UNIVERSITY OF SOUTHAMPTON
FACULTY OF LAW, ARTS AND SOCIAL SCIENCES
School of Law

The Nature of Directors' and Officers' Liability Insurance

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Thesis for the degree of Doctor of Philosophy

October 2005

UNIVERSITY OF SOUTHAMPTON
FACULTY OF LAW ARTS & SOCIAL SCIENCES
SCHOOL OF LAW

ABSTRACT

THE NATURE OF DIRECTORS AND OFFICERS LIABILITY INSURANCE

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The design and inception of a Directors' and Officers' liability insurance policy, far from being merely a straightforward contract or undertaking, is extremely complex. D&O insurance possesses its own features, principles and, in recent times, rules of law, making it unique both in its nature and implementation. The purpose of this research is therefore to scrutinise the origins and the rationale underlying D&O insurance, in order to ascertain whether or not these policies are or not a realistic comfort to directors and to those inside and outside the company who rely upon their actions.

The most important theme of this thesis is that D&O insurance is in fact of less importance than it at first sight appears, as it will not cover a number of important heads of potential liability faced by directors. This is so because directors do not experience the same extensive liabilities to their companies as is the case in the US (where this form of policy originated), because English law has all but removed the possibility that a company director can in his/her personal capacity face liability to a third party, because insurance policies do not cover deliberate acts on the part of insureds and because some of the liabilities, which may be endured by directors, are simply uninsurable. However, there are two scenarios in which D&O significance is unquestionable namely: defence costs cover –albeit this depends upon what the policy says about payment and allocation- and for reinsurance and retrocession although there still is the problem of matching cover.

To my Wife Patricia

To my Daughters Maria Jose and Maria Jesus

To my Parents Adolfo and Nelida

In memory of my Sister Silvita and Brother Gabriel Fernando

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PREFACE

Nowadays, the size, growth and complex structures that companies have developed has motivated law scholars and practitioners to explore the intricacies of these structures in the hope of assessing their repercussions on every day transactions and on the general conduct of the business of corporate enterprises. Key aspects of the investigation are the issues of regulating, protecting and sanctioning the individuals in whose hands corporate assets, shareholders' trust and third party safety is bestowed.

The law relating to the regulation and authority of company directors is complex, given the large number of statutory duties imposed upon them by Companies Act 1985, and ancillary statutes including the Insolvency Act 1986[1] and the Company Directors Disqualification Act 1986 to say nothing of the common law and equitable principles applicable to the field. Surprisingly, less attention has been given by scholars to the question of protecting directors against the myriad liabilities that they may face, and as a result there has been some failure to consider that, by offering to these individuals financial support and guarantees against personal liability, it may be that the fears, risks and worries of those whose trust is reposed in them, would be to some extent alleviated. As a practitioner in company law in Venezuela, and as a student of insurance law, I developed the idea of researching into the extent to which liability insurance, specifically the rapidly developing market for Director's and Officers' Liability Insurance is a realistic financial relief.
Consequently, the aim is to evolve answers for the following matters:

1. What is the real nature of a D&O policy and which of its elements require it to differ from general professional liability insurance?
2. What is the subject matter of D&O insurance and what defaults on the part of the director operate as a trigger for recovery?
3. For whose benefit has D&O insurance been developed, and who is entitled to claim on the policy – one particular question here is whether a person who *de facto* operates as a director or officer is entitled to protection?

[1] As amended by the Enterprise Act 2002, which came into force in June 2003.

4. What types of cover are available?
5. The concept of a "claim" for the purpose of claims made policies
6. The meaning of typical policy exclusions and why their possible coverage might depend upon additional premiums or contractual arrangements?
7. To what extent do the risks which are insurable under D&O cover match the potential liabilities of directors to shareholders, to the company and to third parties – it has been necessary in this thesis to consider the nature of the remedies available against a director in breach of duty to determine whether insurance is an appropriate response to them
8. The extent to which a D&O policy provides indemnification for the costs of defending proceedings and the manner in which defence costs can be allocated as between a group of defendant directors and as between insured and uninsured claims?
9. The use of fronting in other jurisdictions, particularly the South American market, with the effect that D&O risks find their way to the London market by way of reinsurance or retrocession.

In order to achieve these aims, this research has been arranged into nine chapters dealing with these matters. Chapter I: Preamble to liability Insurance since it is from this sort of insurance that D&O comes from; Chapter II: examines the nature and legality of this form of cover; Chapter III: discusses who is cover by these policies and its composite nature when the company is insured alongside its directors and officers; Chapter IV: analyses legal and contractual policy exclusions; Chapter V: deals with the risk insured under D&O policies with emphasis on director's duties to the company; Chapter VI: highlights the remote possibility for a director to incur liability to a third party but from the clearest of circumstances; Chapter VII: gives a general spectrum of director's and officer's liability in Civil Legal System in order to clarify or contradict, later on, reinsurance and retrocession issues; Chapter VIII: examines Defence Costs Cover and Allocation which may entirely depend of policy construction and the method used to apportion costs and; Chapter IX: discusses the reinsurance of D&O policies since UK has proved to be, once more, a leading market for the reinsurance and retrocession of this sort of liability cover.

ACKNOWLEDGEMENTS

The task of conducting a research for a PhD is far from easy and it is impossible to reach the end in complete isolation. The key aspect is then, to be surrounded by wonderful human beings who in one way or another contribute with the successful culmination of a project of this nature. I have had this fortune and luck so it becomes compulsory to thank them all.

I would like to thank my supervisor, Professor Robert Merkin whose talent, professionalism, patience, kindness and most importantly friendship, made my thesis a reality. Always by one's side, giving the best of his knowledge and experience, I could not have been luckier.

I would like to thank my beautiful family: my wife Patricia and my daughters Maria Jose and Maria Jesus, whose love, tenderness and personal achievements propelled my studies. From the very bottom of my heart, I love you and thank you ever so much.

My parents from the distance have given me the most extraordinary example of love and support, thanks Dad for your brilliant ideas in interpreting the law and Mum for making us laugh and care all the time.

I would like to thank also my parents in law who have taught me the meaning of perseverance, sacrifice and faith.

Within the University of Southampton, I would like to thank Mrs Yvonne Baatz, Senior Lecturer in Law and Director of the Institute of Maritime Law for her help and advice as member of my upgrading panel. Also special thanks to Chris Nicoll, Senior Lecturer in Law and also member of my upgrading panel, his help was invaluable. My gratitude to Caroline Wilson, who has been always there enjoying our success as hers.

Friends make life easier and I have had very good ones: Stuart Macdonald, Ahmed Olubajo, Kiriaki Noussia, Aryusri Kumbunlue, Nikolas Geordiadis and Filippo Lorenzon, thank you all for helping me and my family. Peter Corbidge and his late wife Pat you made us feel home with love and prayers thank you so much.

Finally –not least- I would like to thank my friend Miguel Ferreira who has probably not realised how important his friendship has been throughout these years abroad.

October 2005
Chesham, United Kingdom

PART ONE

CHAPTER I

PREAMBLE TO LIABILITY INSURANCE

1. 1 Nature

Insurance as an idea arose for the purpose of restoring the victim of an uncertain and unpredictable event, as far as is possible, to his or her original position. Insurance is essential to risk-allocation between commercial operations, and also operates to remove the fear of personal and financial ruin. Since its earliest days insurance has gradually expanded to cover the increasing risks inherent in a modern society. The earliest insurances were first party, in particular marine and, in due course, life, with the notion of insuring buildings and goods coming later. The idea of insuring against third party liabilities came relatively late, but liability cover now provides a crucial underpinning to all forms of activity. Professional indemnity cover has now become a significant sub-species of liability insurance.

It is important to understand from the outset that one of the features of third party liability insurance is the fact that it belongs to the general area of indemnity insurance. Indemnity insurance may be defined as a contract under which the insurer agrees to indemnify a person called the insured, upon the occurrence of an uncertain and/or unpredictable event causing loss to the insured, for the consideration of payment or promise to pay a stipulated amount of money called the premium to the insurer. The fact that it is a contract of indemnity means that the insured may recover only where he has suffered a loss caused by the occurrence of a peril insured against under the policy.

1. 2 what is a Contract of Indemnity Insurance?

The answer to this question may be approached by differentiating indemnity insurance from non-indemnity insurance. Although, the aim of any type of insurance

is to hold the insured harmless and indemnified where possible, with the exception of life and personal accident insurance which recognise that the provision of an indemnity as such is impossible, such an aim takes different shapes and forms. Indemnity insurance pays compensation up to the amount of actual assessable loss[1] in order to restore the insured to a similar condition had the unwelcome event never happened. The parties will almost always fix the maximum recoverable sum in any case,[2] but unless the policy is valued – in that the parties have fixed in advance the sum to be paid in the event of a loss[3] – the amount of the actual payment is to be ascertained at the time of the loss. Accordingly, the exact amount which may be payable is unknown by the parties when they enter into an indemnity insurance contract. Non-indemnity insurance – life and personal accident – works in a different way as the contractual terms establish *ab initio* the exact sum payable to the insured in case he/she faces the contingency. A contract of indemnity is an agreement upon which one of the parties undertakes the obligation to compensate, within the terms agreed, the sufferer of a loss up to the limit of the amount of his/her actual deprivation subject to the financial limits of the policy. Consequently, where the insured profits from his/her insurance by receiving more that his/her actual loss, the principle of indemnity is violated.[4] The legality and availability of it was established in the decision in *British Cash & Parcel Conveyors v. Lamson Store Service*[5] and there has been statutory recognition of the significance of liability insurance since that date. Indeed, liability insurance is compulsory in a number of fields of activity,[6] third parties are given a right of action against the insurers in the event that the insured becomes insolvent[7] and the Marine Insurance Act 1906 recognises that third party liabilities give rise to an insurable interest.[8]

[1] Clarke, *Policies and Perceptions on Insurance*, Clarendon Law Series.1997, p 23
[2] Compulsory motor insurance in respect of personal injuries has to be unlimited: Road Traffic Act 1988, s 145.
[3] Valued policies are largely confined to marine insurance and to valuable or unique property: liability policies are, by definition, incapable of valuation.
[4] Lowry & Rawlings: *Insurance Law, Cases and Materials*, Hart Publishing, 2004, at 641.
[5] [1908] 1 K.B 1006, 1014
[6] Including motoring (Road Traffic Act 1988), employment (Employers Liability Compulsory Insurance Act 1969), oil pollution (Merchant Shipping Act 1995) and horse riding (Riding Establishments Act 1964).
[7] Third Parties (Rights against Insurers) Act 1930, passed originally to supplement the Road Traffic Act 1930. In motor cases the victim will have a direct action against the insurers even though the assured has not become insolvent: see the European Communities (Rights Against Insurers) Regulations 2002, SI 2002 No 3061.
[8] *Feasey v. Sun Life of Canada* [2003] Lloyd's Rep IR 637 for recognition by the Court of Appeal of the principle that liability gives rise to insurable interest.

1.3. The Scope of Liability Policies

1.3.1 Liability at Law: is there a Loss?

There is an additional important aspect of indemnity insurance that relates to what is considered to be a loss for the purpose of indemnity, as this is in essence the subject-matter of an indemnity policy. The insured's losses might be the result of either a personal detriment, or the fact of becoming potentially liable to pay damages to a third party by reason of a failure to comply with certain commitments or legal standards.[9] Personal detriment, first party property or personal injury, all fall within the first concept. In fact anybody might insure his/her own belongings, house, car, machinery etc, so the contingency would be the risk of losing these assets and the cost of replacing them. Furthermore, concerns could relate to the financial consequences of personal injury, the cost of medical treatment and even loss of income, so insurance might alleviate the insured during the period of recovery and compensate him/her in case of temporal or permanent disability.

