Session n°3

N.43137

R.41760

AEAI/RIMS Conference

THE RISK MANAGEMENT FORUM

"Cross Border D&O: It's a Mad, Mad, Mad World"

11 October 1993

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Introduction [Slide 1]

Good Morning . . . . .

The legal environment and subsequent litigation noted in America and Europe by our previous speakers is not confined solely to the Western hemisphere. In fact, D&O related activity is beginning to surface in what was heretofore a relatively benign legal climate, namely the Pacific Rim.

My principal discussion will focus on Japan and Australia, since these countries represent the greatest activity both in terms of court decisions, macroeconomic events and regulatory trends. I will also provide brief observations on recent events in China, Hong Kong and Taiwan.

Japan - First, I will examine:

1. The background and history of Japanese D&O;

2. Provide some observations on the Japanese Commercial Code;

3. Examine major sources of liability for Japanese multinationals . . . and companies indigenous to Japan;

4. Provide a vision of the future by examining specific trends.

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Australia - will be the second point of discussion and will feature:

1. Specifics of a recently completed D&O survey;

2. Significant court decisions;

3. Observations on recent legal reform and;

4. Outlook on the current state of this market.

I will close my comments with a discussion on current events in the marketplace and program design considerations.

Service [Slide 2]

To set the proper stage on "Serving" which I have adapted for directorships, let me paraphrase former U.S. President Richard M. Nixon:

> No man is truly whole until he has served a cause greater than himself.

For those of you who remember America's Watergate Scandal, several members of this administration . . . . which equate to a Board of Directors of sorts . . . . were reluctantly asked to continue service in a U.S. prison. So much for America's gracious hospitality.

It is indeed a mad, mad, mad world!

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Japan Background [Slide 3]

D&O insurance is a relatively new phenomenon having been introduced in the fall of 1990. While much has changed recently, it's initial introduction was a commercial flop! That is, acceptability was nonexistent and little activity was reported until almost 2 years later.

How could this be? Japan is one of the world's largest industrialized nations.

First, Japan's legal environment is very unique. It is difficult to commence litigation due to the prohibitive cost of filing suit. Although recent legislative changes have modified this situation, the Nikko Securities derivative lawsuit would have cost over 2 million U.S. dollars to pursue. Furthermore, the Japanese attorney or "bengoshi" is simply outnumbered by his Western counterparts. There are more attorneys in virtually any major U.S. city than in the totality of Japan . . . . the ratio of attorneys in the United States to Japan is a staggering 60 to 1!

Second, the cross shareholding structure of many of Japan's public corporations also tends to mitigate lawsuits. In a recent commentary on Japanese investments, the *New York Times* cited that over 70 percent of the shares of corporate Japan are owned by other Japanese companies.

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In addition, shareholders rights from a Western perspective are virtually nonexistent. Consider for example, that annual meetings for shareholders are convened on the same day for approximately 2,000 Japanese companies. This precludes attendance for those investors even with the swiftest of feet and certainly for those who own shares in more than one company.

Finally, much has been written about the Japanese consensus for decision making. The homogeneity of its people . . . . its non-confrontational style . . . does not lend itself to litigation.

The Commercial Code [Slide 4]

Despite a generous legal climate favoring D's & O's, there is a body of law, codified under the Japanese Commercial Code, which outlines sources of legal liability. Generally speaking, D's & O's of Japanese organizations are obligated to be 'faithful' and avoid conflict of interests. If D's & O's have breached any of their professional duties, liability can be both joint and several. It is interesting to note that certain of these liabilities cannot be released without the unanimous consent of **All Shareholders**. While this condition in theory is rather draconian, in practice we Americans say "The bark is worse than the bite," since it is seldom ever exercised.

D's & O's can also be guilty of gross negligence in performance of their duties to third-parties with similar repercussions as noted earlier. Typical actions tend to be rooted in creditor complaints.

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Finally, the Code allows shareholders to seek derivative actions on behalf of the company. Although this course action has always been available to shareholders, it only gained impetus with recent reform measures backed by the Ministry of Justice that reduced the cost of filing suit to 100 U.S. dollars; . . . . expanded access to confidential financial documents for shareholders with at least 3 percent interest and; . . . . increased the number of auditors present on the Board.

