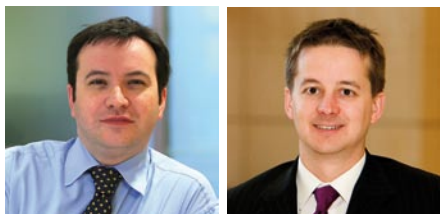


D&O INSURANCE COVERAGE ISSUES



BY RODERIC MCLAUHLAN AND JAMES ROBERTS

INTRODUCTION

Following the U.S. Supreme Court's decision in **Morrison Vs National Australia Bank** that 'foreign-cubed' cases are no longer welcome in the U.S. courts, the exposure of non-U.S. companies to civil shareholder securities claims have been curtailed. However, we have seen a marked increase in the severity and frequency of criminal and regulatory investigations, for which D&O insurers may well have to pick up the costs.

In response to public pressure following the worldwide financial crisis, regulatory agencies globally are increasing their activity, particularly in financial markets and services, anti-corruption and anti-bribery, and competition law. For insurers, this activity raises a host of issues, in terms of costs, practical and procedural difficulties and, importantly, coverage.

KEY ISSUES

Policy triggers for regulatory and criminal investigations can be a grey area. Considerable latitude exists between routine enquiries by regulators that are part of business operations (for example, a routine request for information by the FSA) and a 'crisis' event that triggers internal and external investigations and dealings with the authorities for dishonesty or fraud. There may be agreement that the first is not an insured risk and the latter probably is, but what about the permutations in-between?

Uncertainty is confounded by the absence of a standard D&O wording. Policies may contain separate 'investigation' cover. In addition, investigations may also be 'claims' under the policy's Side A or Side B cover.

In each case it will be necessary to pay attention to the expressions that are used as part of the trigger for cover. These are subject to interpretation, and there is currently little case law on these areas. For example, if the policy provides investigation costs cover in relation to meetings that an individual is 'required to attend', does that mean **legally** required to attend? Does it depend if there is a penalty for not attending?



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There can also be practical issues in relation to areas such as how costs should be split between claims against individuals and the company, and how to distinguish what is covered and what is not where there are parallel civil and regulatory proceedings. There can often be conflicts of interests between individuals necessitating the use of multiple law firms. Therefore, costs need to be controlled. Finally, conduct exclusions for dishonesty or fraud tend to bite only after adjudication has taken place which can mean that the policy limits will be eroded by dishonest parties, leaving innocent individuals with limited cover.

Another issue that arises is whether the insurer is able to access information from the insured in relation to an investigation, without the insured waiving privilege in that information. In England, common interest privilege is relatively wide, and the

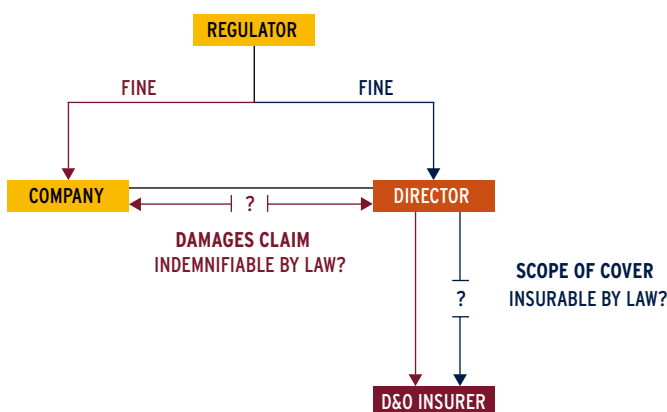
courts are happy to find that such privilege exists between insurers and insureds where their interests are not identical but closely related. For example, it is likely that common interest privilege will still exist even where there is a reservation of rights in place.

In the U.S., the law on privilege is much more fragmentary and may vary between the states. Restrictions may be placed by the regulator on the communication of information to insurers. Insurers need to comply carefully with such limitations internally to avoid their own regulatory issues.

FINES AND PENALTIES

A particular problem is the extent to which fines and penalties fall within the scope of cover. The basic position is shown by the blue arrows in Fig 1. Under some wordings, there is no coverage, but under other common formulations, it might only be criminal fines that are excluded, leaving cover, in principle, for regulatory fines. There may also be other restrictions under the policy, for example, cover only for fines and penalties **'insurable by law'**. Even without this wording in the policy, it arises generally as a matter of law.

FIG 1
FINES AND PENALTIES: COVERAGE REGIME



Even if the policy excludes cover for fines and penalties, there is now the concept of **'indirect'** fines and penalties (the situation shown by the red arrows in Fig 1), which was highlighted following the Commercial Court's decision in **Safeways Vs Twigger (2010)**, which is currently under appeal. In short, Safeways agreed to pay a fine to the Office of Fair Trading for fixing dairy prices. Safeways sued a number of its directors who were held to have been responsible for the relevant price-fixing conduct, seeking to recover the corporate fines as damages for alleged negligence by the directors in breach of their usual duties to the company. This was a straightforward claim as a matter of law, although the issue of whether it is legally valid will be tested further in the appeal. In this situation, the D&O cover is likely to be in play (as it is a claim for civil liability) even if there is an express exclusion for fines and penalties. However, coverage will still be subject to the **'insurable by law'** test, as the company cannot recover as damages from the director a corporate fine that is not indemnifiable as a matter of law, even if it is the director's conduct that resulted in the corporate fine in the first place.

