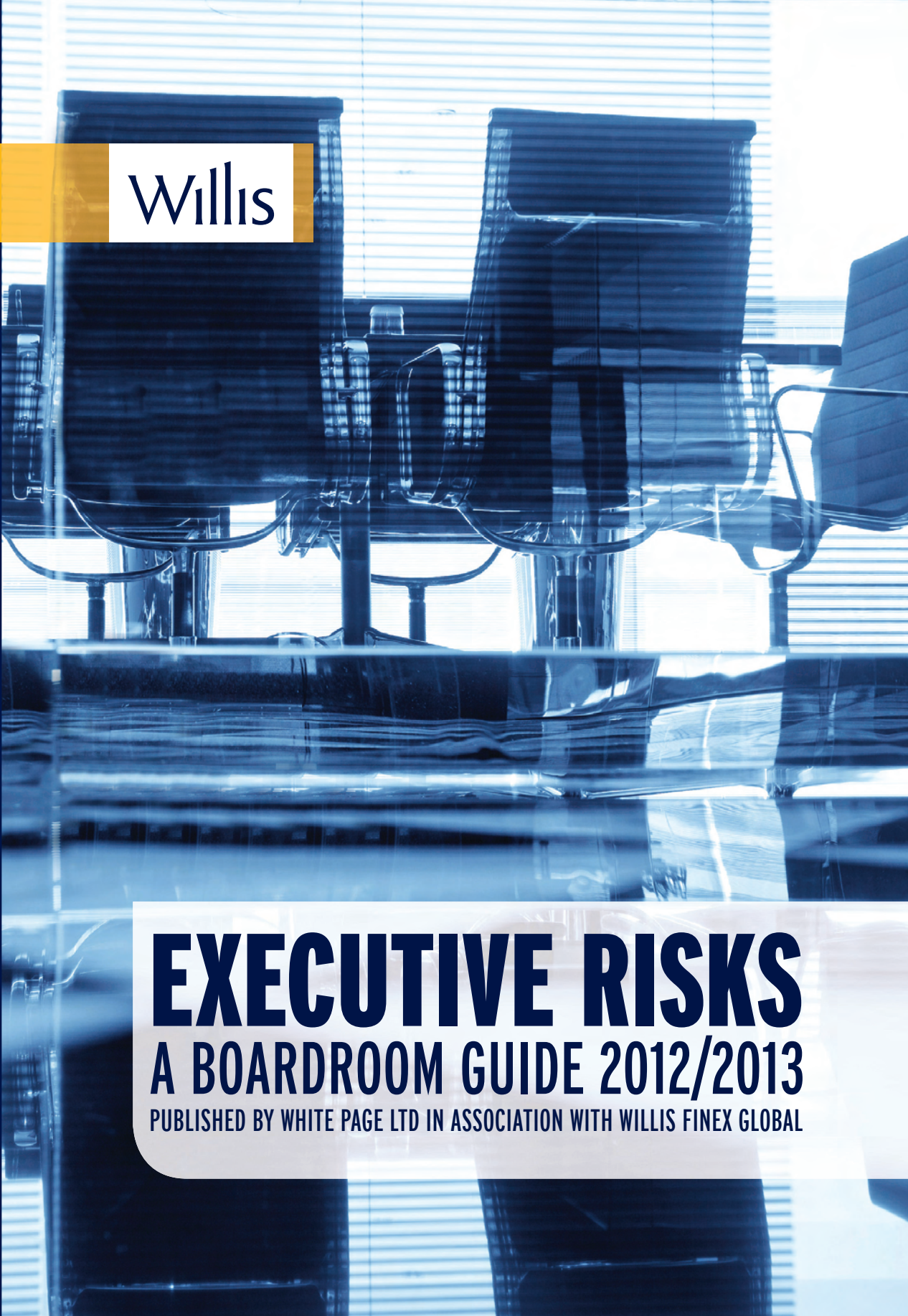

EXECUTIVE RISKS

A BOARDROOM GUIDE 2012/2013

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21
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Rolf Watter, Partner, and
Katja Roth Pellanda,
Senior Associate
Bär & Karrer AG

The basis upon which the personal liability of board directors could be invoked in a Swiss company limited by shares is broad, but court cases outside the bankruptcy of a company are quite rare. Nevertheless, directors' liability has become an increasingly sensitive topic.

