finance lawsuits which they view as having merit in exchange for a share of the award. They are not, however, law firms but rather separate corporations set up for the purpose of financing lawsuits.
21 GeneralCologne Re Loss & Litigation Report “The New Spotlight on Directors & Officers in the EU.”
22 Although one may feel inclined to draw the conclusion that these sectors have the greatest D&O exposure, since the selection of articles we compiled is a non probability sample, this deduction is not legitimate.
23 European Corporate Governance Network: www.ecgn.ulb.ac.be/ecgn/codes.htm (except where noted).
26 GeneralCologne Re Loss & Litigation Report “The New Spotlight on Directors & Officers in the EU.”
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