

D&O and Foreign Subsidiaries

By Priya Cherian Huskins

How to protect the directors and officers of your foreign subsidiaries.



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An ever-growing number of US public and private companies have subsidiaries in jurisdictions outside of the United States.

These foreign subsidiaries have their own directors and officers who need to be protected from suits brought against them, especially given that the severity and frequency of lawsuits against directors and officers has increased in a number of jurisdictions around the world.

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

- Tax violations. In October 2007, Brazilian authorities raided the office of a subsidiary of a large US technology company and arrested a number of employees in connection with an alleged tax avoidance scheme.
- Corruption charges. Of the 500,000 bribery cases investigated in China over the last 10 years, 64 percent involved non-Chinese companies.
- Supervisory liability. After an employee of a large US technology company was tragically murdered by a car service driver, the employee's family sued the subsidiary's managing director.

Attempts to have this case dismissed have failed, even though the driver was not an employee of the subsidiary. The driver was instead the employee of an independent company engaged by the subsidiary.

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

D&O liability

In the face of these litigation threats, it is disquieting to realize that many non-US regimes do not provide the comfort of the well-tested protections enjoyed by US directors and officers when it comes to the advancement of legal fees and indemnification. To the contrary, in many non-US jurisdictions, officers and directors accused of wrong-doing may not be able legally to obtain the advancement of legal fees. This may be the case no matter how willing to advance legal fees and well-capitalized the parent company might be. France, for example, is one such jurisdiction. And consider Russia, a jurisdiction where the law is silent on the concept of the advancement of legal fees, and the practice seems not to have been tested before a court of law.

Certainly a well-written US D&O policy will state that it is written on a world-wide basis and that it is intended to cover all directors and officers of the foreign subsidiaries of

the parent company. The problem is that the mere stating of this intention in the D&O insurance policy contract does not necessarily mean that the US policy is in compliance with the local laws of the specific foreign jurisdictions where the policy is intended to apply.

In the last few years, more and more foreign governments have become increasingly demanding and sophisticated in their oversight of insurance-related compliance in their own jurisdictions. This includes imposing rules that are specific to their jurisdictions. A driver for this increase in insurance regulation and the scrutiny of insurance is the revenue opportunity associated with premium taxes; that is, taxes imposed on the premium paid for an insurance policy covering risk in the local jurisdiction. Companies that fail to adhere to these rules run the risk of not being able to access their D&O insurance when it is needed in these non-US jurisdictions. Non-complying insurers run the risk of fines, penalties and/or the revocation of their corporate business license.

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

1. Scope the potential risk faced by directors and officers in non-US jurisdictions;
2. Calibrate the ability of a parent company in the US to support

directors and officers facing prosecution; and

3. Identify the local requirements with respect to using insurance to protect local directors and officers.

Scoping the potential risk

As a first step to scoping the risk, a company must decide which countries to analyze. This is easier when a company has only a few subsidiaries; such a company will likely decide to analyze all the countries where the company has any exposure. More difficult are the decisions for companies that have a large number of subsidiaries. Given the complexity of the analysis that the risk management department is proposing to undertake, these companies will likely choose a subset of subsidiaries when initially approaching the issue.

Common elements for this decision making process include data such as total revenue, employee count, strategic importance to the parent company, and cultural norms for legal compliance in the country in question.

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

Ability to support local directors and officers

Many foreign jurisdictions have legal regimes that are far less

officer and director-friendly than the US. In these jurisdictions, the willingness of a parent company to use its available cash to support local directors and officers may not be relevant. It may well be the case that the only party legally permitted to advance legal fees is an insurance company (through an insurance policy). The right way to handle this issue is to conduct a legal analysis that considers on a country-by-country basis what is and is not allowed when it comes to advancing legal fees to and indemnifying local directors and officers.

Some companies will decide to place local D&O insurance only in jurisdictions where the parent company cannot reliably advance legal fees and indemnify.

The result of the country-by-country analysis may be the realization that certain steps must be taken in order to accommodate local rules regarding the advancement of legal fees and indemnification. These steps might include processes such as modifying local charter documents or the execution of indemnification letters.

Clarifying local insurance requirements

Some companies will decide to place local D&O insurance only in jurisdictions where the parent company cannot reliably advance legal fees and indemnify. Others will take a broader approach in order to provide some protection to their balance sheet against the possibility of needing to make indemnification payments to directors and officers. In either case, a country-by-country analysis is required to ensure that

D&O insurance will indeed respond when needed. The issues include answering questions like:

- Do local insurance regulators require that the policy be issued by a locally admitted insurance company?
- Do local insurance regulators require the use of a local broker to place the insurance?

The penalties for ignoring these questions range from minimal to serious. For example, in Brazil,

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

Avoiding foot faults—and more treacherous missteps—when it comes to protecting directors and officers of foreign jurisdictions is possible, but only when companies take a systematic approach to mitigating the risks.

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