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SEDGWICK, DETERT, MORAN & ARNOLD

Directors, Officers and Managers Liability

The Legal Position in Switzerland

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DIRECTORS, OFFICERS AND MANAGERS LIABILITY IN SWITZERLAND

In the past few years the frequency and severity of claims against directors and officers of Swiss financial institutions and commercial enterprises has risen dramatically. Gone are the days when outraged shareholders, incensed fellow Board members or managers, or frustrated government officials quietly accept the company's fate.

In its place is a new attitude which seeks to pressure embattled directors and managers into resigning or paying compensation by filing criminal complaints, openly declaring war in the press, and threatening or actually suing in the civil courts. One only needs to review the press from recent years to see how this changing mentality has befallen such stalwarts of the Swiss economy as its largest bank or the national airline. If directors and managers of those companies can be targets, it can happen to anyone.

1. Structure of Swiss Corporate Entities

By far the most common form of for-profit legal entity in Switzerland is the stock corporation. While the Code of Obligations also permits the establishment of limited liability companies, cooperatives, and partnerships limited by shares, as well as more traditional forms of partnerships, the relative simplicity and flexibility of the Swiss stock corporation has traditionally made it the most popular vehicle for doing business in Switzerland. This might be contrasted with Germany, for example, where the limited liability company ("GmbH") form is far more common.

The Swiss stock corporation has a single-tier Board structure. With a minimum legal share capital of only CHF 100,000 it is a suitable form for the smallest to the largest companies. Unlike other European jurisdictions, it should be noted that there is no minimum threshold shareholding for a shareholder to make a claim against the company or its directors and officers.

2. Definitions of Directors and Officers :

Swiss company law recognizes three basic bodies governing a corporation: the general meeting of shareholders, the board of directors, and the external auditor. Subject to that caveat, in this paper, the English word "director" will be equated with the members of the board of directors of a Swiss company.

a. Board Members (Directors)

Directors are those persons who are elected by a meeting of the shareholders and registered as such in most cases with the Commercial Register where the company is domiciled. The majority of the directors must be Swiss nationals and residents.

b. "De Facto" Directors

A "de facto" director is one who, without formal election to directorship by the shareholders, in fact participates in or influences corporate governance. Such persons face the same liability as an elected director under Swiss company law. The test is the extent of actual control exercised over the company by the person in question. For example, the Swiss Federal Court held three representatives of a bank liable as "de facto" directors when they participated regularly in the board meetings together with the sole elected director and where the bank had a financing and share purchase contract with the company. BGE 107 I 349 (1981).

c. Management (Managing Directors, Officers)

In addition to directors, liability can attach under Swiss company law to persons who in any way exercise managerial responsibility and are empowered to do so by the articles of association, internal regulations or as a matter of fact ("officers" herein). Those persons with single signature authority registered in the Commercial Register and who are typically identified as members of senior management will normally be "officers".

Whether other managerial employees are "officers" depends on the individual case; there is no clear delineation. The test is the extent of participation in corporate decision-making. Officers are generally liable only for acts or omissions within the scope of their authority.

3. Legal Basis of Directors, Officers and Managers Liabilities in Switzerland:

a. Nondelegable Duties of the Board

The following basic duties of the board of directors cannot be delegated:

- Overall management and instruction

- Establishing the corporate organisation
- Structuring the accounting system
- Financial planning and control
- Selecting and supervising management
- Preparing the annual report
- Conducting annual shareholder meetings
- Implementing shareholder resolutions
- Equal treatment of shareholders
- Reporting insolvency to the court

Otherwise, company management may be delegated to executive directors and officers.

b. General Duties of Directors and Officers

Directors and officers must exercise due care. This means that they must: (1) act within their authority, (2) possess sufficient knowledge and ability to perform their function, (3) retain expert help if and as necessary, and (4) act as a prudent businessperson. They owe a duty of loyalty to the company, which means they must safeguard corporate interests and business secrets, act in good faith, and avoid conflicts of interest with the company. It is not a defense if the director undertakes by agreement to strictly follow the instructions of the sole or majority shareholder (so-called "fiduciary" directors). The burden of proof is generally with the claimant. In case a duty was delegated, however, the director has the burden of proving that the selection, instruction, and supervision of the delegee was performed with appropriate care.

c. Liability under Company Law

Liability can attach under company law for "indirect" damage to shareholders and company creditors through the impairment of the company's financial position. Article 754 of the Swiss Code of Obligations makes directors liable to the company, shareholders and creditors for

damage suffered by the company due to a violation of the director's duty to manage the company honestly, diligently and with due care.