The common law gradually came to recognise that potential liability to pay damages could amount to a material detriment capable of giving rise to an insurable interest. However, the common law at first postulated that nothing but payment would be satisfactory as proof of loss.[10] Nowadays the established rule[11] applicable to indemnity presupposes that "pay to be paid" is no longer a condition precedent for the right to an indemnity since "the plaintiff need not to pay and perhaps ruin himself before seeking relief".[12] This is the point at which the decision of the Court of Appeal in *Post Office v. Norwich Union Fire Insurance Society Ltd*[13] becomes crucial. In this case it was held that the insured's right to an indemnity under a liability policy arises as soon as his liability to a third party is ascertained by means of a judgment, an

[9] In some cases of course liability may be strict, so that technically the insured cannot be said to be at fault at all, e.g., in cases of vicarious liability.
[10] *Collinge v. Heywood* (1839) 9 Ad. & El. 633
[11] The earliest important case on this rule is *Wolmershausen v. Gullick* [1893] 2 Ch. 514.
[12] *Johnston v. The Salvage Association and Mckiver* (1887) 19 Q.B.D. 458 at 461
[13] [1967] 2 Q.B. 363

arbitration award or a binding settlement contract[14] and not upon the earlier occurrence of the event which gives rise to such a liability[15] or on the later date on which payment is made to the third party by the assured.[16] The standard form of wording under indemnity policies refers to the provision of cover when the insured's 'liability at law' is established, and this wording reflects the position reached by the courts in the *Post Office* case. That said, additional contractual terms might be incorporated into a policy of this nature so as to prevent the insured from admitting liability without the written consent of the insurer or without allowing the insurer to take over the conduct of the defence proceedings on behalf of the insured.[17]

Third party liability insurance is, therefore, the provision of coverage against either actual or potential damage caused by the insured's personal or professional activity to a third person who is generally not a party to the insurance contract and whose individual existence is not contemplated by the policy at the date of its formulation. The insured's insurable interest is based upon his potential legal liability to a third party, so that liability can be the subject matter of indemnity in much the same way as physical loss.

Professional liability may arise either by failing to comply with statutory provisions, contractual obligations or common law rules. In professional indemnity cases there will normally be a breach of duty if the insured fails to comply with professional rules or standards of conduct.[18] Liability generally does not arise on the basis of a failure by the insured to succeed in performing a certain task voluntarily undertaken for a third party,[19] although if the insured voluntarily assumes the responsibility of achieving a particular result then he may face liability for failure to do so.[20]

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[14] As to which, see the much criticised decision of Colman J in *Lumberman's Mutual Casualty Co v. Bovis Lend Lease* [2005] Lloyd's Rep IR 74, which holds that a global settlement which does not apportion the sum received as between the various claims and counterclaims between the parties cannot be used as the basis for a claim against insurers.
[15] See also *Cox v. Bankside Members Agency* [1995] 2 Lloyd's Rep 437; *Bradley v. Eagle Star Insurance* Co Ltd [1989] A.C 957.
[16] Pay to be paid clauses may be used, but their legal effect is uncertain. Contrast *The Fanti and the Padre Island* [1990] 2 Lloyd's Rep 191 with *Charter Reinsurance v. Fagan* [1996] 2 Lloyd's Rep 113.
[17] This aspect is analysed infra under the heading 'Additional Contractual Terms'.
[18] Merkin, *Colinvaux's and Merkin's Insurance Contract Law*, Sweet & Maxwell, 20703
[19] Hodgin, *Professional Liability: Law and Insurance*, LLP. 1999, p 41
[20] *Cf Aneco Underwriting v. Johnson & Higgins* [2001] Lloyd's Rep IR 91.

1.3.2 Claim as a Subject of Indemnity.

Third party liability policies can be issued in either of two forms: "Occurrence" or "Events" based; or "Claims Made". Under an Occurrence policy the insurer is required to provide an indemnity to the insured against his liability to a third party as long as the wrongful act which has caused loss to the third party has occurred during the currency of the policy: it is immaterial that the insured's liability to the third party is determined at some time in the future, as what matters is the date of the occurrence of the contingency but provided that the contingency occurs during the policy period.[21]

Claims made policies work in a different way. Here, the time at which the event that gives rise to the harm is of no significance, as under a claims made policy the insurer is required to indemnify the insured against any claim made against the insured during the currency of the policy even though the event giving rise to the claim may have occurred many years earlier. A claims made policy may also provide indemnity for a claim arising after the insurance contract has been entered into, provided that the claim is made against the assured within the policy period. It is usually a requirement of a claims made policy that the insured has notified the third party's claim to the insurers within the currency of the policy, so that if notification occurs after the policy has expired the insurers are not liable even though the claim was made against the insured during the period of coverage.[22] Once the claim is reported to the insurers, the insured discharges his /her obligation to notify the insurer and it is not necessary for the policy to remain in force at the time the claim is settled or finalised.[23] As a claims made policy will generally apply to events which have occurred prior to its inception, the insurer will generally require any events likely to give rise to a claim to be disclosed when the contract is entered into and it is often made a condition precedent, that the insurer will not be liable for events which have been notified under earlier policies.[24]

The main purpose of a policy of this nature has been addressed by an American court;

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[21] Merkin op cit at 20703. See also www.publiability.com/occurencevsclaimsmade.htm.
[22] *Robert Irving & Burns v. Stone* [1998] Lloyd's Rep IR 258.
[23] www.mandanational.com.au/aboutclaimsmade.asp For recent illustrations, see: *Friends Provident Life and Pensions Ltd v. Sirius International Insurance Corporation* [2005] Lloyd's Rep IR 601; *Tioxide Europe Ltd v. CGU International Insurance plc* [2005] Lloyd's Rep IR 114
[24] Merkin, op cit at 20703.

In *Chas. T. Main, Inc v. Fireman's Fund Ins*[25] the court held that "the purpose of a claims made policy is to minimize the time between the insured event and the payment." This provides a series of advantages for the insurance parties namely:

- By the end of the policy period, assuming that the insured has reported all the claims made against it, the insurer can complete the bordereaux of claims.[26] Based upon this information or claims history the insurance company could assess and accurately estimate the risk thus being able to offer lower premiums.[27] Hence the assured is relieved of the need to establish the exact date of occurrence where the wrongful act – negligence – is spread over a long period of time.[28]

- Shortly after expiration of a claims made policy the insurer can close its books.[29] This is by no means one of claims made most important features; in fact it happens that under an occurrence cover insurance companies are obliged to maintain their accounts open throughout a number of years to meet and cover events happened and reported within insurance period. Claims made policies, as explained above, work in a different way. The insurer on risk is the one to whom a claim is duly notified irrespective of the time in which the event giving rise to such a claim happened or the later moment when assureds' liability is ascertained. This feature allows insurers to retire earlier since between the time at which a third party claims against the insured and that at which the insurer is to indemnify, there might not be more than a few years. Conversely, let us imagine for instance a claim, on an occurrence basis, regarding asbestosis which could develop in 20 or more years. In this case the employer's insurance at risk is the one whose policy was effective by the time the employee might have contracted the disease. This interpretation forces the carriers of insurance on occurrence basis to keep their accounts opened for an inconceivable and why not unfair number of years affecting their reserves, the chance to investigate the claim and the disproportion that there could be between current compensation and the original premiums if inflation is to be

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[25] 551 N.E.2d 28 (Mass.1990)
[26] Carson, *Liability Insurance- Claims Made Policies*. In http://icareview.treasury.gov.au/content/_download/submissions/Carson.pdf
[27] Carson, op cit.
[28] Levitan, *Claims Made Policies in Israel*. [1996] Int. I.L.R 160.
[29] www.eqgroup.com/pdf/claimsMade_expl.pdf.

borne in mind.[30] The problem of asbestosis and the no less controversial decision in *Fairchild v. Glenhaven Funeral Services Ltd*[31] might provide a perfect example for the matter. The decision established that where an employee has been exposed to the dust -which later develops into a disease- by two or more employers, each of the latter is fully and individually liable for the loss resulting thereupon, regardless of the fact that, the employee is unable to prove which of the exposures was the cause of his/her condition. Consequently, a losses occurring policy issued many years in the past, may result in any insurer-at risk when the exposure took place- having to indemnify in full the employee irrespective the disease might develop ten or twenty years later.[32]

- For the insured as the sum insured rises for each policy year, with the inflation of decisions, the sum insured at the time of a late claim is more likely to protect against the then likely judgement.[33] Also for his benefit the insured can change policy limits and negotiate new terms to reflect changes in personal belongings or in accordance with any social, economical or legal environment.[34]
- The occurrence policy provides separate limits of liability. A claims made policy provides as many limits of liability as there are years of cover but the assured has access to one limit at any given point.[35] For example a five year running policy –on an occurrence basis- offers five limits of indemnity; in other words the assured may use on yearly basis up to the total limit of indemnity. A Claims made policy renewed also for five years -despite providing limits of indemnity for the same five years- allows the assured to exhaust only one limit; it being that of the year in which the claim was made and reported.

On the other hand, policies issued on claims made forms have the disadvantage of

[30] Griffiths, *Time Limits in Claims-Made Insurance in Australia and New Zealand.* [1997] Int. I.L.R. 85.
[31] [2003] 1 A.C 32.
[32] For a clear discussion on the matter see Merkin, *Insurance Claims and Fairchild* (2004) 120 LQR 233.
[33] Carson, op cit
[34] Bales, *The Dilemma of Claims-Made Policies* in The Chiropractic Journal. World Chiropractic Alliance, Sep 1992. See also www.worldchiropracticalliance.org/tcj/1992/sep/sep1992e.htm
[35] Bales, op cit

being very complex documents, difficult to interpret and trigger. A policy of this type is triggered by the date the insured first became aware and notified the insurer of a claim or potential claim and thereafter the insurer must defend, settle and indemnify the claim.[36] The issue of notification imposes upon the insured –as explained below- a heavy burden, the execution of which represents a *sine qua non* condition to activate cover.

It is worthy of mention that certain countries dispute or have disputed the legality of claims made policies on the grounds that they are anti-consumer.[37] Two main arguments have tainted claims made policies as being apparently against public policy. Firstly, there is the harshness[38] of depriving the insured of coverage for reasons outside his/her control. In fact, it is in the hands of the victim of any wrongful act to claim and thus to let the insured become aware of a claim in process, should the victim be of the opinion that proceedings or mere claims must be delayed and commenced at some time after wrongdoer's policy period lapses, this may prevent the assured from notifying the insurer on time in order to trigger coverage. This imbalance has led to the second major concern that of there being an unlawful advantage for the profit of the insurer only.[39]Additionally, in Spain article 73 of Spanish Insurance Contract Act[40] was interpreted by the Supreme Court as only allowing the enforcement of policies written on an occurrence basis, so that claims made policies were thought to be against the law.[41]
However, doubts about lawfulness have now been resolved and in harmony with market practice a series of acts were enacted for the purpose of clarifying the issue and lifting the barriers to allow claims made policies to function as designed. In France, for example, the Law concerning Medical Liability in December 2002 authorised claims made policies and this was followed by a broader piece of legislation the French Law of Financial Security in July 2003, article 80 of which

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[36] www.eqgroup.com/pdf/claimsMade_expl.pdf
[37] Youngman, *Directors' and Officers' liability Insurance. A Guide to International Practice,* Woodhead Publishing limited, 1999 at 41
[38] Levitan, op cit
[39] Hankey, *Claims Made Policies and Choice of Law in the European Union*. [1994] Int. I.L.R. 267.
[40]Alvarez-Baron, *Spain's Claims-Made Crisis* quoting Law50/1980: "By liability insurance the insurer undertakes, within the limits of statute and contract, to provide cover in respect of the risk of the insured becoming liable for damages caused by an event envisaged in the contract for the consequences of which the insured is responsible according to the law". [1994] Int. I.L.R 316.
[41] Hankey op cit: Belgium adopted the same approach under article 78 of the law on non-marine insurance contracts.

provides the guidelines for forms of triggering policies.[42] By this time, Spain had enacted "Ley de Supervison de los Seguros Privados" in 1995, article 73 of which finally dissipated all the doubts in this regard.[43] Consequently, it is safe to say that at least the European market represents no obstacle for the implementation and enforcement of policies trigger on claims made basis.