Although no legal changes have been introduced yet, the global focus on corporate governance has resulted in more rigorous standards for directors — through, for example, the Corporate Governance Directive issued by the SIX Swiss Exchange and by 'soft law' such as the Swiss Code of Best Practice for Corporate Governance (SCBP), which both increase the risk of claims against directors if they do not live up to those standards. At the same time, the standards provide guidelines that, if followed, reduce the liability risk.

Leadership structure

The board is the executive body of a company and is therefore responsible for its management and representation within the company's purpose clause.

In principle, Swiss corporate law provides for a one-tier board structure. In practice, though, the board has considerable organisational discretion as the law is quite flexible. Depending on the size and the needs of the company, the board may delegate some or most of its duties and powers (save for the non-transferable ones set out below) to one director, to a board committee, to non-members of the board such as a chief executive officer (CEO), or to an executive management team (in banks and insurance companies, directors have to delegate most of their duties to the management). Such delegation requires authorisation by the shareholders in the articles of association and must be specified by the board in organisational regulations.

Thus, it is possible to create a two-tier board structure, which is what listed companies typically do and is something that the SCBP recommends by asking for a majority of non-executive directors.

Nowadays, most boards of large-sized companies have board committees, and the combination of the role of the chairman of the board and the CEO in the same person is disappearing.

The board is authorised by Swiss law to decide on all matters that are not reserved by Swiss law or the articles of association for the shareholders' meeting. The relationship between the shareholders and the board is one of parity rather than hierarchy, as both parties have distinct responsibilities and competences.

The board consists of one or more individuals as directors who do not need to fulfil specific requirements (with the exception of banks and insurance companies, where different rules apply), although at least one director or one

member of the management who is entitled to represent the company must be resident in Switzerland. However, the duty of care and the liability risk indirectly require a board composition that ensures risks will be recognised and wrong business decisions avoided. This, among other things, necessitates a basic understanding of the business among all board members, specific knowledge of certain areas on the part of certain board members, experience and sufficient time. Moreover, it is considered important that the board can maintain a collegial relationship and be able to discuss controversial matters.

Meetings of the board should take place as often as the business requires. As a rule, at least four meetings should be held each year. If fewer meetings take place, the risk exists that a Swiss court might assume the board has not complied with its duties.

Directors' duties

Non-transferable duties of a board

Swiss corporate law provides for the following non-transferable and inalienable duties of a board, which cannot be delegated to management.

1) Strategy

Based on input from management, the directors must develop a business strategy and determine the means to pursue it — for example, the establishment of a long and a medium-term business plan, and the issuance of appropriate directives and instructions. The aim must be to increase the long-term value of the company, considering the interests of shareholders and stakeholders.

2) Determination of the organisation

The board has to decide on the governance structure of the company and of the board itself by enacting organisational regulations. As discussed above, the board may delegate duties to management, appoint committees (such as audit, nomination, compensation and risk committees) and, unless this is reserved for the shareholders' meeting by the articles of association, select a chairman from among its members. If the board chairman and the CEO are identical, the board should, pursuant to the SCBP, provide for adequate control mechanisms — for example, by appointing an experienced non-executive director as lead director with the right to convene on his own and chair meetings of the board when necessary.

3) Structuring of the accounting system, financial controls and planning

This duty covers not only accounting and the preparation of financial statements — where the board retains the ultimate responsibility for determining such areas as the accounting standard and the reporting currency — but also establishing a financial control system that includes the monitoring of the company's liquidity.

4) Appointment, removal and succession planning

This must be conducted for the persons entrusted with management, along with decisions on the principles of their remuneration, in order to align their interests with those of the company and its shareholders and stakeholders. Whereas the power to appoint the top executive management must remain with the board, appointments at lower levels of the hierarchy may be delegated.

5) Ultimate supervision

The board has to supervise management, in particular with respect to compliance with the law, the articles of association and directives issued by the board. To fulfil this continuous task, the board has to implement a state-of-the art control system — in order to be able to detect 'red flags' in time — and define clear reporting lines.

6) Preparation of the annual report and the shareholders' meetings

The annual report consists of a narrative business report and financial statements that have to include, among listed companies, a disclosure of board and senior management remuneration. Shareholders' meetings also have to be prepared, and the

resolutions of those meetings implemented. The annual shareholders' meeting has to be held within six months of the end of each business year. The board has to call for the meeting in due time, set the agenda and submit motions for every agenda item.

