

## THE MISMATCH BETWEEN LITIGATION INTENSITY AND D&O PROTECTION IN CROSS-BORDER SECURITIES LAW ENFORCEMENT

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*Cross-border listings of securities can lead to mismatches between the litigation environment in the country in which a company lists its shares and the liability protections available to the directors and officers of the company under its home country law. Depending on the countries involved, the officers and directors of a cross-listing issuer can expose themselves to liability risk that neither their home country nor the country in which they cross-list contemplated. Alternatively, an issuer's officers and directors may be so protected that they circumvent the securities enforcement policy of the country in which they cross-list. Using a simple two-by-two matrix, this paper offers a conceptual framework that can be used to identify and unpack the consequences of these mismatches. It then concludes with some suggestions for how countries can redress the issues of inadequate protection and circumvention that arise from the cross-border listings of securities.*

### A. INTRODUCTION

International borders are increasingly porous when it comes to capital investment. One example of this is the prevalence of companies' listing their securities on foreign exchanges. For example, as of the end of 2007, there were 708 non-UK companies from 67 foreign jurisdictions listed on the Main Board and AIM of the London Stock Exchange.<sup>1</sup> There were 1058 non-US companies from 52 jurisdictions registered with the US Securities and Exchange Commission (SEC).<sup>2</sup>

These listings raise potential liability concerns that have gone largely unrecognized. Cross-border listings can lead to mismatches between the

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<sup>1</sup> Statistical Database Relevant to International Financial Reporting (Deloitte Touche Tohmatsu, 2009), available at <http://www.iasplus.com/stats/stats.htm>.

<sup>2</sup> *Ibid.*

litigation environment in the country in which a company lists its shares and the liability protections available to the directors and officers of the company under its home country law. Depending on the countries involved, the officers and directors of a cross-listing issuer can expose themselves to liability risk that neither their home country nor the country in which they cross-list contemplated. Alternatively, an issuer's officers and directors may be so protected that they circumvent the securities enforcement policy of the country in which they cross-list.

Using a simple two-by-two matrix, this paper offers a conceptual framework that can be used to identify and unpack the consequences of these mismatches. It then concludes with some modest suggestions for how countries can redress the issues of circumvention and inadequate protection that arise from the cross-border listings of securities. These proposals include disclosure, coordinated monitoring, and allowing directors and officers to enjoy enhanced levels of protection extra-territorially where such enhanced protections are needed to avoid a mismatch with a host country's levels of litigation.

## 1. Conceptual Overview

A country's securities law enforcement regime is a function of litigation intensity<sup>3</sup> and the level of protection from personal liability that the country's laws allow. In general, countries that expose issuers of securities to high litigation intensity couple that exposure with a high level of personal protection for issuers' directors and officers. The opposite tends to be the case for countries with low levels of litigation intensity. Cross-border listings can, however, disrupt this balanced relationship.

The link between litigation intensity and the level of personal protection available to directors and officers is not coincidental; there are important functional relationships between the two sides of a securities enforcement regime.<sup>4</sup> Personal protections are justified because they serve to protect innocent parties from misapplied legal sanctions. The availability of high levels of personal protection in a high litigation intensity environment likely reflects at least in part an acknowledgement that the enforcement activity in this environment—especially where there are high levels of private enforcement—may target both wrongdoers and innocent parties. By contrast, the paucity of personal protections in a low litigation intensity environment likely reflects a belief that the enforcement activity in this environment is accurately targeted

<sup>3</sup> When discussing high levels of litigation intensity, I am assuming that the litigation is either high in frequency or costly, or both, either at the level of each individual piece of litigation or in the aggregate.

<sup>4</sup> See BS Black, BR Cheffins and MD Klausner, "Liability Risk for Outside Directors: a Cross-Border Analysis" (2005) 11 *European Financial Management* 153, 155.

against wrongdoers, exactly the people that public policy would want to be exposed to legal sanctions.

That link between litigation intensity and available personal protections can break down when a company engages in cross-border listings of its securities. When a company lists its securities abroad, its directors and officers will be subject to the litigation environment of the country in which its shares are listed (the “host” country) and the protection regime of the country in which the company is headquartered (the “home” country). To the extent that a host country’s securities law enforcement regime provides for a low volume of (ideally) well-targeted enforcement actions—an approach associated with countries that primarily rely on public enforcement—the host country’s securities law regime may be undermined. Conversely, to the extent that a home country provides low personal protection while the host country’s enforcement regime casts a wide net around potential violators and forces many issuers to litigate—an approach associated with high levels of private enforcement, especially in the US—directors and officers will be subject to litigation costs and liability risk that they should not bear and that are not borne by domestic officers and directors. As a result, a high litigation country will not receive all the cross-border listings that it would otherwise attract—a result that is detrimental to the host country, the home country and the company that would otherwise list in the host country.