1.3.3 Insurable Risk: Professional Negligence.

The subject matter of liability insurance is not confined to standard terms strictly followed by insurers. One of the most important features of these policies is that they are often tailor-made, individually discussed between underwriters and the insured's broker and adapted to special needs. What is commonplace is that insurers basically observe three elements of risk.[44]

Liability insurance may, in the first place, afford cover for the use of goods supplied by the professional.[45] Motor accidents, the use or machinery or the supply of defective goods are the most important examples of this concept.

Secondly, and most importantly, the policy will extend to liability for the provision of defective services. The idea of provision of services is far more complex due to the variety of shapes and forms it may adopt. The criteria adopted by the law for liability for the provision of services are found in the root decisions in *Donoghue v. Stevenson*[46] and *Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd.*[47] In the first case it was emphasized that for the purpose of indemnity, the victim is not required to be either a customer or a party to a contract with the potential wrongdoer. The break with privity of contract having been achieved, the ruling in *Hedley Byrne* extended liability for the provision of services. In this context, professional negligence can be defined as "a failure to meet the standards of care to be expected from the average competent

[42] Schubert, *Coverage Triggers in French Liability Insurance- The End of a Road Less Travelled.* Insurance & Reinsurance Law Briefing, 89 March 2004 at 6.
[43] Fernandez del Moral Dominguez. *El Seguro de Responsabilidad Civil de Administradores y Altos Directivos de la Sociedad Anonima.* Comares. Spain 1998, 222 ss
[44] Enright, *Professional Indemnity Insurance Law*, Sweet & Maxwell, 1996, p 84
[45] Merkin op cit at 20703
[46] [1932] A.C. 562
[47] [1964] A.C. 465

and experienced practitioner as to render the professional person committing the act, error or omission liable in law to a client or some other third party who occasions reasonably foreseeable loss by reason of reliance of that act, error or omission".[48]

In order to succeed in a claim for professional negligence three requirements are to be satisfied by the victim: (a) it must be proved that a duty was owed by the professional to the victim, normally ascertained by the assumption of responsibility by the professional: (b) it must be proved that there has been a breach of such a duty; and (c) the victim must demonstrate that there has been damage inflicted upon him. The result is that a person who suffers a loss as a result of relying upon negligent advice provided by a professional may successfully sue.[49] Consequently, a professional indemnity policy will grant cover for claims of professional negligence arising out of breach, or even allegations of breach, of the duty of care in contract or in tort,[50] provided the insured was acting in the ordinary course of his/her business or profession.

Thirdly, a professional indemnity policy will extend to coverage for defence costs. Liability for defence costs is analysed in more detail in Chapter VIII, but its salient features may be considered briefly here. This element of cover is generally framed as a separate undertaking, operating independently of the primary cover for legal liability.[51] Accordingly, there may be an obligation to indemnify for defence costs even though there is a dispute as to whether the claim actually falls within the scope of the policy, as this matter may be resolved only in judicial proceedings where the nature of the insured's liability (if any) is examined. What is generally required is the possibility that the claim falls within the scope of the policy.[52] In some cases the contract may provide that, for defence costs to be payable, the insured's liability to a third party in respect of an insured risk has actually been established. Consequently,

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[48] Jess, *The Insurance of Professional Negligence Risks*: Law and Practice. Butterworths. Second Edition 1989, p 1

[49] Enright, op cit p 84

[50] Netherway, *Professional Indemnity Insurance-Scope of Cover and Claims Management: an Insured's Guide* [1998] Int. I.L.R 356.

[51] Merkin, op cit at 20728: "The obligation to defend is distinct from the obligation to indemnify the assured for any damages which may be awarded against him. Nevertheless, that obligation is normally imposed on the insurers only where the claim against the assured is capable of giving rise to a loss within the terms of the policy".

[52] *John Wyeth v. Cigna* [2001] Lloyd's Rep I.R 420.

where the third party fails to prove liability on the part of the insured, the latter might under this type of wording have no rights to recover defence costs under the policy and he must look to the claimant to recover his costs in accordance with the ordinary principle that costs follow the event. This was the approach adopted in *Thornton Springer v. NEM Insurance Co Ltd.*[53] Cover for defence costs may well be available even though the proceedings against the insured are not for damages, the usual remedy in cases of breach of contract, duty of care in tort or fiduciary duty, but are for an injunction, declaration or rescission.[54] Again, the indemnity for costs may extend to the cost of defending proceedings brought by a professional disciplinary tribunal where the sanction against the insured is unlikely to be financial.

One of the consequences of the principle that liability for defence costs is an obligation independent of the insurer's primary obligation to indemnify is the danger of waiver. Where insurers discover a defence to a claim for indemnity, based for example on breach of the duty of utmost good faith, breach of condition or breach of warranty and nevertheless decide to undertake the insured's defence, they might be deemed to have waived their rights to rely upon the relevant defence.[55]

1.3.4 Additional Contractual Terms

The nature of indemnity insurance demands additional contractual terms, designed to prevent spontaneous assumption of liability on the part of the insured or default by the insured in exercising his/her professional obligations. Either of these situations may prejudice the insurer by imposing a liability to indemnify the insured in circumstances where the insured's liability could have been avoided.

As to the first of these possibilities, it is commonplace for insurers to include a clause excluding liability under the policy where the insured has accepted liability without the written consent of the insurers. Sometimes it is specifically stated that consent

[53] [2000] Lloyd's Rep. I.R 590.
[54] For a clear explanation of the remedies available in professional liability cases, see Enright, op cit Chapter 12, "Remedies on the Risk".
[55] Legh-Jones, MacGillivray *on Insurance Law*, Sweet & Maxwell, 10th Edition.2003, pp 28-29. This is the approach in *Evans v. Employers Mutual Ins. Assoc* [1936] 1 K.B 505.

must not be unreasonably withheld,[56] but in the absence of such wording the current weight of authority favours the view that the court cannot second-guess the decision of the insurers in this regard unless it is shown to have been based upon considerations entirely extraneous to the claim.[57] This provision is often coupled with the express right reserved to the insurers to conduct the defence proceedings on behalf of the insured and to agree any settlement arising out of any claim against the insured. There may well be a dispute between the insurers and the insured as to whether it is appropriate to defend proceedings: the insurers may wish to defend if they believe that the insured has a good chance of success but even if the prospects are not good, the insured may nevertheless wish to defend in order to clear his name. To that effect professional indemnity policies have traditionally included a clause providing that insurers shall pay an indemnity without contesting any claim by a third party unless a Queen's Counsel (mutually agreed on by the parties) advises that the proceedings should be contested. These contractual terms are known as Q.C clauses[58] and their purpose is purely to settle any dispute between the insured and the insurer as to whether a claim has to be contested or not. The nature and legality of a QC clause were considered by Devlin J in *West Price & Co. v. Ching.*[59] The issue in that case was whether the QC clause operated where there was a dispute between the parties as to whether the third party's claim fell within the scope of the insured risks. Devlin J classified the QC clause as a form of contingency insurance rather than indemnity insurance and held that a dispute as to coverage had to be resolved by the court before the QC clause could operate.

The second contractual provision relates to the obligation of the insured to take reasonable care to prevent liability from arising in the first place. The problem here is that the trigger of liability insurance is generally a failure on the part of the insured to comply with the required level of care and skill in his dealings with a third party.[60] Since this sort of insurance provides cover for liability arising out of professional

[56] *Hulton & Co v. Mountain* (1929) 28 Ll LR 249

[57] This was the test laid down by the Court of Appeal in *Gan Insurance v. Tai Ping Insurance (No 2)* [2001] Lloyd's Rep IR 667. There are, nevertheless, dicta to the effect that the common law will imply a limitation to the effect that consent may not be unreasonably withheld: *Poole Harbour Yacht Club Marina v. Excess Insurance Co* 1996, unreported; *Thornton Springer v. NEM Insurance Co Ltd* [2000] Lloyd's Rep IR 590; *Glencore v. Ryan, The Beursgracht* [2001] 2 Lloyd's Rep 608.

[58] See Merkin op cit at 20732.

[59] [1957] 1 W.L.R 45

[60] Birds and Hird, *Birds' Modern Insurance Law,* Sixth Edition, Sweet & Maxwell, 2004, at 365-366

negligence, it is apparent that a term of this nature could operate to defeat the very cover provided by the policy. Accordingly, the courts have determined that wording of this type is to be construed as meaning that the insured is not covered where the conduct is deliberately aimed at causing a third party loss, or at the very least where the insured's conduct is with reckless disregard to whether a third party loss is caused. In other words, mere negligence will not defeat a claim under a professional indemnity policy.[61] The contractual position more or less reflects the common law in this regard.

It should also be noted that professional indemnity policies, being contracts of indemnity, confer upon insurers the benefits of the principle of subrogation. Thus, by indemnifying the insured the insurer retains the right to proceed against any third party who has contributed to the insured's liability or any third party whose conduct has wrongfully caused the insured to incur insured defence costs.

[61] *Woolfall & Rimmer v. Moyle* [1942] 1 KB 66; *Fraser v. Furman* [1967] 1 WLR 898; *Aluminium Wire and Cable Co Ltd v. Allstate Insurance Co Ltd* [1985] 2 Lloyd's Rep 280; *M/S Aswan Engineering Establishment Co v. Iron Trades Mutual Insurance Co Ltd* [1989] 1 Lloyd's Rep 289.

CHAPTER II

NATURE AND LEGALITY OF D&O LIABILITY INSURANCE

2.1. Legality - The Effect of Section 309 of Companies Act 1985

Professional indemnity insurance, as its name implies, requires the insured to exercise an activity capable by itself of being lawfully insurable. D&O liability insurance belongs to that complex area regarding professional indemnity insurance and as such deals with three main sorts of cover:

(1) The director's own liability to third parties as a result of any breach of contractual duties,[1] fiduciary duties or tort.
(2) Defence costs in which a director himself or the company may incur as a result of a legal proceeding involving liability under (1).
(3) Reimbursement to the company for any indemnity paid in advance to its directors.[2]

An additional form of protection is represented by 'Entity Covers' which, under the form of a composite insurance, offers cover for both directors and companies' liability.[3] Entity cover has nevertheless been regarded as contradicting the purpose of D&O insurance in the sense that it may exhaust the aggregate limit on claims leaving the directors without protection.

These types of cover are the result of all the principles governing company directorships and directors' liability, representing the interconnection of three parties within an "infernal triangle"[4] in which directors, third parties and the company itself battle to achieve personal goals. Consequently, directors and officers are compelled to follow complex duties which -in case of default- might make them highly vulnerable

[1] But not pure contractual liability as explained infra in Chapter IV 'D&O Exclusions '.
[2] Whether possible in accordance with section 309 of Companies Act 1985 as amended by the Companies (Audit, Ivestigations and Community Enterprise) Act 2005 which came into force on April 2004.
[3] For an explanation on entity cover, see Chapter III. Who is the Insured? – Composite Policies
[4] Baxter, *"Demystifying D&O Insurance"* [1995] OJLS 537, p 539.

in both civil and criminal law. Liability insurance, therefore, seems to be essential to allow directors to exercise their functions without fear of potential pecuniary losses from a variety of sources.