7) Special duties in case of financial difficulties at the company

- **Loss of capital**. If the standalone statutory balance sheet shows that the net assets do not fully cover half of the share capital and the legal reserves any more, the board must call a shareholders' meeting without delay and propose restructuring measures
- **Over-indebtedness**. If there is concern that the company's net assets are negative, an interim balance sheet must be prepared and submitted to the auditors for examination. If the interim balance sheet shows that the claims of the company's creditors are not covered by its assets on either a going concern or a liquidation value basis, the board must file for bankruptcy. It may only refrain from doing so if it takes immediate steps to reorganise the business (both operationally and financially) and/or improve the balance sheet such that a sustainable recovery of the company is highly probable. Often, certain classes of creditor will have to be convinced to subordinate their claims or convert them into equity to resolve the over-indebtedness.

In general, management does the preparation and implementation work for all of these non-transferable and inalienable duties. But the overall responsibility remains with the board.

Further (possible) duties

Besides the core duties described above, further duties can be relevant:

- **Duty to manage and assess risk**, defining, for example, the company's risk appetite and tolerance and monitoring possible risks
- **Duty to set standards in corporate social responsibility**, including, for example, sustainability and responsible use of the company's resources, and monitoring the company's performance and compliance
- **Duty to communicate and engage with shareholders on an equal basis**, while maintaining confidentiality of non-public information and ensuring that the board is aware of any material changes in the shareholder base
- **Duties under SIX Swiss Exchange regulations for listed companies**. These include rules on ad hoc publicity, and disclosure requirements for important shareholders and management transactions, as well as corporate governance rules on disclosure in the annual report (for example, on responsibilities within the board and for each committee, work methods and compensation)
- **Duties in takeover situations**. Swiss company and Swiss stock exchange laws restrict the board of a target company in several ways. First, the target's board is not allowed to conclude any transactions that would significantly alter the assets and liabilities of the company, without a resolution at a shareholders' meeting. Second, it cannot conclude 'golden parachute' agreements with directors or senior management, or sell or purchase assets worth more than 10 per cent of the overall assets of the company, without a resolution at the shareholders' meeting. Moreover, the board of the target company has to give advance notice to the Swiss Takeover Board if it is planning to take defensive measures
- **Duties contained in various other forms of legislation**, such as the Merger Act, Criminal Code (with respect, for example, to insider dealing and stock exchange price manipulation) and Old Age Insurance Act.

Standard of care

In general

The directors and the management must carry out their duties with due care. In other words, a judge

would ask what kind of behaviour could be expected in the given situation from someone in the same situation who acts properly; insufficient skills or lack of time are no excuses.

Directors must always act in the interest of the company (duty of loyalty) and must not compete with the company, for example by luring away customers or grasping corporate opportunities. Furthermore, directors and persons related to them must conduct any business with the company on an arm's-length basis.

In areas where the board has delegated its duties to the management, the liability of non-executive directors is limited to the proper selection, instruction and supervision of the managers. Supervision requires an adequate reporting system, and directors must read and analyse the information provided, ask for further information if needed and take the necessary actions.

In addition, the board must ensure that shareholders are treated equally, although it may have regard to the interests of a specific shareholder if others are not disadvantaged and the decision taken is in the interest of the company. The principle of equal treatment at listed companies applies in particular to the registration in the share register, share buyback programmes and, most importantly, the information provided to shareholders.

Finally, the board has to observe a duty of confidentiality in respect of price-sensitive, non-public information on the company and its business.

Conflicts of interest

Currently, conflicts of interest are not explicitly regulated by Swiss law. However, the SCBP recommends that they should be avoided, if possible.

If a conflict arises, the relevant director should disclose it to the chairman of the board, who in turn should request a decision by the full board. Most scholars recommend that the conflicted director should abstain from board discussions and voting on the issue. In our view, it is advisable that such decisions should be made by way of a double vote — in other words, that votes with and without the conflicted director take place and that both votes need to be affirmative. This avoids the possibility that conflicted directors can withhold information and escape liability.

Other possible measures are dealing at arm's length and obtaining a 'fairness opinion' from a third party. Moreover, in specific situations such as a takeover or a transaction to go private, it can be advisable to establish an independent board committee consisting of members who have neither a financial interest in the transaction nor any other potential conflict. The independent committee would represent the board in all matters relevant to the transaction and prepare the decision making by the board.