Fig 1 presents securities law enforcement regimes as a function of levels of litigation intensity and available personal protections. I refer to countries with high volume enforcement litigation as “high litigation” countries, and countries

		<u>Litigation</u>	
		High	Low
<u>Protection</u>	High	United States	Potential Circumvention
	Low	Inadequate Protection	China Singapore South Korea

*Fig 1* Securities Law Enforcement Regimes

with low volume enforcement as “low litigation” countries. Countries with laws that provide for high levels of protection for officers and directors are referred to as having “high personal protection”, and countries without such protections are referred to as having “low personal protection”. The figure illustrates matches and mismatches between levels of litigation and levels of protection. The US is the best example of a high litigation intensity/high personal protection securities law enforcement regime (upper left quadrant). China, Singapore and South Korea are examples of historically low litigation/low personal protection securities law enforcement regimes (lower right quadrant).

The upper right and lower left quadrants of Fig 1 reflect potentially problematic cross-border securities listings. The upper right quadrant shows a company from a high protection country, like the US, listing in a country with low levels of litigation. In this situation, to the extent that the host country’s own securities enforcement regime contemplates low levels of protection, the host country’s securities enforcement regime can be circumvented.<sup>5</sup> The lower left quadrant reflects the situation of a company from a low personal protection regime listing in a high litigation regime like the US. In this situation, the directors and the officers of the cross-listing company will not have adequate protection to cope with the host country’s enforcement regime.

## **B. HIGH LITIGATION INTENSITY/HIGH PROTECTION**

The US has a long history of active public and private enforcement of securities laws. The US’s system of securities law enforcement combines high litigation intensity, especially in the realm of private enforcement, with high levels of personal protection afforded to individual directors and officers of publicly listed companies, especially with respect to private enforcement.

### **1. Securities Law Enforcement in a High Litigation Country**

The primary focus of securities law enforcement for a public company in the US is the prohibition against material misstatements or material omissions in the dissemination of information to the public. The primary controlling laws are section 10(b) of the Securities Exchange Act of 1934 and section 11 of the

<sup>5</sup> I do not discuss cross-border listings by companies from high personal protection home countries into low litigation/high protection host countries because they are not problematic. They are not problematic because there is a match between the level of personal protection available in the home country and the host country. An example of this situation would be a listing by a US company in the UK. In such a situation, there is no circumvention of the host country’s securities law enforcement regime because there is no mismatch between the level of protection offered in the home and the host countries.

Securities Act of 1933. These laws allow for both public and private enforcement.

*(a) Public Enforcement*

The main source of public enforcement activity in the US is the Securities and Exchange Commission (SEC). The SEC, a civil agency, has the authority to investigate all violations of federal securities law, ranging from insider trading to massive disclosure fraud. Subjects of SEC investigations rarely litigate an enforcement matter to its conclusion. Instead, they typically reach a negotiated settlement with the SEC. The SEC has the authority to order the disgorgement of ill-gotten gains, monetary penalties, the freezing of assets and a bar on a defendant's being a director or officer of a public company in the future.

Criminal prosecution for securities law violations is less common than SEC enforcement. The Department of Justice, which can initiate a case on its own or after referral from the SEC, prosecutes only the most egregious violations of the securities laws. The Department of Justice can seek monetary fines or jail sentences, which can extend up to 20 years.

*(b) Private Enforcement*

Private securities litigation is justified in the US to bolster public enforcement. The law allows private plaintiffs to bring suits to recover losses suffered as a result of material misstatements and omissions. The defendants in these suits include directors and officers of a company alleged to have violated the law, as well as the company itself. These cases are typically brought as class action lawsuits.

This supplemental enforcement is useful because of the inherent limitations to a public enforcement system. The SEC's budget will always be limited and therefore not finely tuned to enforcement needs at any particular time. The SEC's budgetary limits are particularly problematic in the US, where corporate and individual defendants possess the resources<sup>6</sup> to hire expensive defence attorneys. These attorneys are able to mount vigorous defences to which the SEC must devote substantial resources in response. In addition, governmental enforcement priorities can shift over time. Consequently, there may be times when securities law enforcement is not a top priority and private enforcement is needed to fill the gap. Finally, there is the issue of corruption, or at least capture of a regulator by the constituency the regulator is supposed to regulate. While the US has not seen a case of blatant corruption within the SEC, inappropriate influence is always a danger in a public agency. Certainly the spectre of capture

<sup>6</sup> See below for a discussion of contractual rights to the advancement of legal fees, a key mechanism that allows defendants who are not extremely wealthy to nevertheless expend millions of dollars in legal fees on their defence.

has been raised on occasions when someone other than the SEC has been the first to bring major securities violations to light.<sup>7</sup>

Notwithstanding the positive aspects of the private enforcement system, there are drawbacks. One problem with private enforcement is its inaccuracy. The private enforcement regime generates a large number of non-meritorious, even frivolous, suits against companies, directors and officers.<sup>8</sup> The problem of non-meritorious suits stems from another problem inherent in these suits: the “collusive” settlement.