Prior to the enactment of the Companies Act 1929 it had been accepted, that the articles of association could exculpate directors and officers from liability, provided they were not guilty of fraud or wilful default. In other words, it was perfectly legal to incorporate indemnity clauses – within the articles of association – to alleviate directors from the fear and reality of becoming negligently or innocently liable.[5]This principle was completely transformed by the work of the Greene Committee on Company Law which suggested this practice be prohibited. This recommendation was implemented by the Companies Act 1929 s 152, followed by s 205 of the 1948 Act, former section 310 of the Companies Act 1985 and evolved as to what is today section 309 of The Companies act 1985 as amended by Companies (Audit, Investigations and Community Enterprise) Act 2004. Nowadays, it is clear from the principle of "Moral Hazard"[6] that companies are prevented in all circumstances from indemnifying their directors for damages awarded against them resulting from the dishonest or negligent performance of their duties. Consequently, the Companies Act 1985 has removed the possibility of obtaining – on the part of directors – economic benefits due to their lack of commitment in this respect. It is thought that this approach may raise the level of efficiency and loyalty in the performance of their obligations.

Thus, Section 309(a)(1)(2)(3) of the 1985 Act- as amended- provide as follows:

"(1) This section applies in relation to any liability attaching to a director of a company in connection with any negligence, default, breach of duty or breach of trust by him in relation to the company.
(2) Any provision which purports to exempt (to any extent) a director of a company from any liability within subsection (1) is void.
(3) Any provision by which a company directly or indirectly provides (to any extent) an indemnity for a director of – (a) the company, or (b) an associated company, against any liability within section (1) is void."

[5] *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 and *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.
[6] Parson, *"Directors' and Officers' Liability Insurance: a target or a shield?"* (2000) 21 Co Law 77. The author emphasises the fact that public policy impeded the application of liability insurance because it could lead to " carelessness by industrialists and others who knowing they were insured might take less trouble to avoid accidents".

Thus, attempts by the company to exclude the liability of the directors[7] or to agree to indemnify them for breach of duty are void[8] as a matter of law. This limitation applies only as regards liability in relation to the company and not in relation to third parties.[9]

What has led to serious debate is the fact that nowadays it is recognised that directors' responsibilities may fall into two different classes namely duties as such and disabilities.[10] The first class embodies duties which cannot be modified without infringing section 309 of the Companies Act 1985. The duty to act honestly or in good faith and the tortious duty of care and skill are associated with this group. Public policy limitations impede the likelihood of exclusion and indemnity clauses where directors disregard the interest of the company or act negligent to its detriment.
As regards disabilities, as the word suggests, directors are unable to carry out certain activities, in contravention of their fiduciary obligations, had they not been previously disclosed to the company. The rule is thus, that the general prohibition that a director cannot contract with the company is a disability capable of being modified by the consent of the shareholders.[11] The no-conflict and profit rule are deemed to belong to this sort of amendable duty.[12]

We have seen that, by way of exclusion clauses within the articles of association, director's disabilities –the no conflict and profit rule- can effectively be changed. This situation is the default position where the company has not drafted its own articles but has adopted articles 85 to 90 of the Model Table 'A' Regulations 1985. The issue here is to reconcile the operation of exclusion clauses under the 1985 Act and under article 85 of Table A since under that article an exclusion clause of this nature is perfectly permissible. The decision in *Motivex Ltd v. Bulfield* [13] has provided unambiguous guidance as to the interpretation of section 310 (now 309) of the CA 1985; concluding

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[7] Birds, *"Excluding the duties of directors"* (1987) 8 Co Law 31
[8] Whether dishonest or negligent.
[9] *Burgoine v. Waltham Forest London Borough Council* [1997] 2 B.C.L.C 612; and now to some extent clarified by the new section 309 subsection (4) and s 309(b) of the Companies Act 1985, which allows third party qualifying indemnity provisions, provided they do not indemnify directors against liability.
[10] Rogerson, *Modification and Exclusion of Directors' Duties* in Rider Barry A K, *The Realm Of Company Law*, Kluwer Law International. 1998 p 102
[11] Ferran, *Company Law and Corporate Finance*, Oxford 1999 at 169
[12] Infra Chapter V 'Conflict of Interest and Non-Profit Rule'.
[13] [1988] B.C.L.C 104

that it may co-exist with that of the Table A Reg 85[14] and that exclusion clauses are indeed permissible.[15]

What has been problematic is that the original version of s 310 of the Companies Act 1985 was unclear as to whether or not companies could incur the cost of an insurance premium and thereby insure against directors' potential liability in damages without contravening the terms of the section. In the absence of clarity on the point, the development of the market for D&O insurance cover was severely hampered. The matter was resolved when section 137 of Companies Act 1989 came into effect and opened the doors to D&O liability insurance by amending s 310 and establishing the 'legality of such cover'. This has been ratified by the insertion of a new section 309(5) of the Companies Act 1985, which is in the following terms:

"(5) Subsection (3) does not prevent a company from purchasing and maintaining for a director of-(a) the company, or (b) an associated company, insurance against any liability within subsection (1)."

2.1.1 Moral Hazard

There has been substantial debate as to whether or not directors' conduct might change as soon as the risk of facing liability for damages was removed from them and transferred to insurers,[16] thereby questioning the justification of this type of economic relief.

It has been argued in the first place that the existence of fallback insurance may motivate directors and/or officers to take risky decisions in the belief they are protected in any case. This freedom might lead directors to act in a fashion which conflicts with their basic obligation to the company to exercise their business judgment for the best interests of the company. It is thus asserted that decisions which would have not been taken in the past could be easily carried out even at the expense of the company and its shareholders.

[14] On this regard see Passmore, "*Company Law: Directors Indemnities*", (1995) 16 Co Law 243.
[15] Albeit giving the fact that section 310 has been recently amended by the Companies (Audit, Investigations and Community Enterprises) Act 2004, it would be necessary to wait until new precedents clarify the issue.
[16] Faure and Hartlief, "*Remedies for Expanding Liability*" [1998] OJLS 681.

It might be thought that this suggestion is divorced from reality. Directors and officers, even with insurance cover, are far from able to act with complete freedom, let alone carelessly or recklessly. In fact the Companies Act 1985 alone contains many offences of diverse nature, many of which are by their nature incapable of being underpinned by liability insurance. Any duty, the breach of which leads to criminal or administrative fines, or civil liability not based on losses to third parties, are by their nature uninsurable, but such sanctions are a key characteristic of directors' obligations. Additionally, the Company Directors Disqualification Act 1986 imposes disqualification upon the wrongdoers, for indictable offences, persistent breaches of duties, fraud etc, none of which are by their nature matters against which insurance can be obtained.

Further, the effect on directors' reputation plays a crucial role indeed, mostly on those who hold office in well known companies or upon those non-executive directors who hold office in more than one corporate body. Hence, it does not seem that the introduction of D&O insurance is the reason behind carelessness or imprudent decisions. Experience shows that the degrees of harm caused by directors in recent corporate scandals is based on deliberate fraud, ignorance as to what is or is not permissible (often the result of lack of legal assistance and advice) and the shield of corporate personality.

A second strong argument against the legality of D&O insurance is supported by the idea that such insurance undermines the internal rules of a company and may lead to a partial or complete absolution of the director.[17] To this it might be said that insurance does not mean exoneration of culpability, it could be exculpation in an economic but not in a judicial sense.[18] This point needs further clarification.

The purpose of liability insurance is to hold the insured harmless, in terms of his economic situation; D&O insurance of course shares this feature. The ascertainment of a director's liability is a *conditio sine qua non* of his right to be indemnified: this

[17] Roncero Sanchez,. *El Seguro de Responsabilidad Civil de Administradores de una Sociedad Anonima (Sujetos, Interes y Riesgo),* Aranzi, Spain 2002, p37.
[18] Ibid , p 42

means that a director must be found by a court or arbitrator to be guilty of a breach of duty, or he must be at least a party to a settlement regarding his responsibility. It is irrelevant to the finding of liability whether or not the director is insured. It is also to be borne in mind that the true beneficiary of a liability policy is not so much the insured person but rather the victim of the insured's person's breach of duty, as liability insurance provides a fund against which a claim can be made in the event that the insured is personally unable to meet the claim. The real effect of liability insurance is that the insurer undertakes to make good the harm inflicted on the victim by the insured. Where the issue of economic exculpation is considered, attention should focus on who is the real beneficiary of the insurance and in this sense D&O cover does no more than act as a guarantee of the director's solvency to the third party victim, including the company.

A third argument against D&O insurance, and perhaps the weakest, is the fact that a court, when discovering directors or officers are covered by insurance, might tend to impose additional duties upon directors, or award increased sums against them, in the belief that directors are insured and will not ultimately have to pay for the loss. Indeed, it is the case that disclosure principles under the Civil Procedure Rules make it almost certain that the existence of a liability policy will become apparent in the course of any legal proceedings. The argument founders on the basis that there is to date no evidence that – at least in D&O cases – the courts have taken into account the coverage granted by D&O policies to fix the liability of the director.

There are positive reasons to believe that D&O insurance is unlikely to affect the conduct of a director's activities. Restrictions on indemnity are found in such policies, and the danger of "moral hazard" is alleviated by way of deductibles, co-insurance, restrictions and limits of coverage.[19] Thus by imposing an excess or limiting the cover the insured could be persuaded to take more interest in his/her own claims understanding.[20]

In conclusion the question of the legality and justification of D&O insurance should no longer be a live one, and that allegations of the dilution of "moral hazard" seem to

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[19] Parson, op cit at 84

[20] Bennet, *Dictionary of Insurance*, Pitman Publishing. 1992, p 222

have no bearing on what third parties, shareholders, companies and directors themselves may need or experience.

2.2. Nature of D&O Policies

A working definition of D&O cover may be found in the insuring clauses of such policies. A typical wording is as follows:

> 'The undertaking on the part of the insurer is to pay on behalf of Directors and Officers, to the extent they are not indemnified, loss arising from any claim first made against them during the period of insurance and notified to the Insured during the period of insurance by reason of any Wrongful Act perpetrated in their capacity of Director or Officer for the consideration of payment of a premium to the insurer.'

Obviously, the expression 'pay on behalf of', leads to the conclusion that D&O insurance belongs to the general area of indemnity insurance and more specifically professional liability insurance. The insurer agrees to make good to third parties on behalf of the insured a sum of money designed to compensate the third party for losses accruing by reason of the insured's misconduct. This is a typical example of third party liability insurance, where the person to be indemnified is a stranger to the insurance contract and is potentially unidentified at the date of its formation. D&O policies are, therefore, subject to the ordinary rules which apply to liability covers. Nevertheless, it cannot be doubted that D&O possesses certain individual characteristics which are not found in other forms of liability insurance. These unique features are considered below.

2.2.1 Directors: Are They Professionals?

The question whether company directors carry on a profession may at first sight seem to be of academic interest only. In fact, the point is of major practical significance. Insurance cover taken out by a corporate group or enterprise will generally be in the form of a package and will include all manner of first party and third party insurances, including specific D&O cover. The terms of professional indemnity cover and D&O cover may be quite different, and the point has arisen in practice – although it has not

yet been decided – whether a director is entitled to indemnity under the professional indemnity section of the policy as well as under the D&O section. It might be thought that the answer is that there is no point in having separate D&O cover if there is protection by reason of professional indemnity insurance, although the wording of policies does not automatically lead to this conclusion. That said a stronger point is that being a director is not a "profession" at all.