The goal of the board in these situations is to avoid liability claims from investors and creditors. Following due process (as described above) can be an important defence under Swiss law, because courts in effect apply a theory that is similar to the US Business Judgment Rule, which says that if an appropriate process is chosen and if conflicts are excluded, a judge would not second-guess board decisions. Therefore, if the board follows due process, the risk that its decisions could lead to liability will be minimised. Directors will also be protected from reputational risks as they can claim to have observed international standards.

Directors' and officers' liabilities

Civil liability

Qualification as corporate body and breach of duties

In Switzerland, directors and all persons managing a company (everybody who is important in the decision-making process, including de facto directors such as, potentially, major shareholders or banks) are personally liable if: 1) damage is suffered by the company or the claimant; 2) the defendant has violated a duty set out by law, the articles of association, organisational regulations or other internal directives through 3) an intentional or negligent act; and 4) the violation of a duty has caused the damage.

Depending on who is damaged, a successful liability claim can lead to payments to the company or to the claiming shareholders or creditors of the company. While the company and the shareholders may bring a claim at any time, creditors can in general only do so once the company has become insolvent and is declared bankrupt. In other words, creditors may not bring claims against a solvent company based on directors' liability, unless they have suffered direct damage — in which case, ordinary tort law principles apply.

With regard to the burden of proof, Swiss courts de facto require that once a violation of duties is established, the defendant must exonerate himself.

If a number of directors are liable for the damage, any one of them is jointly and severally liable to the extent the damage is attributable to him based on his own fault and the circumstances. Claims are calculated from the day the injured party has knowledge of the damage and the liable person. Claims are barred after five years.

In cases where the board has lawfully delegated part or all of the duties and powers to other individuals, the liability of the directors is limited to the required care in selecting, instructing and supervising those persons.

Risk of personal directors' liability

In practice, shareholder actions against directors are rare outside bankruptcy but quite frequent if a company becomes insolvent. Recently, directors' liability claims have also been brought in the context of unfriendly takeovers to put pressure on the board.

Successful liability claims against boards are still the exception in Switzerland but have been threatened a number of times in takeovers and even more so in transactions to take a company private. Most claims end with out-of-court settlements, often financed by directors' and officers' (D&O) insurance policies.

Measures to mitigate the risk of liability

Boards can mitigate the risk of personal liability by:

- following a decision-making process that leads to unbiased and informed outcomes — through, for example, using appropriate and up-to-date information, debating the pros and cons, considering alternatives and their respective risks, and consulting experts in areas where the board does not have sufficient expertise. Part of this process is to carefully draft the board minutes so that they reflect the discussions or at least the fact that an in-depth discussion has taken place
- ensuring that the board and the company are adequately organised — for example, through establishing an independent committee
- delegating all tasks that can be delegated to management and applying due care in the selection, instruction and supervision of the managers
- ensuring compliance with financial reporting obligations, closely following the financial situation of the company based on internal reporting, and, in the event of financial distress, taking immediate action.

Even though the Business Judgment Rule applied by US courts has not been formally recognised in Swiss legislation, it is widely agreed that adhering to the formal criteria provided by this rule significantly reduces liability risk. Consequently, Swiss courts are likely not to review a business decision that is based on proper and meaningful documentation and is taken without any conflict of interest. However, as well as focusing on formal and procedural requirements, boards have to ensure that they comply with their non-transferable duties in substance.

Insurance and indemnification of directors

Swiss law does not explicitly address the question of whether or not insurance and indemnification of directors is permitted. In a nutshell, the legal situation is as follows:

- **Advances of legal costs to directors**. Advances by the company are widely accepted. Although

successful liability claims against directors are rare and the legal costs are often shifted to the losing party, directors may build up significant expenses over many years until the proceedings are closed. Several legal scholars state as a precondition for such advances that the company is not the claimant and that the claim is not based on a substantial or wilful breach of duties