The problem of collusive settlements has been discussed frequently in the academic literature.<sup>9</sup> It arises as a result of the fact that all parties at the settlement table are agents, not principals. The officers and directors who have been sued are the agents, formally for the corporation but functionally for the corporation’s shareholders. These officers and directors can be motivated to settle even non-meritorious cases. First, the officers and directors who are named in the suit face the possibility of financial ruin if they lose a suit. Secondly, even if they are confident that they can win, they face years of arduous litigation. Thirdly, as will be discussed below, the rules governing indemnification and director and officer liability insurance (D&O insurance) make litigating a case through trial far more risky to directors and officers personally than settling a case. In addition, aside from the personal interests of the directors and officers, settling a non-meritorious suit can be less costly to the corporation than litigating a case through trial.

On the other side of the table sits not the actual individual plaintiff class members but rather the lawyer for the plaintiff class, who is of course an agent of the class members. Notwithstanding this lawyer’s fiduciary responsibility to the class, the class lawyer will naturally be motivated to settle cases in a manner that maximises his economic best interest. The class lawyer typically gets between 25 and 33% of any amount the plaintiffs receive.<sup>10</sup> While he may get more in the aggregate if he wins an amount at trial that is greater than what he receives from an early settlement, litigation through trial is expensive, the

<sup>7</sup> See, eg M Bullard, “Madoff Scandal: Who Was Really Asleep at the Switch?” *Morningstar*, 18 June 2009, available at <http://news.morningstar.com/articlenet/article.aspx?id=295708> (noting that “[t]he SEC has spent several decades helping brokers [whom it regulates] avoid regulation . . .”).

<sup>8</sup> See, eg CF Baum, JG Bohn and A Chakraborty, “Securities Fraud Class Actions and Corporate Governance: New Evidence on the Role of Merit”, Working Paper, Boston College, April 2007, available at [http://escholarship.bc.edu/cgi/viewcontent.cgi?article=1425&context=econ\\_papers](http://escholarship.bc.edu/cgi/viewcontent.cgi?article=1425&context=econ_papers); SJ Choi, KK Nelson and AC Pritchard, “The Screening Effect of the PSLRA” (2009) 6 *Journal of Empirical Legal Studies* 35; MF Johnson, KK Nelson and AC Pritchard, “Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act” (2007) 23 *Journal of Law Economics and Organization* 627.

<sup>9</sup> See, eg T Baker and SJ Griffith, “How the Merits Matter: D&O Insurance and Securities Settlements” (2009) 157 *University of Pennsylvania Law Review* 755.

<sup>10</sup> T Eisenberg, GP Miller and MA Perino, “A New Look at Judicial Impact: Attorneys’ Fees in Securities Class Actions after *Goldberger v Integrated Resources, Inc.*” (2009) 29 *Washington University Journal of Law and Policy* (forthcoming).

outcome is uncertain and the plaintiffs' lawyer must pay his own litigation costs along the way (whether he wins or loses). The class lawyer will therefore be inclined to accept a settlement. The availability of compensation for bringing even non-meritorious suits of course creates incentives for the plaintiffs to bring cases where the merits are questionable.

Given the dynamics at work on both the defendant and the plaintiff sides of the table, it is no surprise that almost no private securities enforcement cases go to trial.<sup>11</sup> The average settlement for the 10 year period between 1999 and 2008 was \$34.8 million. The median settlement for the same period was \$5.8 million.<sup>12</sup> Over this same period, 194 (or 21%) of the total 943 settlements made (to date) were \$2 million or less, a level that is often assumed to reflect a non-meritorious case.

## **2. Protections for Directors and Officers in a High Personal Protection Jurisdiction**

The high risk of being subject to non-meritorious suits coupled with potential for financial ruin in private class actions requires a high level of protection for directors and officers. First, there is a belief in the US that without high levels of personal protections it will be difficult for corporations to retain the best possible officers and directors. Moreover, in the US there is a cultural belief in the right to a vigorous defence to any kind of government enforcement action, a belief that is enshrined in the US Constitution with respect to criminal matters.<sup>13</sup> Consequently, the US's regime of securities law enforcement is characterised by broad access to personal protections such as the advancement of legal fees, indemnification, and director and officer liability insurance. These protections are authorised by law in each of the 50 states, and companies make them available to directors and officers to the full extent permitted by law as a matter of routine practice.