Shareholders' Actions [Slide 5]

What are the likely sources of liability for companies operating within Japan? Let us revisit some of the particulars of the Wyatt Survey. Shareholder lawsuits comprise 52 percent of all actions in America. While there is no comparable research in Japan, we can identify specific areas of potential or actual shareholder actions to predict exposure to loss. One source of litigation is direct shareholder suits. Many foreign multinationals seek direct access to foreign financial markets by listing stock. In the U.S., this is facilitated by the issuance of American Depository Receipts or ADRs. For the Japanese concern, an ADR listing is tantamount to public ownership in America with all the attendant advantages & disadvantages.

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American courts can proceed with the extradition of a lawsuit where the conduct of the Ds & Os have had a detrimental effect within the U.S. This is known as the "Effects Test."

A recent example of extradition involved Sony Entertainment and numerous foreign affiliates of Sony Corporation. The plaintiff brought suit against both the U.S. concern and each foreign affiliate for infringing on a copyright. Sony argued to dismiss the affiliates from the suit on the grounds that they had no U.S. interests. The judge ruled in favor of the plaintiff, thereby allowing extradition of the suit and including each affiliate as a defendant.

A second exposure is where shareholder derivative actions are brought on the corporation's behalf against the Ds & Os of the organization. Perhaps the most prominent example is the current derivative suit against 16 Nikko Securities Ds & Os seeking approximately 400 million U.S. dollars. This suit has been followed by a similar action against Nomura Securities.

Finally, North American pension funds purchased a net 4.9 billion U. S. dollars of Japanese equities in 1992. Ownership often yields control and in a recent precedent, Nomura Capital complied with a request from Calpers, the California pension fund, to appoint an outside director.

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Employment Actions [Slide 6]

The Wyatt Survey noted employment actions as the second largest source of liability in the U.S., but this is likely to be mirrored throughout the rest of the world. The global recession and the need to be competitive in all markets has forced all companies, despite boundaries, to do more with less people.

In Japan, a landmark suit was filed and won by a woman plaintiff for sexual harassment. The International Labor Office, a U.N. affiliate, recently published a lengthy report based upon surveys in 23 countries. Over 82 percent of respondents in Japan experienced 'Seku Hara', a statistic which should not be lost on those risk managers whose companies hire foreign nationals. In Australia, sexual harassment comprised 36 percent of total discrimination filings; over 84 percent of Spanish women experienced some form of harassment and in the U.K.; 47 percent of women and . . . . . somewhat ironically, 14 percent of men experienced some form of harassment. I suspect the latter has something to do with the English's sense of fair play.

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It is worthwhile noting that 8 countries have enacted legislation prohibiting sexual harassment, including Australia, Belgium, Canada, France, New Zealand, Spain, Sweden and the U.S.

The legacy of lifetime employment in Japan is now a thing of the past. Japanese society was shocked when NTT, the giant telecommunications concern, announced it would be shrinking payroll by 30,000 employees over the next three years. In a recent survey of Japanese executives, 86 percent indicated that lifetime employment would disappear and that pay scales based on merit would be adopted.

[Slide 7] "The Second Wave" or a type of unemployment Tsunami hit Japan last month when several multinationals announced continued cutbacks in employment.

[Slide 6] Although this discussion has principally focused on employment liabilities in Japan, it is equally worthwhile to analyze this same exposure in those countries that have enacted employment legislation. Japanese companies in particular have not fared well in the U.S. in part due to cultural differences and in part due to corporate practices. The list of transgressors is a virtual "Who's Who" of Corporate Japan -- Sumitomo, stung twice by class action labor lawsuits; Honda for Department of Labor discriminatory violations; Matsushita & Itoh Chu for sexual discrimination.

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Government Actions [Slide 8]

Foreign multinationals need to be ever vigilant to the changing political climate in any country.

Since the Clinton Administration took office in January 1993, the Japanese have been much more aggressive in enforcing compliance related offenses. Japanese officials have charged the foreign unit of Medtronic with bribery; the Fair Trade Commission has filed complaints against four large printing concerns alleging bid rigging; and recently, the senior executives of Shimizu Construction have been arrested on allegations of bribery. Although for the most part, the law had been available as a recourse against these activities, compliance only recently surfaced to ensure foreign firms were competing on a 'level playing field'.

Similar transgressions have occurred cross border and, in the U.S., several Japanese companies like Honda have been fined or are under investigation by the government for allegations ranging from bribery to fraudulent securities actions.