- ◆ An action for damages is available at any time to the company and to any shareholder (though only for payment to the corporation, similar to a common law "derivative" action). The shareholders may vote at the general meeting for the appointment of a "special auditor" to investigate the facts regarding a situation implicating the potential liability of directors. Such an appointment most recently occurred at the SAirGroup annual meeting with respect to billions in losses reported in the 2000 group accounts.
- ◆ Minority shareholders may also apply to the court for the appointment of such a special auditor.
- ◆ Creditors can only claim against D&Os if and when the company has become insolvent and is declared bankrupt. An action is filed on behalf of all the creditors by the liquidator.
- ◆ If the liquidator declines to sue, individual creditors can apply to proceed against the D&Os at their own expense, with any recovery being used to satisfy their claims first.
- ◆ Liability is based on fault. However, where there has been a permissible delegation of duties, fault will be presumed, and the defendants must exculpate themselves. Previous law also made all of the directors jointly and severally liable. The 1992 company law revisions require Swiss courts to apportion liability according to each D&O's percentage of fault and as the circumstances may warrant. In other words, a comparative fault principle applies. Courts have applied this new rule to banks, even though joint and several under Banking Act Article 44 was not similarly revised.

d. Prospectus Liability

Liability attaches to any person who participates in the deliberate or negligent provision of false, misleading or incomplete information during the incorporation of a company or the issuance of shares, bonds or other securities that are accompanied by a prospectus. Liability can also apply if share subscriptions are taken from insolvent persons or contributions in kind to the share

capital are overvalued. Liability is joint and several to the direct purchaser of the securities. Prospectus liability only applies at the time that securities are issued as opposed to any time the shares are publicly traded, so securities “stock drop” claims of the kind regularly seen in the United States are rather infrequent in Switzerland. The recent IPO wave and subsequent failures of some of the “New Market” companies may change matters, however.

e. Liability for Tortious Acts

Directors and officers are liable under Civil Code Art. 55 for the direct damages caused by their tortious acts even if the act is committed within the scope of company's business or in the company's best interest. In such cases, liability to the damaged party is joint and several with the company, which is vicariously liable if the act was committed within the course and scope of employment. As a practical matter, claimants typically sue only the company in such cases.

f. Contractual Liability

If a director or officer expressly or implicitly concludes a contract on behalf of the company, the director or officer is not personally bound by the contract. Personal liability could arise in cases where a director fails to indicate that he or she is acting for the company, if this is not apparent from the circumstances.

g. Statutory Violations

Aside from the criminal law, there are any number of Swiss civil statutes which impose direct liability on directors and officers. The most important of these are as follows:

- Banking laws and regulations
- Health and safety legislation
- Data protection laws
- Bankruptcy code
- Taxes and social security

- Environmental liability laws

There is also significant overlap between criminal and civil law violations. In Switzerland, D&O claims often involve criminal complaints or investigations against the directors or officers. Note that some criminalized activities, such as insider trading, have no counterpart in Swiss civil law.

Criminal violations of the money laundering statute have led to civil claims by aggrieved parties against D&Os, but it is uncertain whether such civil claims may be legally made.

4. Is there an equivalent to the US business judgement rule?

There is no direct equivalent to the US business judgement rule in terms of a specific shield against liability. Swiss law requires a breach of the duty of care to be demonstrated by the claimant and that the D&O's conduct fell below the level required as set forth earlier. The courts will however generally recognize that due care encompasses discretion by management and will not second-guess business decisions that simply go wrong.

5. Who can sue: typical claimants and claim scenarios:

a. Company Claims

The company may claim against directors or officers through the board or directors. If the board refuses to do so, the shareholders can resolve to appoint a special representative to pursue the claim. In practice, such a claim by a solvent company against its D&Os has been unusual in Switzerland. This tradition appears to be falling by the wayside.

As noted above, shareholders may vote for the appointment of a "special auditor" to investigate certain facts to enable them to determine whether to pursue claims. A minority shareholder also has the right to apply to a court for the appointment of such an auditor.

Depending on its outcome, a special audit may be the prelude to a claim.

Bank Vontobel: The Board summarily fired several D&Os involved in a failed venture to establish an on-line Internet bank, which cost hundreds of millions of francs in write-offs. Neue Zürcher Zeitung, 16.3.2001.

SAirGroup: Following the reporting of some CHF 2.8 billion in losses in the 2000 accounts, shareholders form a special interest group and threaten suit against the D&Os of the airline group arising out of “biggest scandal in Swiss business history.” Sonntags-Zeitung, 11.3.2001.

Kuoni: The company Board attempts to suspend its Chairman from further duties in the wake of a dispute concerning control over the company, the remuneration of certain directors, and transactions between related entities. The Chairman announces to the press that he is the subject of an internal conspiracy. Neue Zürcher Zeitung, 7.5.2001.

b. Liquidators

The liquidator (or trustee in bankruptcy) normally acts for the company in bankruptcy cases. Historically, liquidations have generated the greatest number of as well as the most severe D&O claims in Switzerland.