Unquestionably, the task undertaken by directors and officers is often referred to as a 'profession', although it might be thought that this is the result of a general confusion between the term 'profession' and the notion of 'professionalism'. It is true that directors are appointed for, and carry out their functions by reference to, esoteric knowledge and complex skills required of them.[21] However, the feature of esoteric knowledge does not mean, that special training or theoretical education is essential to hold office. Nevertheless, the massive amounts of investment which companies nowadays put into business make the occupation of being a director one of some status[22] and consequently, the need to be exercised with certain professionalism.[23] The professionalism required of directors imposes upon them a code of conduct[24] the component elements of which are, amongst others, the law of contract (memorandum and articles of association), principles of equity (since the directors act not only as fiduciaries but also as agents of the company) and the common law standard of care generally demanded[25] in the performance of any legal or general activity. Thus, being a director *per se* is not a profession, but rather it is the complexity of the law surrounding directors and the imposition on them of a considerable number of diverse duties which gives the appearance of a discrete profession. It is thus submitted that directorship is not a profession,[26] but rather is an intricate post demanding from its holder care, skill, loyalty and good faith.

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[21] Freidson, *Professionalism Reborn*. Policy Press. 1994, p 13, which discusses the term 'profession'.
[22] *Ibid.*
[23] Millerson, *"Dilemmas of Professionalism"*, New Society. 4 June 1964, p 15. The concept of profession embraces different elements, amongst others (1) skill based on theoretical knowledge. (2) Training and Education. (3) Testing Competence. (4) Organization. (5) Adherence to a professional code of conduct and (6) Altruistic Service.
[24] Ibid.
[25] See Infra Chapter V: Relationship Between the Company and its Directors.
[26] Fernandez del Moral Dominguez, op cit p 39 ss. In continental Law the notion of what is deemed to be a profession is complex since it may have more than one meaning. However, it is mostly related to a way of living, the activity which provides the main source of income and has nothing, or very little, to do with professional skills or knowledge. This is why, without doubt D&O insurance is associated and identified with professional indemnity insurance.

Additionally, the term profession, as far as professional indemnity insurance is concerned, implies qualifications to carry out certain activities. In this way, a doctor, solicitor, engineer etc, must qualify and obtain permission to practise their respective careers. Such permission means that a professional is allowed to exercise an activity on his/her own behalf for the benefit or interest of third party clients. As far as directors and officers are concerned, they do not exercise any activity in their own behalf but rather act on behalf of the corporate entity[27] and represent the company in its everyday activities in respect of clients or customers. What is missing therefore *a sine qua non* requisite in any profession is 'the exercise of the acquired knowledge or skill on his/her own behalf.' All of that said, some types of public liability insurances cover employees who are exercising the skills demanded of a "true" professional, eg, those of a lawyer or an accountant: the cover here is based on the profession itself rather than on the fact that the person in question happens to be a director, and accordingly the insurance is not D&O cover at all.

It should also be commented that there are no legal requirements or qualifications for the holding of office. Directors only need to be appointed by the co-founders of the company or by the majority of shareholders in general meeting, or they may carry out functions as a shadow or *de facto* director. The only skills demanded of directors are those required by the company itself. This is far from being an argument designed to disparage directors: the point is that while D&O insurance is derived from professional indemnity insurance, the former has gained its own place as a new sort of cover, with its own features of legality, enforcement and policy construction.

2.2.2 D&O Subject-Matter.

Insuring clauses of the type set out above provide indemnity against claims for losses arising from wrongful acts committed by the director acting in his capacity as such. In the vast majority of cases liability will be based on the negligent performance of the director's obligations, as "in matters of fine judgment or great complexity no human

[27] Roncero Sánchez, op cit at p 64.

being can be right every time."[28] English law allows recovery of pure financial loss where there has been a breach of contract or in tort where the defendant has voluntarily undertaken an obligation to the third party to hold him harmless from such loss. The concept of "loss" nevertheless, has been expanded in the context of D&O insurance, since it may include not only sums payable by way of damages but also legal costs incurred in the defence of proceedings, settlements or arbitration of claims.[29] According to the form LSW 736 of Lloyd's, "costs and expenses" are defined as including "all necessary and reasonable fees and expenses incurred, by or on behalf of, the directors and officers with the written consent of the insurer resulting from the investigation, monitoring or settlement of any claim." These costs are part of the total limit of indemnity and sometimes are paid in addition to the total limit of indemnity,[30] all depending on policy construction.

The coverage of defence costs as part of the insured risk gives rise to two difficult and for the most part unresolved issues of law: the separability of defence costs from the main indemnity, and allocation of defence costs. As mentioned earlier, the issue of separability depends on the proper construction of the policy and the most important issue is to ascertain whether defence costs are covered within the overall limit of indemnity or whether they are subject to a separate limit of indemnity. In fact it is commonplace for a director to be indemnified for the costs incurred by him in defending his personal liability irrespective of the consideration that the cause of action brought by the third party alleges fraud, deliberate or wilful misconduct (all inherently excluded perils) in the event that such allegation is not made out at trial. By contrast, if the director is found liable for fraudulent or deliberate breach of duty, while there is plainly no right to recover under the indemnity provided under the policy for liability, as the policy does not respond, there may be an issue in relation to defence costs. It is a matter of construction in every case as to whether defence costs are covered absolutely, or whether they are covered only where the director's liability is found to be based upon a risk insured under the policy.[31]

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[28] Powell, *Jackson & Powell on Professional Negligence*, Sweet & Maxwell. 1997, p 5
[29] Lloyd's LSW 736. (f) "Loss shall mean legal liability of the Directors or Officers to pay: (i) damages or costs awarded against the Directors or Officers; (ii) settlements as agreed by Underwriters .... (iii) Costs and Expenses".
[30] Bennett, op cit at 84.
[31] Supra Chapter VIII D&O: Defence Costs Cover and Allocation

Allocation of defence costs cover in practice, leads to very complicated situations which fall within one of the four following categories.

(1) The issue of allocation of defence costs between insured and uninsured directors. It was held in *Re National Funds Assurance Co*[32] that whenever more that one director participates in the breach of the duty they are jointly and severally liable to make good the amount owed to the company. If the breach involves, for example, an executive and a shadow or non-executive director, the latter may not be insured under the company's D&O policy and an allocation problem arises.

(2) The allocation of defence costs between directors who are protected under different policies.

(3) The allocation of defence costs between the company and its directors whenever entity cover is offered.

(4) The allocation of defence costs between an uninsured company and insured directors.

These categories give rise to a unique sort of insurance in which two different parties, on one side the company and on the other its directors (who act on its behalf), battle to determine what portion of defence costs should bear as a loss which is not insured and what amount should be paid by the D&O insurer.[33]

2.2.3 Uncovered Loss: Restoration of Property and Missing Goods

A company is entitled to recover its property from directors or from third parties in possession of its property -who are deemed to hold the trust property as constructive trustee- provided that the property is traceable and therefore recoverable *in rem*. This remedy is open to the company even against directors who by the time of the breach of duty had ceased to hold office, as was held in *Re Lands Allotment Co*[34]. Where a director is required to hand back property to the company which he has

[32] (1878) 10 Ch D 118. See also: *Re Carriage Co-operative Supply Association.* (1884) 23 Ch D 322; *Re Faure Electric Accumulator Company* (1889) 40 Ch D 141.
[33] Rosenberg, Sigelko and Miller, *"D&O Liability Insurance-Coverage, Liability and Advice Issues"*, 1995, American Bar Association, p 1.
[34] [1894] 1 Ch 616. "Directors of a company are trustees as to moneys of the company which have come to their hands or are under their control..." See also *Forest of Dean Coal Co* (1879) 10 Ch 540.

misappropriated, there is no prospect of his recovering an indemnity under a D&O policy. Insofar as the misappropriation was deliberate, liability will by the nature of the cover be excluded. Insofar as the misappropriation was negligent or innocent, the wording of a D&O policy refers to liability for damages resulting from breaches of personal duties, giving rise to actions *in personam* toward the company or third party. Additionally, it could be asserted that profits which have accrued to the director as a result of his misappropriation of corporate property are recoverable *in rem*; as such profits are treated as corporate property because they flow from the use of company's property.[35] In *Attorney-General for Hong Kong v Reid*[36] the Privy Council held that bribes paid to fiduciaries were the property of the company for the purposes of an action for breach of fiduciary duty. In so deciding the Privy Council rejected the previous understanding that bribes were not held in a fiduciary capacity, and ruled that a fiduciary holds the bribe as a constructive trustee and as such he was bound to account not only the bribe itself but also whatever he acquired as a result of its investment.[37]

A director who is no longer in possession of corporate property misappropriated by him, and who has not received benefits from that property will nevertheless face liability to the company for the value of its property[38] by reason of his breach of duty in relation to it. However, it would seem that this form of liability would be covered by a D&O policy as long as the misappropriation was not fraudulent or reckless.

In practice the problem of misappropriation is dealt with by first party fidelity policies taken out by companies, although such policies in practice are confined to theft or dishonesty on the part of the director.[39] Once insurers have paid the claim, they have subrogation rights against the guilty directors.[40]

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[35] Davies: *Gower and Davies', Principles of Modern Company Law*. 7th ed. 2003. 426.
[36] [1994] 1 AC 324.
[37] Allen, "*Bribes and Constructive Trusts: A-G of Hong Kong v. Reid*" [1995] MLR 87.
[38] Virgo, *The Principles of the Law of Restitution*. Oxford.1999, 3: "This means that the defendant is liable to pay the value of the benefit to the plaintiff rather than transfer the benefit itself to the plaintiff".
[39] Youngman,*Directors' and officers' Liability Insurance. A Guide to International Practice.* Woodhead publishing Limited *1999* at 47. "The intention of a fidelity policy is to protect the company from losses of money or goods in the event of fraud and dishonesty by employees or directors".
[40] The fact that the fidelity cover and the D&O cover may form part of the same global policy will not be a defence to a subrogation action, as a fraudulent co-assured cannot resist subrogation proceedings even though an innocent co-assured may be able to do so: see *National Oilwell (UK) v. Davy Offshore*

In summary D&O insurance can indemnify a director against loss of or damage to the company's profits flowing from his breach of duty, but such a policy cannot cover the director's obligation to restore the company's property to it as the claim against him is in respect of the company's own property. In cases such as *Attorney-General for Hong Kong v. Reid*[41] D&O insurance seems unlikely to be functional.

2.2.4 The Meaning of Wrongful Act

It is worthwhile emphasising that a loss, to be covered by a D&O policy must be the result of a wrongful act committed by the director in his capacity as director; in other words, the insured must incur liability in the performance of duties on behalf of the entity.[42] These two issues must be considered separately.

The term "Wrongful Act" is generally defined as any actual or alleged breach of contract, breach of duty, breach of trust, act, neglect, error, omission, misstatement, misleading statement by the director or officer[43] in his/her insured capacity. The coverage is sometimes extended, on the payment of additional premiums, to libel, slander, breach of warranty of authority, or wrongful trading under section 214 of the Insolvency Act 1986. This seems to be an exclusive feature of D&O insurance as well because loss arising out of wrongful acts is the insured event in a policy of this nature.[44]

As noted earlier, the meaning of wrongful act excludes fraudulent, deliberate or criminal conduct which gives rise to liability. This is a matter of public policy, although the point is often made express in policies themselves. Conversely, when the voluntary act denotes a failure to foresee the negative consequences of behaviour, as a reasonable man would do, such conduct, albeit harmful, is nevertheless within the scope of a D&O insurance policy since the wrongdoer (director or officer) has not

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Ltd [1993] 2 Lloyd's Rep 582.

41 [1994] 1 AC 324.

42 Coregis, COR.OOC.2043 (7/97).

43 The Lloyd's form LSW 736 is less specific by defining that a wrongful act shall mean: "any actual or alleged wrongful act or omission by directors".