Competitor Actions [Slide 9]

Competitor actions represented only 6 percent of all D&O claims in the U.S. However, for many foreign high technology companies, it represented the single largest source of loss. Honeywell settled two large patent suits with Minolta Camera and a consortium of mostly Japanese camera manufacturers for a 127.5 million and 124 million U.S. dollars respectively. In Japan, IBM also filed suit against Kyocera for patent infringement.

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The size of these awards would be significant losses to any company's net worth. Furthermore, losses of this magnitude often result in additional litigation involving Ds & Os . . . . for example, employment actions through layoffs and, in some cases, fines and penalties by regulatory authorities.

Competitor actions can also be less direct in action, but equally devastating. In 1992, the Los Angeles County Transit Commission rescinded a contract award previously granted to a foreign multinational to build light rail cars for its subway system. This resulted in lost business of 120 million U.S. dollars, as well as significant acquisition costs.

D & O Trends in Japan [Slide 10]

The previously enumerated liability sources all serve to underscore D&O trends for those companies operating in Japan. First, shareholder activism has been introduced. These changes, coupled with recent stock divestitures of the Keiretsu, will continue to erode management defenses. Second, the Japanese banking industry has been crippled by the speculative real estate boom of the eighties. Major stock analysts have estimated loan losses from these activities ranging from 150 to 230 billion U.S. dollars. With banks significantly curtailing lending and corporate profits down, corporate boards need to brace for litigation from angry shareholders, employees and creditors.

The third fundamental trend occurring in Japan is the abolition of lifetime employment.

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The final trend is the impact of several macroeconomic variables converging in Japan. The yen valuation vis a vis the U.S. dollar has impacted both exports (reduced profits) and those companies attempting to enter Japan. Trade tensions, most notably depicted in Japan's recent trade surplus of over 100 billion U.S. dollars, will force regulators to aggressively enforce compliance measures. The 'Bubble' economy that fueled Japan's growth in the eighties will continue to have dislocations. The tragedies will likely be manifested in bankruptcies, of which there were over 1,400 in 1992; continued layoffs and; increased litigation.

Australia - The D&O Setting [Slide 11]

The Australians certainly are not to be upstaged by their neighbors to the North. The background of what is occurring in Australia can best be summarized by some of the salient findings in the BIS Shrapnel survey. The survey recorded responses from 38 percent of Australia's top 1,000 revenue earning companies and indicated that 22 percent were without cover; 1 of 10 companies responding to the survey experienced a claim during the past two years . . . .with two claims exceeding 50 million Australian dollars. Ds & Os viewed regulatory actions, i.e., by the Australian Securities Commission, or Trade Practices Commission, as the biggest sources of potential litigation. This is in marked contrast to results published in America by the Wyatt Company. One interesting difference between D&O insurance in Australia and other parts of the world is the requirement that Ds & Os pay for premium.

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Compass Airlines [Slide 12]

The most significant D&O court case in Australia was Carden v. C.E. Heath, otherwise known as the Compass Airlines decision. The decision, which favored the directors of now defunct Compass Airlines, essentially relieved the directors of their duty of disclosure on the grounds that subject directors were in essence 'beneficiaries' to the contract, not 'parties to'. If this decision is allowed to stand, there will be major repercussions in the D&O market and those of you doing business in Australia. The disclosure issue will require all Ds & Os to **individually** file/sign applications which will result in increased administration, ... increased costs . . . . and increased premiums. Terms and conditions will retract and only preferred risks will likely find a market. Furthermore, given the similarity between D&O and professional indemnity, there could be a ripple effect within this line of business.

Significant Court Decisions [Slide 13]

In Morley v. Statewide Tobacco, emphasis was placed on family directors who abrogated responsibilities due to their passive roles. This case sends a warning to directors who ignore their duties.

Commonwealth Bank's notoriety is simply the size of the judgement. The court ruled in favor of the plaintiff and awarded judgement totalling a staggering 96.7 million Australian dollars. Despite what might appear to be a negative trend towards Ds & Os in Australia, the AWA decision demonstrated that a successful defense can be developed where the proper level of care is exercised.

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Reform [Slide 14]

The recent claims activity in Australia has prompted a reexamination of the Corporations Act, which is the law governing the various duties of Ds & Os. In February 1992, the Australian Attorney General proposed a number of reforms that would: 1) increase the duties of directors on a level comparable to the U.S.; 2) exclude directors from meetings where there is a conflict of interest; 3) require increased disclosure of Ds or Os where there is a conflict of interest and; 4) provide civil penalties up to 200,000 U.S. dollars on a reduced burden of proof.