Spar- und Leihkasse Thun: Liquidator of this failed savings bank sues board members, management and auditors for CHF 50 million for mismanagement. Neue Zürcher Zeitung, 14.9.1995.

Omni Holding: A former board member paid CHF 5 million to settle the liquidator's claim of liability for his breach of care in connection with the CHF 1 billion failure of this financial holding company. Tages-Anzeiger, 9.8.1997.

c. Shareholders

Shareholders may claim against directors for their "direct damage", where an individual shareholder sustained damage himself. For example, a direct purchaser of shares can make a claim under prospectus liability for direct damage.

More common are shareholder claims for "indirect damage" to the company itself. While the shareholder may sue in such a case, an award of damages would be payable to the company. (This is a rough equivalent to common law “derivative” suits.) Moreover, in such a shareholder

suit the court may apportion the attorney's fees and court costs between the company and the shareholder, even if the shareholder loses the case.

It should be noted that the shareholders typically vote at the annual meeting to discharge the board of directors from liability for the previous business year. Any shareholder who votes against such a discharge has six months within which to bring suit against the directors.

Union Bank of Switzerland (BK Vision AG v. Senn):

An investment fund and major shareholder in Union Bank of Switzerland brought a CHF 240 million lawsuit against the entire board for allegedly failing to intervene in illegal dealings in the bank's own shares. The shareholder alleged that the bank bought votes to manipulate the outcome of a shareholder's meeting which altered the share structure of the bank to the detriment of the claimant shareholder. Neue Zürcher Zeitung, 27.9.1995. Biber Holding: A shareholder group called SIS sue the former head of this bankrupt company for alleged mismanagement and misinformation in an amount reported to be between CHF 5 - 20 million. Tages-Anzeiger, 24.6.1998.

d. Creditors

A creditor may sue at any time for "direct damage", where an individual creditor (as opposed to the company itself) has sustained a loss. Creditors may also sue for a violation of a statute intended to protect creditors.

As noted above, creditors cannot make a claim for "indirect damage" if the company is solvent. In case of bankruptcy, a creditor may claim for such damages only if the liquidator declines to do so. If successful, the creditors who sue recover first, followed by the shareholders and the estate.

Though shareholder actions are rather infrequent, creditor claims against the directors of an insolvent company are very common and often partly or wholly successful. Even if the real cause of the insolvency is a criminal act or error of judgment by a junior employee, it can be difficult for the directors to prove a lack of fault on their part.

Trans-K-B: According to the press, the board members of this bankrupt investment and asset management company settled a CHF 15 million creditors claim for CHF 4.5 million, part of which was paid for by insurance. Politik und Wirtschaft, No. 3, 1988.

e. Third Parties

Customers, employees, and other tort claimants fall within the group of potential plaintiffs bringing tort claims. The most common kind of claim is probably for bodily injury where the company is vicariously liable for acts committed in the course and scope of employment. Claims by investors where a bank or other financial institution has also been involved in some fashion are also quite common in Switzerland and often include claims against management.

JP Morgan: Aggrieved customers of two Swiss investment companies called Gefipro and Norit lost CHF 100 million in a "house of cards" and filed criminal complaints against various persons, including managers of the Zurich branch of JP Morgan. After six years of investigation in Geneva, the criminal investigation against the bank managers was dropped on statute of limitations grounds; thereafter a civil claim against the bank was filed. Sonntags-Zeitung, 4.2.2001.

f. Government Authorities

Government regulators may be empowered to claim against the directors of companies. Tax and social security statutes usually provide specifically for a direct liability of the directors (together with the company) for any unpaid taxes or contributions. Such liability often arises in the case of an insolvent company, and the authorities will normally pursue the directors for unpaid amounts.

Criminal penalties are also levied against directors in cases of fraud (cf. "wrongful trading"). Government regulators also wield great power in terms of withdrawing banking and other licenses as well as forcing closure of companies where in the public interest.

Saseq: A former Saseq board member is sentenced in 1995 to six years' imprisonment for criminal acts leading to the collapse of this Geneva finance

company. The bankruptcy resulted in losses of CHF 900 million. See *Neue Zürcher Zeitung*, 31.10.1998.

Cantonal Bank of Solothurn: Following a very exhaustive, five-year criminal investigation of eight accused former D&Os of this failed bank, which included some 15,000 pages of interrogation of 54 persons by the authorities, charges of fraud were brought against only one of the eight accused. *Neue Zürcher Zeitung*, 22.2.2000.