44 Bennett, *Dictionary of Insurance*, Pitman Publishing 1992.

proceeded maliciously. There exists also a category of culpability, being that of imputing responsibility to the wrongdoer irrespective of fault (bad intention or negligence). Strict liability may arise in a number of common situations, e.g., breach of statutory duty, infringement of copyright, vicarious liability and the rule in *Rylands v Fletcher*.[45] While the liability of the director in any of these cases does not depend upon his state of mind, his ability to recover under a D&O policy may well rest upon the fact that his breach of duty was not deliberate or reckless.

Further, the claim under the policy must relate to the director's liability.[46] What is required, therefore, is a civil wrong on the part of the director, which may be defined as a "breach of a legal duty owed to another".[47] Thus, if there is no duty broken, there can be no wrong and thus no claim against the director. This point emphasises that a D&O policy covers the liability of the director, and does not cover losses suffered by the company on a first party basis.

2.2.5 In What Capacity must the Wrongful Act be Executed?

D&O policies cover defaults by a director and it is immaterial that the insured has ceased to hold office at the time of the claim against him. By way of example, Forms LSW 736 of Lloyd's and 14-02-2009 of Chubb[48] provide that a director or officer is any natural person who was or is or may hereafter be a director or officer of the company,[49] and they expressly exclude from the definition any person who has not held office in any way and/or any time. Assuming that the insured has held the relevant office, a claim may be made under a D&O policy only where the director's liability has arisen by reason of conduct attributable to him in his capacity as director,

[45](1868) L.R.3 H.L 330 " Where the owner of land, without wilfulness or negligence, uses his land in the ordinary manner of its use, though mischief should thereby be occasioned to his neighbour, he will not be liable in damages. But if he brings upon his land any thing which would not naturally come upon it, and which is in itself dangerous, and may become mischievous if not kept under proper control, though in so doing he may act without personal wilfulness or negligence, he will be liable in damages for any mischief thereby occasioned".
[46]Youngman, op cit at 18.
[47] McBride and Bagshaw, *Tort Law*, Longman. 2001, p 3.
[48] Chubb, Form 14-02-2009: "Insured person means any natural person who has been, now is or shall become a duly elected director or trustee, duly elected or appointed officer, employee or committee member (whether or not salaried) of an Organization, and any natural person acting in a voluntary capacity on behalf of an Organization and at the specific direction of such Organization".
[49] Form LSW 736 Lloyd's . 3.Definitions (a)(i).

and not in his capacity as shareholder or private person. The only available ground upon which the director may receive indemnification under the substantive provisions of a D&O policy (i.e., excluding any provisions relating to defence costs) is where the claim is made by the director in his capacity as such. This means that a distinction, which is not necessarily an easy one, has to be drawn between the various capacities in which a director may act. For example, shareholder's agent or shareholders of a small private company in which, usually a distinction cannot be drawn, between being a member of the company and forming part of the board of directors.

Additionally, it is essential to consider in what capacity the directors were acting at the time losses were inflicted on the company and not at any other time. The point may be illustrated by the facts in *Forest of Dean Coal Co*,[50] where a shareholder who later becomes a director was held liable for not disclosing to the company a misappropriation of company's assets which he was aware of, before holding office. In the context of D&O, the fact that a claim is made against the director and reported to the insurers while the director held office would not mean that his liability arose as director within the insuring provisions of the policy. In the same way, the alleged breach of duty might refer to a contract entered into on behalf of the company at a time its actual director was not in charge of company's affairs. In considering this matter it is also important to bear in mind the distinction between "occurrence" policies and "claims made" policies. Most D&O policies are written on the latter basis, so that the cover responds to any claim made against the director during the currency of the policy irrespective of the date on which the act, giving rise to the claim, took place.[51] The insurer might indeed offer cover on a claims made basis and contractually agree upon the coverage of past defaults on the part of the director for which he faces liability to the company whether or not at the time he was acting in his capacity of director. In practice, however, this is not the case.

2.2.5.1 The Unwelcome Scenario

It is perfectly possible to contemplate that companies, shareholders or third parties

[50] (1879) 10 Ch 450.
[51] Parsons, op cit at 77.

wishing to bring proceedings against a director may frame their claim in a manner which ensures that the claim falls within the director's D&O policy. The point is of particular significance where there has been fraud on the part of the director, as a claim based on fraud will automatically prevent the cover from attaching and may well mean that any judgment obtained by the director's victims will be meaningless.[52] A clear example is the recent case of *MacDonnell Information Systems Ltd v. Swinbank and others*,[53] involving a professional indemnity insurance which expressly excluded fraud on the part of the insured's employees where the insured could have reasonably discovered it. The claimant, seemingly aware of the existence of an insurance policy and its exclusions, opted to claim against the company based upon negligence, error or omissions in the performance of their duties and on breach of contract, thereby purporting to remove any argument on the part of the insurer that the claim could be denied on the basis that fraud had been "alleged". On the facts there was clear fraud on the part of employees, and not mere negligence and it also seemed that the insured could not have been unaware of that fraud. The Court of Appeal accepted the insurers' argument that it was necessary to look at the true basis of the claim rather than the manner in which it had been formulated and that the true basis of the claim was fraud. Accordingly, if it could be shown at trial that there had been fraud by the assured's employees and that the assured had been aware of it, the insurers would have had a defence even if judgment had been obtained against the assured on the basis of breach of contract or negligent breach of duty.[54]

2.3. D&O: Trigger of Coverage

D&O policies issued in the London market are written on a claims made basis, which means that the contingency insured against is the making of a claim against the assured within the period of insurance irrespective of when the incident giving rise to the claim happened. As explained before[55] the essence of a policy of this nature is to

[52] Baxter, op cit at 563: "....There is evidence, in the US; it is not uncommon for cases of dishonesty to be called negligence, often with the connivance of the defendant, simply to bring them within D&O cover".
[53] [1999] Lloyd's Rep IR 98.
[54] Ibid. 99 " ...if the insurers could show that such acts or omissions were perpetrated after McDonnell could reasonably have discovered or suspected the improper conduct of its employees, the exception in clause 2(b) would potentially be applicable".
[55] Infra Chapter I: Claims as a Subject of Indemnity.

deem the claim, as much as losses or liability at law, as the contingency which duly notified, activates the insurance. Such a claim is the condition which sets in motion the insurers' primary obligation to make payment, although that obligation is crystallised only where there is a judgment, award or settlement in favour of the third party. This type of provision is generally framed as a condition precedent, breach of which automatically relieves the insurer from any liability to meet the claim against the assured. In *Pioneer Concrete (UK) Ltd v. National Employers Mutual General Insurance Association Ltd*[56] the judge was of the view that an insurance condition requiring the insured to give written notice -of 'any accident and any claim and any proceedings' immediately after any of these contingencies have come to his knowledge- to the insurer was a condition, the breach of which, enabled the insurer to refuse the claim it being irrelevant whether or not the breach had caused the insurer a prejudice. Where the clause is not framed as a condition precedent, the insurer cannot refuse to pay the claim but he may have a counterclaim for damages for breach of condition by proving that loss or prejudice has been suffered as a result of the delay or non compliance with due notification.[57]

Conversely, the approach taken in both Australia[58] and New Zealand[59] seems not to follow the same rule of law. In Australia in *East End Real Estate Pty Limited v. C E Heath Casualty & General Limited*,[60] it was held that section 54 of Insurance Contracts Act 1984 prevented the refusal of a claim purely based on grounds of

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[56] [1985] 1 Lloyd's Rep. 274. See also *Eagle Star v. Cresswell* [2005] Lloyd's Rep IR (forthcoming).

[57] See *Friends Provident Life & Pensions Ltd v. Sirius International Insurance* [2005] EWCA Civ 601, rejecting the view expressed in *Alfred McAlpine v. BAI (Run-off)* [2000] Lloyd's Rep IR 352, as applied in *Bankers Insurance Co v. South* [2003] Lloyd's Rep IR 1, that a serious breach of a claims condition could allow the insurers to refuse to pay the claim. See also Netherway, *Professional Indemnity Insurance- Scope of Cover and Claims Management: An Insured's Guide.*[1998] Int. I.L.R 356 at 359. It is clear from Friends Provident that the prospects of an insurer recovering damages are remote, as any loss is purely speculative.

[58] Insurance Contracts Act 1984 s 54 (1) " Subject to this section, where the effect of a contract of insurance would, but for this section, be that the insurer may refuse to pay a claim, either in whole or in part, by reason of some act (which by sub-section 6 includes an omission) of the insured or of some other person, being an act in respect of which sub-section (2) applies (acts reasonably regarded as being capable of causing or contributing to a loss) the insurer may not refuse to pay the claim by reason only of that act but his liability in respect of the claim is reduced by the amount that fairly represents the extent to which the insurer's interests were prejudiced as a result of that act".

[59] Insurance Law Reform Act 1977 s (9): " A provision of a contract of insurance prescribing any manner in which or any limit of time within which notice of any claim by the insured under such contract must be given or prescribing any limit of time within which any suit or action by the insured must be brought shall: (b) (non-life policies) bind the insured only if in the opinion of the arbitrator or court determining the claim the insurer has in the particular circumstances been so prejudice by the failure of the insured to comply with such provision that it would be inequitable is such provision were not to bind the insured".

[60] (1991) 25 N.S.W.L.R 400.

failing to notify within policy period, should not such failure amount to any prejudice to the insurer.[61]The same approach was followed in *FAI General Insurance Company Ltd v. Australian Hospital Care Pty Ltd*[62]where during the currency of the policy the insured – a doctor- received a letter form a patient saying that he was considering suing for contracting post-operative septicaemia. The doctor who also owned the hospital failed to notify the insurer and after expiry of the policy the patient initiated proceedings against the assured. The insurer refused indemnity due to a failure on the part of the assured to report the aforementioned letter during the period of insurance. It was held that section 54 operated on those circumstances thus the insurer could not refuse to pay the claim.[63] The burden of proving prejudice will be on the insurer[64] who must ascertain what act or omission on the part of the assured worked out to his detriment.[65]

2.3.1 Substantive Trigger of Liability

It follows that the exact meaning of the term "claim" or "circumstances likely to give rise to a claim" against the insured must be considered and it should be said from the outset that it is the claim against the insured by the third party rather than the claim by the insured against the insurers which is the trigger of coverage.[66] It is generally understood that a claim is a demand for money or services or assertion of legal rights.[67] In *West Wake Price & Co v. Ching*[68] it was decided that the word 'claim' is attached to the object that is claimed. This means that a claim for money-within the insurance context- should be regarded as a demand for a sum against the pretended wrongdoer irrespective of the cause of action by which it is supported or in which it is based. In this case a clause in the policy required "immediate notice in writing of any

[61] Griffiths, Time Limits in Claims-Made Insurance in Australia and New Zealand. [1997] Int. I.L.R 85.
[62] [2001] HCA 38.
[63] Ibid.
[64] *Equitycorp Industries Group Ltd and Others v. Hawkins and Others and CE Heath Casualty & General Insurance* (NZ) (1994) 8 A.N.Z.I.C 61-207 at 65-276.
[65]See Hobson, *High Court Examines Liability of Insurers Under Section 54 of The Insurance Contracts Act*. [1997] Int. I.L.R. 362.
[66] Parsons, op cit at 78. See *Royal and Sun Alliance v. Dornoch* [2005] Lloyd's Rep IR (forthcoming), which applied this principle in relation to a reinsurance notification of loss clause.
[67]Bordon, *Directors' and Officers Liability Insurance*. Deskbook. American Bar Association. 1998, p 43.
[68] [1956] 3 All ER 821.

claim made upon them" (the insured); the clause was construed by the court as implying that underwriters wanted to be told at once of any claim that was likely to be of interest to them under the policy[69] without imposing upon the assured the burden of first construing the wording of the insuring clause- act or neglect, default or error- as to attached to the claim. Thus a claim is not be confused with the cause of action against the assured. Stocker LJ in *Thorman v. New Hampshire Insurance Co Ltd*[70] noted that "...a claim can only be enforced by legal proceedings where the appropriate cause of action is pleaded and proved, but the cause of action is not, itself, a claim but the necessary vehicle for its legal enforcement..."[71] Consequently, the word claim in this context can be classified – following Professor Clarke's ideas[72]- as follows:

- The happening of circumstances of fact which may give rise to injury and its consequential liability.[73]
- The happening of circumstances of fact which may give rise to a claim.
- The happening of circumstances of fact which are likely to give rise to a claim.[74]
- Notification to the insured of circumstances which may give rise to a claim 'mere allegations'.
- Notification to the insured of circumstances likely to give rise to a claim.
- The institution of either civil or arbitration proceedings against the insured.