### *(a) Advancement of Legal Fees*

In the US, corporations are allowed to advance legal fees to their directors and officers prior to a final adjudication of the merits in litigation brought against them.<sup>14</sup> This is permitted in the event of both public and private litigation. In both cases the advances must be returned if there is a finding of intentional wrongdoing on the part of the defendant in a final adjudication. These advances, however, can be unsecured and interest free, and made without regard to the

<sup>11</sup> See BS Black, BR Cheffins MD Klausner, "Outside Director Liability" (2006) 58 *Stanford Law Review* 1055, 1146 (finding that between 1980 and 2005 only 25 private securities law enforcement cases went to trial).

<sup>12</sup> Woodruff-Sawyer & Co Director and Officer Liability Database (Databox).

<sup>13</sup> United States Constitution, Sixth Amendment of the Bill of Rights.

<sup>14</sup> See, eg Delaware General Corporation Law § 145(e); California Corporations Code § 317.

alleged conduct of the director or officer in question. Advances can, and typically are, made with nothing more than the bare promise that the officer or director in question will return the money if he is found liable for intentional misconduct in a final adjudication. It is common for directors and officers to enter into arrangements with their companies whereby the company will be obligated to make these types of advancements (as opposed to leaving the matter of whether to advance legal fees to the discretion of the company).

As a practical matter, it is rare for directors and officers to be required to return sums that were advanced to them in order to pay for their legal defence. As discussed above, the vast majority of securities suits—public and private—against directors and officers in the US settle before reaching a final adjudication following trial. These settlements typically involve no admission of wrong-doing, and thus do not trigger an obligation on the part of the settling directors and officers to return the legal fees advanced to them. Certainly the threat of losing at trial, and consequently having to repay advanced legal fees to the corporation, is a powerful motivation, among others, for defendants to settle claims before trial.

*(b) Indemnification*

In the US, corporations are allowed to indemnify their officers and directors for costs associated with private litigation, including private suits for securities law violations.<sup>15</sup> Indemnifiable costs include litigation expenses, settlement payments, and in some cases payments pursuant to judgments that do not involve the finding of any intentional wrongdoing. Similar to the advancement of legal fees, the risk of losing at trial carries with it the risk of losing the right to indemnification. Just as in the case of the advancement of legal fees, this risk provides defendants with a powerful motivation to settle before a court concludes in a final adjudication that there was an act of intentional wrongdoing. Since the vast majority of suits against directors and officers in the US settle before reaching trial, it is a rare situation that directors and officers are not indemnified (so long as their company is solvent).

Indemnification in the case of public enforcement is more restricted because, unlike the case of private litigation, directors and officers may not be indemnified by their corporations for any settlements, fines or judgments that result from public enforcement actions. This public policy position is intended to force bad actors to bear the cost of their misconduct. However, directors and officers may be indemnified for litigation expenses they incur in defending themselves against an SEC enforcement action—even if the action results in their paying a fine or penalty.

<sup>15</sup> See, eg Delaware General Corporation Law § 145(a);(b); California Corporations Code § 317(b), (c).

*(c) D&O Insurance*

Finally, corporations are allowed to purchase D&O insurance for their directors and officers.<sup>16</sup> The D&O insurance policy can advance (and reimburse) legal fees to directors and officers in the case of both public and private enforcement. In the case of private enforcement, the D&O insurance policy can also pay settlements. The insurance policy will not cover settlements with the SEC, however. The SEC requires that parties with whom it settles pay the cost of the settlement, or endure litigation to trial. In the cases both of public and private enforcement, a final adjudication of intentional wrongdoing will cause the insured directors and officers to lose the benefit of the D&O insurance policy and require that they return any advanced legal fees to the insurance carriers.

The combination of expansive rights to the advancement of legal fees and indemnification with the availability of strong protection from D&O insurance makes the US a high personal protection environment. As illustrated by the upper left quadrant of the securities law enforcement regime diagram (Fig 1), this high level of personal protection complements the high litigation levels found in the US.

### C. LOW LITIGATION INTENSITY/LOW PERSONAL PROTECTION

The securities law enforcement regime illustrated by the lower right quadrant of Fig 1 is that of a low litigation intensity/low personal protection environment. An example of a low litigation intensity country historically has been the People's Republic of China (PRC). Notwithstanding having a public securities market and securities laws on the books, there do not seem to be many public or private securities law enforcement actions in the PRC. Contributing to this low level of litigation against publicly traded companies in the PRC might be the fact that the government owns a large stake in many such companies. In addition, the PRC judicial system either does not contemplate or at least discourages class action suits. Moreover, there is no tradition of contingent fee litigation, a mechanism that fuels private enforcement. Consequently, the enforcement activity that exists tends to be public enforcement activity.