Bank Globo: The Federal Banking Commission withdrew this bank's license due to violation of capital requirements as well as organizational and management deficiencies. The FBC imposed involuntary liquidation proceedings on the bank, which had lost money in real estate investments in Germany. *Ausserschwyzer Zeitung*, 21.12.1998.

Bank Rinderknecht: Another case in which the Federal Banking Commission withdrew the banking license and forced a liquidation or sale of this family-controlled institution, here based on perceived management problems involving substantial losses in derivative instruments. *Neue Zürcher Zeitung*, 29.8.1997.

g. Foreign "Adventures"

A frequent area of D&O claims arises where a company expands its business through acquisition or the establishment of subsidiaries and branches abroad, or else has extensive dealings in foreign markets (e.g. a listing on a foreign stock exchange).

The dangers include a lack of awareness of local law, customs and even language, the inability to adequately control affairs from abroad, and legal standards which make Board members jointly and severally liable for mismanagement and in particular insolvency of the company.

The rules pertaining to the sale and trading of the company's shares on foreign stock exchanges, especially in the United States, are far-reaching and complex. In the United States, for example, it is the norm that D&Os are sued in securities litigation brought by investors. So when a Swiss

company is listed on a US exchange, whether under an ADR program or otherwise, its exposure to these types of claims rises dramatically.

Even outside of the US, so-called “outside” directorships can also lead to unexpected liability in a foreign jurisdiction. It is often the case that managers are required as part of their employment to take seats on the Board’s of their employers’ business partners. Not uncommonly, when financial trouble strikes that foreign partner, the directors become the targets of claims by shareholders, creditors and liquidators.

6. Statute of limitations

The statute of limitations under Swiss law can vary considerably. The general rule as to shareholder actions is 5 years. There is a special 6-month provision for shareholders seeking to challenge the discharge of directors at the annual shareholders meeting.

The general limitations period for contract claims is 10 years.. To the limited extent that Swiss law recognizes discrimination, harassment, or wrongful termination claims in the employment relationship, these would generally fall within the 5-year employment contract limitations period.

The statute of limitations for torts is one year.

Tax laws vary from Canton to Canton; generally, the limitations period in tax matters is 5 years.

7. What is the Enforceability of a Foreign Judgment on Swiss Directors, Officers and Managers under Swiss Law?

Switzerland is a signatory to the Lugano Convention and accordingly judgements rendered in signatory states (e.g. the EU) may be readily enforced according to the terms of the Convention. With respect to non-signatory nations, Switzerland generally provides for enforcement pursuant to its Act on Private International Law.

8. Can the Directors, Officers and Managers be Liable for Punitive Damages Under Swiss and are Punitive Damages Insurable Under Swiss Law?

Punitive damages are not known under Swiss law. There is no precedent regarding insurability of punitive damages, but such damages are generally considered insurable. By contrast, the

punitive damages portion of a foreign judgement is generally considered unenforceable in Switzerland as their imposition is considered to violate Swiss public policy (“ordre public”).

9. Can the Company Indemnify its Directors, Officers and Managers Under Swiss law and Under Which Conditions?

The conditions in which the company may indemnify its D&Os is not addressed by statute. There is limited legal commentary and no leading case or other precedent on the subject. The commentators suggest that indemnification is impermissible in respect to claims brought by shareholders, although providing a defence may be allowed as long as the claim is unsuccessful. The scope of indemnification may also be affected by the terms of the articles of incorporation or by (e.g. employment) contract.

10. Is Directors, Officers and Managers Liability Insurance Legal?

Legal commentators generally consider D&O insurance legal. This form of insurance has become widespread and an accepted form of insurance. The premium for the cover is usually paid by the company. There is no insurance permitted by law for wilful or intentional acts.

11. General Comments

Since approximately the mid-1990s, and certainly inspired by the enormous interest in the BK Vision v. UBS shareholder suit both domestically and abroad, the Swiss D&O insurance market has been flourishing.

What is interesting about this development is that the explosion has occurred even though there have been no corporate governance initiatives in Switzerland comparable to other European countries (other than the 1992 revisions to company law). Shareholder activism has a surprisingly broad base in Switzerland, ranging from powerful Swiss institutional and private investors (Martin Ebner’s BZ Bank Group) to a new breed of grassroots activists (such as SIS).

What the most recent situations involving major Swiss institutions really drive home, however, is that no Swiss company, no matter how strong and connected it may seem, is immune from the crippling impact of a D&O claim in its own backyard. The more global and connected the world becomes, moreover, the more likely these claims will sprout up against Swiss D&Os in far-ranging, distant places. The only true protection is effective risk management, including

insurance suitable to the needs of the Board members and executive management of the organisation and its subsidiaries worldwide.

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