From the very definition of 'claims made' policies one may appreciate that communication between the victim of the wrongdoing and the insured is indispensable. In this regard, Staughton LJ in *Robert Irving & Burns v. Stone*[75] emphasised that " in the ordinary meaning of the English language the words 'claims made' indicate that there has been a communication by the client to the surveyor of some discontent which will, or may, result in a remedy expected from the surveyor. There must be communication". [76]

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[69] Ibid.
[70] [1988] 1 Lloyd's Rep 7.
[71] Ibid at 16.
[72] Clarke, *The Law of Insurance Contracts* . Fourth Edition. LLP. 2002 at 514.
[73] This sort of liability is contractually excluded in D&O policies.
[74] See supra The Procedural Trigger of Liability: When Notice Must Be Given.
[75] [1998] Lloyd's Rep IR 258 at 261.
[76] Ibid.

Based upon the above arguments, it seems that a claim could take the form of oral statements as well as writing notice and it is the author's view, that both of these will suffice for the purpose of communicating to the assured that a third party has been prejudiced by the latter's wrongful act. However, for the avoidance of doubt, it is the practice of lawyers acting for an injured third party to make the claim in writing: this at least eases the assured's obligation to prove the date on which the claim was made against him or her.

Furthermore, the term 'written notice' or 'claim in writing' is capable of a very wide interpretation. The point is clarified by form LSW 736 of Lloyd's, which provides that a claim is to be understood as:

"(h) Claim shall mean:
(i) any writ or summons or other applications of any description whatsoever; or cross-claim or counter claim issued against or served upon any Director or Officer for any Wrongful Act, or
(ii) any written communication alleging a Wrongful Act communicated to any Director or Officer".[77]

Consequently, a claim could be defined as: a "written notice received by an Insured that a person or entity intends to hold any Insured responsible for a Wrongful Act. A Claim will be deemed to have been made when such written notice is first received by any Insured".[78]

The risk insured under a claims made policy is that of becoming liable to a third party following a claim first made upon the insured during the policy period.[79] The fact that a claim must first be made upon the insured implies that the insurer will not provide cover on claims made and/or indemnified under previous policies and also reflects the duty to disclose to the insurer any circumstance likely to give rise to a claim known – at the time of contract formation- by the assured.[80]

For example and in support of this argument, a standard policy of Australian International Insurance Limited, under the heading 'Coverage' clause 1.1 establishes:

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[77] Lloyd's form LSW 736.
[78] Executive Risk Indemnity Inc, Form C22208 (9/96 ed.)
[79]Carson, *Liability Insurance-Claims Made Policies*. In http://icareview.treasury.gov.au/content/_download/submissions/Carson.pdf.
[80] Marine Insurance Act 1906 s (15).

"AII will pay on behalf of the insured............
1.1.1 in respect of which a claim is first made against the insured during the period of insurance and notified in writing to AII during the period of insurance; or

(i) first discovered by the insured during the period of insurance;

(ii) which a reasonable person would have considered, when the circumstances were discovered, were likely to give rise to a claim against the insured; and

(iii) which were reported to AII in writing during the period of insurance".[81]

Five conclusions are readily apparent:

- First, a claim as such, could be a mere threat, warning or intimation made against the insured irrespective of the fact that such a threat has not matured in the form of legal or arbitral proceedings. Some policies clarify the issue by affirming that any written demand irrespective of pursuing or not a monetary compensation attaches.[82] This is by no means one of the main features of a D&O policy as explained before; in fact the risk covered under these policies, albeit clear in meaning 'liability to third parties', does not take the form of a unique event the happening of which activates the insurer's duty to provide indemnity. On the contrary it is a complex threefold process of following cumulative requirements. First, it is necessary that a claim is made against the assured director or officer - in the terms explained above- affecting their personal liability. This claim puts in motion the covering effects of the policy but resolves nothing on the grounds that the other party to a contract –the insurer- is still unaware of the event. This is why the process must move on to its second stage which is the notification to the insurer on the part of the assured that a claim has been made. Compliance with the notification obligation permits the ascertainment of a number of important issues, amongst which are: fixing the identity of the insurer to meet the claim as being the insurer on risk when the claim was made and duly notified within the period of insurance; and it also allows the insurer –without waiving his rights- to become involved in the claim by controlling proceedings,[83] assisting the assured or preventing the assured from admitting or assuming liability.

[81] Australian International Insurance Limited. Policy OIIL (6-2000) CM.
[82] WWTCALL99-2002.
[83] Usually, by means of claims control clauses.

However, other issues remain unresolved after notification: is the assured liable? If so, for how much? And are the insurers liable? The answer lies in the execution of the last requirement which is that the assureds' liability must be ascertained by way of legal proceedings, settlement or arbitration award. This final stage requires the assessment of the nature of director's or officer's liability and, in line with insurance contract's construction, determination if it is insured, uninsurable or contractually excluded. It being covered – the assured- the measurement of his liability might establish the amount to be indemnified or allocated between assured and uninsured directors or the company itself whether entity cover is provided. The reason for highlighting this threefold process is to clarify that the word "claim" as the substantive trigger of liability is relevant only to first stage: it is the phase in which either directors or officers realistically feel and experience the threat of being financially liable to third parties.

- Secondly, the claim must be first made upon the assured during the currency of the policy. It seems obvious that no insurer will provide cover for claims made under previous policies, or at least refuse to grant cover on that specific subject-matter since the prospects of having to meet any liability are necessarily increased. But the rationale behind this feature goes beyond simple predictions in fact, obtaining cover for previous claims or prior acts may distort the assured's motivation to purchase insurance since, knowing about any existing claim or loss may not only make D&O policies operate against accepted insurance principles but also allow the insured to select an insurer to meet his loss.[84] This exclusion embraces interrelated wrongful acts[85] on the understanding that the wrongful act and its subsequent claim may develop in a number of stages nevertheless having its roots in a single event or trigger of coverage. What must be clarified is the fact that this exclusion refers to prior acts notified under any earlier policy and not to those which, although occurring in the past, have not been subject to a claim against

[84] Herman & White . *D&O What you need to know*. Nonprofit Risk Management Center . USA. 1998. at 34.
[85] Ibid at 35: some policy wordings such as that of CAN, G-20717-A deal with this issue by indicating that the company will not cover claims which are: D. based upon, directly or indirectly arising out of, or in any way involving: " 2. any wrongful act whenever occurring, which, together with a wrongful act which has been the subject of such claim or such notice, would constitute interrelated wrongful acts".

the assured. Were it otherwise, a claims made policy would be useless. A D&O – as claims made- policy works backwards in time providing cover for claims made today for wrongful acts on the part of directors and officers that took place before or during the inception of the policy;[86] the exclusion refers thus only to those which have been previously notified under earlier policies. Additionally, a claim made during two different periods of insurance will be deemed as a unique claim subject to a single retention and policy limit.[87]

- Thirdly, the claim must not be known at the time of contract formation. Here Utmost Good Faith principles apply; as a result the assured is obliged to disclose, even without being asked, all material facts that might influence the knowledge of a prudent insurer by fixing the premium or taking the risk. A failure on the part of the assured entitles the insurer to avoid cover upon grounds of misrepresentation or non-disclosure. Assessing the breach of duty of utmost good faith appears to be more difficult where the company itself is the purchaser of insurance on behalf of its directors. Needless to say, the directors themselves – representing the company- might deal with the insurer, thus being aware of circumstances which require to be disclosed or not misstated. However, what is the duty imposed upon those directors who do not get directly involved in the negotiation? The answer to this question lies in the fact that directors may be insured either individually or as a board. In the former case it is suggested that every director is compelled to disclose matters of interest to the insurer and this is achievable by means of personal questionnaires completed by each of them. In the latter case, if the board is insured as a whole, it could be that a breach of the duty of utmost good faith by the director negotiating with the insurers could affect the rights of all of them. A solution to this potential unfairness is to construe the policy as offering independent cover to each of the directors on a composite basis, irrespective of being contracted for the whole board, thereby removing cover from the guilty directors but leaving the innocent directors insured. This was the approach taken by Rix J in *Arab Bank v. Zurich Insurance Co.*[88]Another important aspect of the duty of disclosure is with regards to the possibility of

[86] www.eqgroup.com/pdf/claimsmade _expl.pdf
[87] Bordon, op cit at 50.
[88] [1999] 1 Lloyd's Rep 262.

misrepresentation by not disclosing circumstances likely to give rise to a claim known before holding office. It is uncertain if this is a material fact, but it is the author's opinion that the duty of utmost good faith embraces the entirety of a director's knowledge without drawing a line between past and existing circumstances. Consequently, a director is obliged to disclose all that he knows in regard to potential claims to guarantee the enforcement of the D&O policy. It is commonplace for policies to exclude claims of which the insured had knowledge, albeit mere allegations or threats seem not to attach. There is no English authority on this matter, but US authority is helpful. The case of *Gibraltar Cas. Co v. A. Epstein & Sons Int'l, Inc*[89] dealt with the issue of a claim as "an allegation". The insurance policy expressly excluded claims of which the insured had knowledge prior to the inception of the policy. The insurer argued that that claim was excluded since the insured knew prior to the inception of the policy about a claim by receiving a letter from the claimant making general allegations based upon negligence, non-feasance and malfeasance. The court was of the opinion that due to want of specificity, the letter did not configure a claim under the wording of the policy thus the exclusion was not triggered.[90]

- Fourthly, a claim must be in written form. Where it takes the form of a claim form, this must be served on the defendant in order to trigger cover, as a result of the decision in *Robert Irving & Burns v. Stone*[91]; this case decides that a claim form must be served before it can be regarded as giving rise to a claim. In this case a claim form was issued against the insureds in respect of loss and damage allegedly suffered as a result of negligence, during the period of insurance. The claim form was served on them after the policy had ended, without any prospect of them becoming aware of the existence of the claim during the currency of the policy. The insurers contested liability on the grounds that the claim was not made within the cover period of insurance. Conversely, the assureds' argument was that since the claim form was issued during the period of insurance, the policy attached. The defence was rejected

[89] 562 N.E. 2d 1039 (III. App. Ct.1900).
[90] Bordon, op cit at 44.
[91] [1998] Lloyd's Rep IR 258.

by the Court of Appeal.[92] Alternatively, there must be a specific claim made by the third party, normally but not necessarily in the form of a letter before action.

- Fifthly, the claim must convey to the insured an unambiguous message from which he genuinely believes that legal proceedings regarding his/her personal liability are pending. Therefore, an unfortunate accident in a petrol station involving a customer who fell in the premises sustaining an injury was not deemed as being either a claim or a circumstance likely to give rise to a claim, despite this matured in legal proceedings some time afterwards.[93] This leads to the conclusion that isolated disappointments or disagreements in a company regarding directors' or officers' functions, do not amount to a genuine reason to believe their liability is at risk, so that a claim necessary to trigger the coverage of the policy is not to be regarded as having been made. In the same way, simple or isolated threats are not on their own claims which are capable of being notified.