Given the low levels of enforcement activity, it is unsurprising that the PRC is also a low personal protection regime. This might reflect faith in the meritorious nature of public enforcement and comfort with the low to almost non-existent levels of private enforcement. With respect to the advancement of legal fees and indemnification, the law is silent; there is no authorisation or prohibition. In practice, there have been efforts to include indemnification provisions in articles

<sup>16</sup> See, eg Delaware General Corporation Law § 145(g); California Corporations Code § 317(i).

of association or in personal contracts, but it is unclear whether such efforts would ultimately be effective.<sup>17</sup>

The PRC is not the only low litigation/low personal protection regime where the advancement of legal fees is unavailable. Another example of a low litigation/low personal protection regime is Singapore. Singapore prohibits the advancement of legal fees before a final adjudication of innocence.<sup>18</sup> There is nothing in the law that would indicate that a waiver of this rule is available for litigation outside Singapore.

South Korea is another example of a low litigation/low personal protection regime. Focusing on indemnification, South Korea is a jurisdiction where this critical personal protection is all but unavailable.<sup>19</sup> This is because indemnification is only allowed if agreed to by all shareholders unanimously.<sup>20</sup> As a practical matter, such a unanimous consent would be unobtainable for a publicly listed company.

Difficulties in obtaining broadly protective D&O insurance are also a feature of a low protection level environment. For example, a PRC company may purchase D&O insurance so long as the purchase is approved at the shareholder's general meeting.<sup>21</sup> Both in the PRC and in Korea, a company's D&O insurance policy must be issued on a local basis.<sup>22</sup> This usually means that the policy may not be as comprehensive as policies that are created in jurisdictions that have a lot of experience with securities enforcement litigation. The result is likely to be a weak D&O insurance policy replete with exclusions that lead to little or no insurance coverage for directors and officers.<sup>23</sup>

Low personal protection regimes are similar to high protection regimes insofar as neither indemnification nor D&O insurance is permitted to pay settlements, fines and penalties that result from public enforcement actions. A country's decision to make reimbursement unavailable for public enforcement action settlements, fines and penalties is consistent with a belief in the public enforcement mechanism's ability to pursue appropriate, meritorious enforcement activities (and refrain from pursuing unmeritorious ones).

In sum, there are two key differences between low personal protection regimes like the PRC and high personal protection regimes like the US. First, in

<sup>17</sup> D&O Foreign Exposure, Indemnification and Insurance Database, Woodruff-Sawyer & Co, 2009.

<sup>18</sup> Singapore Companies Act, ch 50, s 172.

<sup>19</sup> D&O Foreign Exposure, Indemnification and Insurance Database, Woodruff-Sawyer & Co, 2009.

<sup>20</sup> Korea Commercial Code, Art 400.

<sup>21</sup> Code of Corporate Governance for Companies Listed in China, ch 3(2)/(39) (issued by the China Securities Regulatory Commission).

<sup>22</sup> The D&O Foreign Exposure, Indemnification and Insurance Database, Woodruff-Sawyer & Co, 2009.

<sup>23</sup> An example of a problematic exclusion is the following: "Such insurance shall not cover the liabilities arising in connection with directors' violation of laws, regulations or the company's articles of association" (*ibid*).

public enforcement actions, high personal protection regimes allow directors and officers to have someone else—be it their company or their D&O insurance carrier—advance legal fees. Secondly, in private enforcement actions, high personal protection regimes allow for the advancement of legal fees, indemnification of litigation expenses after the fact and indemnification for settlements as well as for judgments that do not reflect intentional misconduct.

#### **D. BREAKDOWN IN THE LOGIC OF A LOW LITIGATION/LOW PERSONAL PROTECTION REGIME: CROSS-BORDER LISTING FROM A HIGH PROTECTION JURISDICTION**

As discussed in sections B and C, the securities law enforcement regimes illustrated by the upper left and lower right quadrants of Fig 1 are not problematic because they match complementary levels of litigation and personal protection for directors and officers. Cross-border listings can, however, lead to the mismatches represented by the upper right and lower left quadrants.

The upper right quadrant describes companies incorporated in high protection countries that list securities in countries with low litigation intensity. The result of this combination is a bifurcated regime in the host country: one for domestic directors and officers, and another for directors and officers who hail from foreign, high protection countries. Since the host country's securities law regime contemplated a relatively low level of personal protections and foreign directors and officers have access to higher levels of protection, these foreign directors and officers have effectively circumvented the logic of host country's securities law regime. Compared to their domestic counterparts, the foreign directors and officers will likely be better able to avoid exposure to legal sanctions and may well be less compliant with the host country's securities laws.

##### **1. Applicability of Host Country Securities Enforcement Regime**

Take, for example, a US company listing its securities in a low litigation intensity/low personal protection jurisdiction. By listing their company's securities in the host country, the directors and officers of the US company effectively agree to respond in the host country's courts to suits brought to enforce the host country's securities laws, be it through public or private enforcement.