- **Assumption of legal costs by the company**. Usually, only some of the costs (attorneys' and other advisers' fees) will be covered by the losing claimant in the event of a positive outcome for a director; moreover, most of the lawsuits end up with settlements where no costs are reimbursed. In these cases, the assumption of costs by the company is generally allowed. However, a number of legal scholars consider it unlawful if the director is held liable, particularly in cases of wilful or substantial breaches of duties. Most authors allow, however, an assumption of cost in case the director has breached his duties with slight negligence only
- **Indemnification clauses in articles of association or individual agreements**. Such arrangements are in general regarded as unlawful to the extent that they also cover wilful or substantial breaches. An indemnification for slight negligence is generally accepted, based on the argument that forcing directors to be too careful will make them totally risk averse
- **D&O insurance**. There is wide consensus that directors may be 'held harmless' under a D&O liability insurance policy purchased by the company. Normally, intentionally wrongful acts are excluded in such policies
- **'Hold harmless' clauses with the major shareholder** (for example, the parent company). These clauses are considered lawful, with the parent company then usually undertaking not to bring any claims against directors. This of course does not bind shareholders who have not consented to such an agreement, and nor does it bind creditors of the company.

In any case, it is not possible to indemnify directors against criminal liability.

Criminal liability

Directors can become subject to personal criminal liability if they do not comply with their corporate duties. Apart from fraud, misappropriation, general mismanagement or insider dealing, crimes or offences arising in connection with bankruptcy and debt collection are of particular relevance. In general, as opposed to claims for civil liability, mere negligence will not be a sufficient ground for criminal liability.

Looking ahead — legal trends

A fundamental revision of the company provisions of the Swiss Code of Obligations is under way. The main goal is a strengthening of corporate governance rules, particularly in relation to shareholders' rights, proxy rules and board compensation. However, as several parts of the revision are the subject of strong political controversy, it might take years before they become law. That said, it is possible that all the compensation-related provisions will become law towards the end of 2012.

Bär & Karrer AG

Brandschenkestrasse 90, CH-8027 Zurich, Switzerland

Tel +41 58 261 50 00

Fax +41 58 261 50 01

Web www.baerkarrer.ch

Rolf Watter
Partner
Email rolf.watter@BaerKarrer.ch

Professor Rolf Watter is a partner with Bär & Karrer and has served on the board and management committee of the firm for nine years.

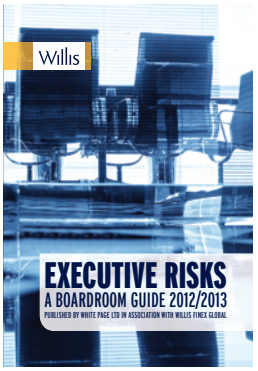
Dr Watter graduated from the University of Zurich with a doctorate in law and holds a Master of Laws degree from Georgetown University, Washington DC. He has been lecturing at the University of Zurich since 1990. Dr Watter has broad experience in all types of M&A and capital market transactions. He also specialises in corporate governance questions.

Dr Watter is presently a board member in the following listed companies: Zurich Insurance Company (also a member of the audit committee) and Nobel Biocare (presently chairman). He is also a board member of Faber-Castell (Holding) and UBS Alternative Portfolio, and a member of the regulatory board of the SIX Swiss Exchange. He regularly publishes on governance matters and transaction issues and is an editor of the law journal *GesKR* and of the Basler Kommentar.

Katja Roth Pellanda
Senior Associate
Email katja.rothpellanda@baerkarrer.ch

Dr Katja Roth Pellanda, a senior associate at Bär & Karrer since 2005, advises clients in corporate and commercial matters, with a particular emphasis on corporate governance and regulatory issues concerning regulated institutes (ie, financial institutions and insurances) and listed companies. A graduate of the University of Basel, she received a doctorate in law from the University of Zurich, was a visiting researcher at Stanford Law School, California, and holds a Master of Laws degree in banking and financial regulation from the London School of Economics and Political Science.

Dr Roth Pellanda is a member of the European Corporate Governance Institute. She regularly publishes on governance and company law matters.



Published by White Page Ltd in association with Willis Limited, 'Executive Risks: A Boardroom Guide 2012-13' brings together contributions from leading legal practitioners in 18 jurisdictions worldwide, as well as special focus chapters dealing with specific issues of interest to directors and officers in the US and internationally. Overall, the publication has been designed to provide readers with a guide to recent developments affecting directors and officers, including their exposure to executive risks and the steps they can take to insure themselves against these risks. Our country correspondents have set out to identify significant changes in local regulation and case law which impact – or look likely to impact – the risk exposures of directors. Based on first-hand practical experience, their analysis addresses the key trends in this fast-evolving field.

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