Therefore, the question for coverage purposes is the extent to which fines and penalties are indemnifiable by law. The relevant principle of English public policy is known as **ex turpi causa**, or the illegality defence. In essence, the court will not allow a person to recover an indemnity against liability resulting from his own unlawful conduct.

The **Safeways** case and another recent case in the Commercial Court, **Griffin Vs UHY Hacker Young (2010)**, make it clear that, for the illegality defence to apply, there must be an element of ‘moral turpitude or moral reprehensibility’ involved in the relevant conduct. Applying that test is not altogether straightforward, although the **Safeways** appeal may resolve some of the remaining uncertainties.

There are essentially three types of conduct for which a fine might be imposed: intentional or reckless wrongdoing; strict liability situations, where no particular fault is required; and negligence. There are also three types of legal regime that can result in fines: criminal, regulatory and civil. Whilst this is a helpful way of breaking it down, in practice some of the categories overlap or cover a wide range of possibilities.

Broadly, however, the position is as illustrated at Fig 2:

FIG 2
INSURABLE BY LAW? WHAT IS CLEAR AND WHAT IS NOT.

	INTERNATIONAL/ RECKLESS CONDUCT	STRICT LIABILITY/ NO FAULT	NEGLIGENCE
CRIMINAL	X*	✓	?
REGULATORY	X	✓*	?
CIVIL	X	✓	✓

* For Corporate fine 'X' if directly liable, but '✓' if merely vicariously liable

* Some Regulators (e.g. FSA) prevent insureds from relying on insurance even if otherwise available

- Intentional wrongdoing will not be indemnifiable whatever the type of fine, and might also, in any event, be excluded by other policy provisions, such as fraud or dishonesty, or personal advantage exclusions. But there is a caveat for ‘indirect’ fines: a company might still be able to recover from a director a corporate fine resulting from intentional conduct if the company can show it was only **vicariously** liable for that conduct. There are difficult issues of attribution here: when do the actions of the directors count as the actions of the company (so the ‘insurable by law’ test applies), and when do the actions of the directors merely render the company liable under agency principles (so the ‘insurable by law’ test doesn’t apply)?
- Strict liability or no fault fines will be indemnifiable generally speaking across the board. There is a caveat in relation to regulatory fines that the regulatory regime itself or the settlement with the regulator may prohibit those who are subject to it from relying on insurance (something of an increasing trend).
- Negligent conduct is, however, a complicated area. Civil fines or penalties imposed for purely negligent conduct will be insurable, and this would apply to punitive and exemplary damages under English law, and subject to policy wording, to multiple damages awards in other jurisdictions.

What is very unclear is the extent to which criminal or regulatory fines imposed for negligent conduct would be insurable.

In both **Safeways** and **Hacker Young** such fines were imposed. In **Safeways**, the judge appears to have held that they were **uninsurable**, whereas in the later **Hacker Young** case the judge seems to have said that they might be **insurable**. It may be, however, that we will end up with no ‘**one size fits all**’ approach following the judge’s comments in **Hacker Young**. In the regulatory sphere there is a huge range of potentially quite different regimes with different degrees of seriousness and different consequences, with the result that, if one has to apply a test of moral turpitude, it may ultimately always be necessary to look at matters on a case-by-case basis.

So the law is in a period of confusion and, typically, in the area that is currently of most practical significance: regulatory fines for conduct following short of intentional wrong doing. We will have to see whether the Court of Appeal brings any clarity to this in the forthcoming appeal.

Roderic McLauchlan and James Roberts are both partners in the professional and financial disputes team at Barlow Lyde & Gilbert LLP.

If you would be interested in further details regarding the **Safeway Vs Twigger (2010)** case, these can be found in the article written by Francis Kean (who features in our ‘meet and greet’ article on page 4) in the May 2010 edition of **Insurance Law Monthly**.

MEET THE TEAM



FRANCIS KEAN

We are delighted to welcome Francis who joined Willis in September 2010. Prior to that, Francis was a partner specialising in Directors and Officers Liability and accountants negligence at Barlow Lyde & Gilbert LLP, a leading international law firm renowned for its commercial litigation and dispute resolution, as well as insurance and reinsurance practice area.

In his capacity at Barlow Lyde & Gilbert, Francis advised a wide range of Lloyd's syndicates, London Market companies and captive insurance companies in connection with policy construction and coverage disputes. Francis headed up the firm's Directors' and Officers' Liability team, handling a wide variety of coverage disputes and claims including disqualification proceedings, wrongful trading actions and regulatory investigations. He is the leader and editor of the Insurance Institute of London's publication Directors' and Officers' Liability Insurance and is a familiar face on the lecture circuit.

Francis will add huge additional depth to FINEX Global, the financial and executive risk division of Willis Ltd. He will assist in policy development, coverage reviews and support our claims advocates in dealing with contentious claims, and his 25 years experience as a practising solicitor will greatly strengthen our client offering.

Francis is married with two children and in his spare time is a keen cyclist. He enjoys outdoor pursuits and can occasionally be seen trying to stay upright on a surfboard.

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