##### **2. Availability of Home Country Protections**

When the host country's securities law enforcement regime is a low litigation/low personal protection one, the ability of an individual to access higher levels of protection may result in a circumvention of the regime's intention to expose

enforcement targets to legal sanctions. In the example of a US company listing its securities in a low litigation/low personal protection jurisdiction, the US company's directors and officers can be covered by the higher levels of protection available in the US. The US company can provide this protection by giving officers and directors based in the host country advancement and indemnification commitments and insurance payable in the US, their home country. Consequently, the US company is able to circumvent the host jurisdiction's low litigation intensity/low personal protection securities enforcement regime. Indeed, notwithstanding the fact that protection against SEC enforcement is limited in the US, the US company could even protect directors and officers living outside of the host country from enforcement by the host country's securities enforcement agency, so long as the host country's enforcement agency is unable to tell that payments are being made to directors and officers outside of the host country. This ability of a foreign issuer to circumvent a host country's enforcement regime both undermines that country's enforcement efforts and creates an unfair difference between the exposure of some foreign issuers' directors and officers and the directors and officers of local issuers.

*(a) Advancement of Legal Fees*

US directors and officers typically have personal indemnification contracts that include rights to the advancement of legal fees. Some of these agreements contemplate the need to provide for the advancement of legal fees to foreign-based directors and officers notwithstanding a host country's disallowing these protections domestically. In order to avoid violating the host country's laws, these agreements can provide for direct payments of legal fees to law firms—as opposed to giving the money directly to the accused director—so that there is never a “technical” advancement to an officer or director. Alternatively, there is also always the possibility of bonus or other “true-up” payments that essentially serve to offset incurred out-of-pocket costs. This route is a particularly easy one for a corporation to take if the host country's laws do not require disclosure of the compensation received by the director or officer in question. Finally, if a director or officer has a bank account outside of the jurisdictional reach of the host country, it is all the easier for his company to make payments to him in contravention of host country rules. Given that advancements are allowed in the US, it is likely that the US company would regard such payments as normal business payments. Given its cultural expectations, it might not even occur to the US company that it is engaged in an intentional circumvention of the host country's rules.

*(b) Indemnification*

Indemnification that may be prohibited in the host jurisdiction can be similarly handled in a contract with the director or officer in question executed in the

home country. Indeed, if the directors and officers were to sue to enforce a company's indemnification obligations in their home country, the fact that indemnification is prohibited in the host jurisdiction is unlikely to matter. The home country court, in this example a US court, would look to its own law, where indemnification is enforceable.<sup>24</sup> In addition, just as with the advancement of legal fees, making bonus compensation payments to the director or officer in question is simple to do and difficult to detect in the absence of required compensation disclosure. Finally, if a director or officer has a bank account that is not located within the jurisdictional reach of the host country, making payments to a director or officer in contravention of the host country's rules is easy. Once more, it is likely that the US company would regard such payments as normal business payments rather than an intentional circumvention of the host country's rules.

*(c) D&O Insurance*

D&O insurance is another source of protection for directors and officers from high protection countries. It may, however, be one of the few places where the host country can enforce the integrity of its low litigation/low personal protection regime to some extent. In the example of the US company listing its securities outside of the US, it is likely that the US company's D&O insurance policy is intended, by its contractual terms, to cover directors and officers on a worldwide basis. The intention of an insurance contract formed in a home country to respond to claims based on enforcement actions in another country, however, is not necessarily controlling.

Each country has its own insurance regulations. These regulations may prohibit an insurance policy from covering a claim based on a host country's enforcement action if the policy was brokered in a way that failed to comply with the host country's rules and regulations. These regulations often include insurance carrier licensing requirements, taxation protocols and even a requirement to use a local insurance broker to place the insurance. To the extent that a host country is able to monitor and stop the influx of large sums of cash into its borders, the host country can stop the proceeds of a foreign, non-compliant insurance policy from entering the host country. This effectively forestalls the circumvention of a host country's local insurance laws to the extent that cash is needed within the host country, for example to post bail for a jailed officer or director.

However, the host country may not be able to stop insurance from responding outside of its borders, for example by reimbursing a parent company that has

<sup>24</sup> This is clearly true in the US. Whether it is true in other countries allowing high protection would be a matter for the home country's conflict of laws rules.

every intention of reimbursing its director or officer for having to make any personal payments. Even though the host country may seek to prohibit such payments, as a practical matter enforcement is difficult because of the host country's inability to discern that such payments are being made in the home country. This concern might be mitigated, however, if the insurance carrier writing the insurance in the home country seeks also to write insurance policies in the host country. In such cases, the host country may have somewhat more leverage over the insurance company to make it refrain from making extra-territorial payments to reimburse losses incurred in the host country. It should be noted, however, that the host country would not know that it needs to assert this leverage if it were unaware of the extra-territorial payments.