Although Japan and Australia are the two largest areas of D&O activity in the Pacific Rim, it is beneficial to provide a few observations on other emerging countries.

HONG KONG [Slide 15]

At common law, directors owe general fiduciary duties and a duty of skill and care to the company. Interestingly, the Hong Kong ordinance was drafted from the Companies Act of 1985 of the United Kingdom, but heretofore has not been amended to specifically permit the companies' purchase of insurance for its Ds & Os. Furthermore, the failure for Hong Kong authorities to amend legislation technically poses an interesting question -- is D&O insurance legal?

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Absent of any formal amendment, a few suggestions are in order. First, insurance should be considered in a manner which does the least to offend the local law. A holding company purchases a master global contract from its country of origin with local indemnification provisions. Second. . . . amend the local articles of incorporation to allow insurance and finally . . . . have shareholders ratify the amendment.

Despite the uncertainty surrounding the legality of D&O cover, its need is apparent as evidenced by the recent Chintung Futures case. Chintung Futures opened an account on margin with little investigation of a Thai investor. Heavy trading on this account resulted in the liquidation of the company. The court found Chintung and its owner/director negligent for the amount of debt owed to creditors, 83.9 million Hong Kong dollars.

CHINA [Slide 16]

The conversion of China from a communist to quasi-capitalist society is evident by the significant economic growth of this region. In June of this year, angry investors cried foul over the loss of one billion yuan for the collapse of the Great Wall Corporation. Great Wall floated a junk bond offering yields of 24 percent. Government intervention is the only recourse to investors who will never realize full return of their principal investment. Although D&O cover does not yet exist in China on an admitted basis, the indictments against both executives and public officials, could very well change this situation.

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TAIWAN [Slide 16]

Like China, Taiwan has no admitted market for D&O cover. However, exposure to this region of the world is beginning to increase with indictments against executives in several well publicized court cases. Among these are: 1) the Halliburton scandal, which involves allegations of profiteering and forgery against 7 executives; and 2) the Formosan Rubber Stock manipulator scheme that has resulted in a 360 million U.S. dollar loss and indictments against several executives.

The legal climate clearly indicates that others will seek retribution from executives in cases of wrongdoing. Risk Managers should also take note that Taiwan has historically been a country where intellectual property piracy is considered the norm. The International Intellectual Property Alliance estimates that piracy cost U.S. companies 669 million U.S. dollars in 1992. If we consider this offense with the successful judgements rendered worldwide, we can foresee a huge potential exposure for those high-tech companies employing foreign nationals indoctrinated to local practice.

Let us now turn to market issues in the Pacific Rim.

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[Slide 17] The Japanese Market

As most of you are painfully aware, many of the covers are regulated in Japan by the Ministry of Finance (MOF). D&O is no exception and after considerable analysis, the MOF approved the AIU policy form in 1990. I would caution any of you who are considering an admitted policy, since there is no flexibility of cover. On the other hand, if you are merely seeking cover to reflect local custom, it may serve you well.

The market is comprised of two U.S. insurers and a host of Japanese insurers. The market leader is AIU which mirrors it position worldwide. Activity is beginning to accelerate as this type of cover is now being successfully marketed to indigenous Japanese companies.

Local capacity is a bit undefined, but tends to hover around 10 million U.S. dollars. Deductibles are modest by American standards. Pricing tends to follow the legal climate and again by American standards, is quite competitive.

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[Slide 17] The Australian Market

D&O is very prevalent in Australia. There are 7 major insurers which include AIG, Chubb, Heath, Pacific Indemnity, FAI, GIO and Zurich. Heath is the market leader. All policy forms are different and an exhaustive review of each is warranted prior to effecting local cover. One interesting feature of the Australian policy is the segregation of premiums for company reimbursement and individual Ds & Os. For those of you who are providing cover on a global, non-admitted basis, be certain you endorse the policy to reflect premium contribution by the individual Ds & Os. Finally, indemnification in Australia is the far from all encompassing. In fact, it is prohibited in those instances where Ds & Os are found negligent in their duties. This raises some interesting questions regarding the advancement of defense, whether by insurer or employer and subsequent findings of negligence.

We began this journey in the United States by outlining sources of liability and noting legal trends. We have developed a similar theme throughout Europe, Latin America and the Pacific Rim. Let me close by providing some suggestions with regard to your current program.

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