Thus, circumvention is a problem for a low litigation/low personal protection host country that allows a company from a higher protection country to list its securities on the host country's exchange. The host country's low litigation/low personal protection securities law enforcement regime will be circumvented because the directors and officers from the high litigation/high protection home country will be able to benefit from the higher levels of protection available to them back home.

#### **E. BREAKDOWN OF THE LOGIC OF THE HIGH LITIGATION/HIGH PERSONAL PROTECTION REGIME: CROSS-BORDER ISSUERS FROM LOW PERSONAL PROTECTION JURISDICTIONS**

The combination of high litigation intensity and low personal protection—illustrated by the lower left quadrant of Fig 1—also leads to unfortunate consequences, especially for directors and officers of cross-listing firms. The problem in this scenario is that the host country's enforcement regime will impose excessive costs on the directors and officers of the foreign issuer—costs that it does not impose on the directors and officers of domestic corporations. This will deter at least some foreign firms from issuing securities in the host country.<sup>25</sup>

By listing in a high litigation jurisdiction, such as the US, foreign issuers agree to submit themselves to the jurisdiction of the courts in that country. As a result, they are subject to the same enforcement mechanisms that apply to domestic issuers. This means that their directors and officers are subject to the hazards of this high litigation regime. In the US, this means exposure to the risk of non-meritorious class actions in addition to enforcement actions by the SEC.

<sup>25</sup> For those firms that do issue securities, it will induce excessive caution among directors and officers.

Unlike home country issuers in the high litigation jurisdiction, the foreign issuer will have lower levels of protection because its home country's low litigation regime normally will not authorise these protections to the same extent to which they are authorised in the US. Thus, the foreign directors and officers are unlikely to have as broad commitments from their company to advance legal fees or to indemnify them against litigation expenses, settlement payments or damage payments. They are also unlikely to be covered by a D&O insurance policy that is as protective as the ones offered domestically to US companies. In the absence of a frothy, US-style litigation environment, the local D&O insurance market will lag in developing US-style levels of protection.<sup>26</sup>

*(a) Advancement of Legal Fees*

If prohibited under the laws of the home country, even a highly capitalised, wealthy company could not advance legal fees to its directors and officers who are sued in a class action in the US. These directors would have to pay for their defence out of their own pockets. Although they may be reimbursed after they are found innocent (provided the home country rules allow for this), the cost of mounting a vigorous legal defence in the US can present a cash-flow problem for even very wealthy individuals. If a company is knowledgeable about this issue, it could purchase a US-style D&O insurance policy at the time the company lists in the US. This purchase would be with the expectation that the policy would advance legal fees if the home country would not allow the company to do so. If the D&O insurance policy were placed by an unsophisticated insurance broker and consequently failed to perform when needed, the directors and officers would be faced with the terrible choice of either personally settling the litigation or personally funding their defence through trial in the hopes that, after a finding of innocence, their company could reimburse them for their expenses.

*(b) Indemnification*

Given the high rates of non-meritorious private securities litigation against companies listed in the US, the directors and officers of US-listed companies put themselves at tremendous personal financial risk if their home country limits indemnification or makes it altogether unavailable. Once more, if a company is knowledgeable about this issue, it could purchase a US-style D&O insurance policy in the hope that it would respond where the company could not.

<sup>26</sup> One solution would be for the company listing in a high litigation environment to purchase a D&O insurance policy from a skilled broker working in the high litigation environment. This practical solution is often overlooked in part because the company in the low litigation environment may not realise that its home country D&O insurance policy is inadequate. A reason why this solution may be intentionally ignored is the fact that the D&O insurance policy from the high litigation environment will likely be more costly than the D&O policy the company from the low litigation environment is used to purchasing.

(c) *D&O Insurance*

As in the US, the corporate law of most non-US jurisdictions allows companies to purchase D&O insurance for their directors and officers. However, the insurance regulations in a number of jurisdictions require that the D&O insurance policy be placed by a local broker and with a locally licensed insurance carrier. Because the D&O market is just developing in these countries, it is entirely possible that these directors and officers will have a D&O insurance policy that provides little protection compared to a policy negotiated and brokered in a market like the US where lawyers and brokers have extensive experience with the terms of D&O policies and the application of those terms in a variety of factual settings.

The failure to have a broadly protective D&O insurance policy is catastrophic where a non-US director of a company listed in the US is from a jurisdiction with narrow or non-existent rights to the advancement of legal fees and indemnification. It results in the directors and officers of the non-US company potentially paying both to defend themselves and to settle the case against themselves when they are sued in the US for alleged violations of securities laws.

The likely result of the threat of being exposed to these potentially personally bankrupting possibilities will be a decreased interest by issuers from low protection countries in listing in high litigation intensity countries. This is detrimental to the company for at least three reasons. First, the company presumably sees a cross-border listing as an attractive source of capital. Secondly, the company may see cross-border listing as a way to create additional liquidity for their securities. Thirdly, the company may see a cross-border listing as a way to commit to better corporate governance where the host country's corporate and securities law regime is better than that of the home country.<sup>27</sup> The loss of the cross-border listing opportunity is also detrimental to the home country because its companies lose the opportunity to obtain financing and to commit to enhancing their governance. Finally, the loss of the listing opportunity is detrimental to the economy of the would-be host country, which loses the financial, legal and accounting business activity associated with a listing.

## F. PROPOSALS TO ADDRESS THE MISMATCH PROBLEM

### 1. Proposals to Address the Circumvention Problem

In order to ensure that directors and officers of foreign issuers from high protection regimes are exposed to sanctions in the same way their domestic

<sup>27</sup> See, eg JC Coffee Jr, "Racing Towards the Top? The Impact of Cross-listings and Stock Market Competition on International Corporate Governance" (2002) 102 *Columbia Law Review* 1757.

counterparts are, a host country might consider ways to forestall the ability of foreign directors and officers to access higher levels of personal protection. For example, the government might require that any settlements include a contractual obligation on the part of both the individual defendants and the foreign issuer to refrain from allowing the foreign issuer to indemnify an individual in a manner that is broader than what local law would allow. Clearly, the efficacy of such a proposal would be dependent on the host country's ability to enforce such a provision and would likely require some level of cooperation from the home country's securities enforcement authorities.

For example, consider the situation in which a host country is attempting to force an individual bad actor personally to bear the cost of a fine, penalty or disgorgement payment. This kind of payment is intended to be punitive and to discourage future bad acts. In most cases, however, a foreign issuer has the ability to circumvent a host country's prohibition on indemnification merely by labelling reimbursement payments made to the officer or director as something other than indemnification. As a consequence, the threat of a host country penalty will carry less deterrent effect since potential bad actors know that they will suffer no loss. Instead, they will be reimbursed by the company that benefited from their bad acts.

The only way to address this issue may be through good monitoring by regulators and perhaps international cooperation treaties. Also, to the extent that local rules require—or evolve to require—itemised disclosure of compensation payments made to directors and officers, it will be more difficult for directors and officers to receive large indemnification payments under the guise of ordinary compensation.

## **2. Proposal to Address the Overexposure to Personal Risk Problem**

Recognising the benefits of their home companies' listing abroad, home countries should consider ways to provide personal protection for their home country directors and officers when they are exposed to an extra-territorial, high litigation environment. The easiest way to do this would be to permit such directors and officers to enjoy the same personal protections as those of the host country. The home country could limit these expanded protections to litigation matters taking place abroad. This would allow the home country to maintain its own low litigation/low personal protection securities law enforcement regime while at the same time protecting its home company directors and officers from unnecessary levels of personal risk when listing their securities abroad.

Another alternative, of course, is for a low personal protection regime to modify its laws to become a high protection regime. To the extent that a low litigation intensity regime becomes, over time, a higher litigation intensity

regime, a related evolution to a higher level of personal protection may well be the natural result.<sup>28</sup>

### G. CONCLUSION

Using the example of the US as a high litigation intensity/high personal protection regime, this paper examined how cross-border listings of securities can lead to a mismatch between the litigation intensity level within the host country and the levels of personal protection available to directors and officers of the issuer. Specifically, a host country's securities law enforcement regime may be circumvented when a low litigation/low personal protection country allows an issuer from a high protection country to list its securities on an exchange within the host country's borders. Conversely, when an issuer from a low personal protection regime lists its securities on an exchange located within a high litigation/high protection securities law enforcement regime, consequences that are unfavourable to individual directors and officers may result. These issues should be addressed, in the first instance, to the extent that a low litigation/low personal protection country wants to avoid allowing foreign issuers to circumvent its securities law enforcement regime. They should also be addressed to the extent that a low litigation/low personal protection home country recognises the benefits of encouraging its companies to list abroad, including in jurisdictions like the US that have high litigation enforcement regimes.

<sup>28</sup> Consider, by analogy, what happened in Japan with respect to derivative suits. Statutory reforms in 1993 led to a pronounced increase in derivative of litigation. After a few high-profile suits led to out-of-pocket payments by directors, the legislature responded by increasing the level of personal protection available to directors. See BR Cheffins and BS Black, "Outside Director Liability across Countries" (2006) 84 *Texas Law Review* 1385, 1457-61. Japan is not the only example: *ibid.*, 1459 (discussing patterns of increased liability followed by statutory reforms that result in a "liability chill"). Although the Japan example provided here is not specifically related to securities law enforcement, the relevant concept is that of a low litigation regime transforming itself into a high litigation regime followed in short order by statutory reforms to provide for high levels of personal protection.