When these conditions are satisfied and a claim has therefore been made against the insured, coverage under the policy is triggered on a contingent basis. That liability will, however, only come into being if the insured complies with notification obligations imposed upon him by the policy and it is normally the case that the insured is required to notify the claim to the insurers within the currency of the policy. The point, therefore, is that the word "claim" is used in two separate ways in a D&O policy: the notification to the insured within the currency of the policy of a claim against him (the substantive trigger of liability); and the notification by the insured to the insurers within the currency of the policy of the fact that a claim has been made against him (the procedural trigger of liability), which is the subject-matter of followings paragraphs.

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[92] See also *Thorman and Others v. New Hampshire Insurance Co (UK) Ltd and Home Insurance Co* [1988] 1 Lloyd's Rep 7.
[93] *Jacobs v. Coster* [2000] Lloyd's Rep .I.R. 506

2.3.2 The Procedural Trigger of Liability: When Notice Must Be Given

The purpose behind notification is that of making the insurer aware of all the circumstances surrounding the substantive claim, allowing him as *dominus litis* to examine and investigate at the earliest possible opportunity;[94] additionally insurers at this stage might decide whether or not it is worth contesting liability and to ascertain whether the assured has attempted to mitigate any loss. It follows, that these types of policies are in reality not only claims made but 'claims made and reported'.
The market offers at least four different sets of clauses all of which deserve independent assessment since they differ from one to another radically. Lloyd's form 736 is an example that belongs to the first group, it incorporates the following clause:

"the Directors and Officers and the Company shall give to underwriters written notice as soon as practicable of any circumstances of which the Directors and Officers or the Company shall become aware which might be expected to give rise to a claim against the Directors or Officers, giving reasons for the anticipation of such Claim, with full particulars as to dates and persons involved."[95] (Emphasis added).

Interpreting the phrase 'as soon as practicable' might lead to controversy; the meaning of the word 'practicable' refers to a state of affairs in which a person is able to carry a task or plan out successfully. Based upon these grounds a director or officer is obliged – as condition precedent- to give notice to the insurer as soon as he/she is physically capable in so doing. For example, if the assured has been notified of a claim in circumstances which makes it impossible or extremely onerous for him to notify the insurer, he will be regarded as having been temporarily discharged from notification while the exceptional situation still remains in existence. Once the situation returns to normal, the contractual duty is activated and the assured is under a duty of immediately proceeding to give written communication to the insurance company. In the unlikely event that there is no stipulation in the policy with regard to notice it is suggested that the insured should give notice of his loss or claim within a reasonable

[94] *Pioneer Concrete (U.K) Ltd v. National Employers Mutual General Insurance Association* [1985] 1 Lloyd's Rep. 274 at 278
[95] Lloyd's Form 736. 6 Claims Provisions (b).

time "as part of his general obligation to act with good faith towards his insurer":[96] in other words, the insured is prevented from unreasonably delaying a claim to the detriment of the insurer.

On the other hand the expression 'might be expected to give right to a claim' finds its roots in principles of English grammar. In fact 'might' -albeit considered to be the past tense of 'may' – refers to something where it is possible that it will happen.[97] The decision in *Rothschild Assurance Plc v. Collyear*[98] contains the guidelines to be followed for the interpretation of a clause of this type requiring the insured to notify, during the policy period, in typical claims made insurance policy. In this case the claimant, in compliance with obligations imposed upon it by the regulator relevant to its activities under the Financial Services Act 1986, appointed agents through whom they sold personal pension schemes to investors. It was obvious that investors might have experienced difficulties by not receiving appropriate advice from the claimant's representatives. Shortly after commencing business there was a publication from the regulator stating that there had been numerous complaints on the part of investors as to the advice provided in regard to the pension scheme. The claimant had taken out three liability policies with Lloyd's underwriters. These were claims made policies covering the period from 1 February 1993 to 31 January 1994 inclusive. In August 1993 the umbrella regulatory authority commissioned accountants to prepare a report which prompted the financial serving regulator to notify its member about rising problems in regard to the misselling of pensions. This notification brought to the knowledge of the claimant early in 1993 that at some time in the future it could be obliged to compensate investors for losses resulting of misselling pensions carried out by its agents. The claimant, aware of its potential liability at this stage, notified the insurers by sending a letter dated January 1994, in which it was made clear that about 2500 policies were to be reassessed. It is necessary to emphasise that there was no possibility of the claimant at this stage identifying the precise policies under scrutiny. The financial services regulator suggested to the claimant that it carried out a review. This was achieved by sending questionnaires to investors and evaluating their

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[96] Legh-Jones, *Macgillivray On Insurance Law*, Sweet & Maxwell, 10th ed, 2003 para. 1584. Whether this suggestion can stand with the virtual abolition of the continuing duty of good faith in *The Mercandian Continent* [2001] Lloyd's Rep IR 802 is extremely doubtful.
[97] Collins Cobuild, Essential English Dictionary.
[98] [1999] Lloyd's Rep IR 6

responses. As was anticipated, the results demonstrated that the selling of pensions had not complied with the standards set by the statutory provisions, so that the payment of compensation to investors was unavoidable. The claimant had by June 1998 paid or agreed to compensate up to £10,000 to investors. These amounts were claimed from the insurers under the relevant policies.

For present purposes the most important issue was the insurer's allegation that the assured had contravened general condition 2, thus discharging them from their contractual obligation to indemnify. That general condition provided as follows:

"2. The Assureds shall as a condition precedent to their right to be indemnified under this policy give to the underwriters notice as soon as possible during the period of this policy as set forth in the schedule:

(a) of any circumstance of which the assured shall become aware which may give rise to a claim or loss against them or any of them;
(b) of the receipt of notice from any person whether written or oral of an intention to make a claim against any of them;"[99] (Emphasis added.)

The insurer contended that notification was given at a very early stage, just after the insured had become aware of the report and not at any later date by which the assured had become aware of anything new which could amount to the risk of being sued. The question before the Court therefore was whether the correct interpretation of the clause was to be understood as circumstances 'likely to give rise to a claim' or ' may give rise to a claim'. Rix J was of the view that clauses including 'may' suggested a lesser degree of probability than those including 'likely' he went on to say that clauses with this wording are not subject to an objective test, as alleged by the insurer. The importance in this decision is that it establishes the foundation upon which claims made policies are built. In the learned judge's words: "While it is true that GC2 [the insurer] gives to an assured a significant extension of cover, a "claims made" policy could hardly work on any other basis. Otherwise, by the time that a claim came to be made, it is quite likely that it would have become impossible to obtain cover for it, either at all or on any but prohibitive terms".[100] The essence of a deeming provision[101] of a policy of this kind is that all claims notified to the insurer under the policy are to be understood as made within the period of insurance irrespective of the latter moment when the claim matures either as judicial or arbitral proceedings, let alone at

[99] Ibid.
[100] Ibid.
[101] Infra Deeming Provision.

the later date when the assured's liability is ascertained.
It is worthy of note – due to the international relevance of D&O insurance- that *Rothschild* contrasts with the approach in US courts; in *Abidafel v. Cigna Ins Co,*[102] where it was decided that a regulatory examination report was not to be deemed as a claim under a bank's D&O policy. The court of California held that such regulatory reports were just simply reports showing the bank's deficiencies but did not constitute request for payment or assertion of legal rights which might have triggered the D&O policy.[103]

The second group of policies is characterised by imposing upon the assured the burden of notifying any circumstance 'likely to give rise to a claim'. *Layher Ltd v. Lowe*[104] confirms that these sorts of clauses are interpreted according to an objective test which denotes at least a 50% chance that a claim will be brought after the happening of the circumstances motivating it. Contrary to the reading of clauses denoting 'may' –which refer to a lesser degree of probability- the expression 'likely' requires an enhanced chance of a claim. In this case, the claimants acting as suppliers provided certain materials for the fitting of a temporary roof. A storm blew off the temporary roof on January 25th 1990. The claimants were insured at Lloyd's. The insurance certificate contained a clause on the following terms: "The assured shall give immediate notice in writing, with full particulars, of the happening of any occurrence likely to give rise to a claim under this certificate, of the receipt of the Assured of notice of any claim and of the institution of any proceedings against the Assured..."[105]
In June 1992 the claimants gave notice to the Lloyd's syndicate of a possible claim on them by the recipient of those materials supplied; that was denied by the insurer on the grounds that notice should have been given immediately after 25th January 1990 and not two years later. The Court of Appeal, deciding for the claimants, held that the expression 'likely' should be given at least 50% chance of a claim and the mere fact that a claim was made two years later did not represent enough evidence as to say that that claim was likely on January 25th. Thus the insurer was duly notified; this approach is consistent with that in *Moore v. Canadian Lawyer Insurance*

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[102] 9 Cal.Rptr.2d 910 (Cal. Ct. App.1992).
[103] Bordon, op cit at 45.
[104] [2000] Lloyd's Rep. I.R. 510
[105] Ibid.

Association.[106]

The third group is represented by policies in following terms: "If during the policy period or extended reported period (if exercised) an insured becomes aware of circumstances which could give rise to a D & O claim or a Fiduciary claim".[107] (Emphasis added). Now the expression 'could' imposes upon the assured the burden of first construing the wording of the insuring clause- act or neglect, default or error- as attached to the claim and then based upon his understanding of the facts, to give due notice to the insurer. Obviously, wording of this nature may require –prior to notification to the insurer- unambiguous understanding by the assured that his wrongful act, if any, attaches to the policy wording; and it is then that the burden of giving notice to the insurer may arise. It is the author's view that this sort of wording represents no benefit either for insurers or assureds due to the difficulty in assessing whether or not an event could give rise to a claim covered under the insurance certificate. In other words, the expression 'could' goes further that mere probabilities; it denotes 'capability' for a claim to mature into the form of real threats or assertion of legal rights. This can only be achieved if the assured assesses the claim as to attaching the insurable event.

To the last group belong policies including the following wording: 'the insured and reassured shall upon knowledge of any loss or losses which might give rise to a claim under this policy, advice the underwriters thereof'(Emphasis added).
This wording is used in both insurance and reinsurance cases and is construed in the same way in both contexts. The wording was recently considered by Aikens J and the Court of Appeal in *Royal and Sun Alliance insurance Plc v. Dornoch Ltd*[108] which is of particular interest as it involved a D&O policy reinsured into the London market. The facts of the case were the following. The reinsured subscribed to an insurance policy issued to the Coca Cola group, for the period April 1997 to April 2002. This policy contained Director's and Officer's Liability cover triggered on a claims made basis and required the insured to give notice to the insurer as soon as practicable of

[106] (1992) 95 DLR (4th) 365. The leading judge went on to say that the onus is upon the insurer to prove non-compliance since the rationale for the notice requirement is to permit the insurer to investigate the loss, and possibly eliminate or reduce its financial exposure 370-71.
[107] Chubb Form 14-02-1968(Ed.5-96).
[108] [2004] EWHC 803, affirmed [2005] EWCA Civ 235

any circumstance which might give rise to a claim. Insurance was 100% reinsured in London Market by means of two Lloyd's syndicates. The reinsurance slip incorporated all the terms of the original policy and in addition to a claims control clause, which required as a condition precedent, compliance with the following: "the reassured shall upon knowledge of any loss or losses which might give right to a claim under this policy, advice the underwriters thereof by cable within 72 hours". Coca Cola and three of its directors and officers were sued in two class actions in Georgia US; in those actions the claimants claimed losses accruing as a result of acquiring Coca Cola's stock at inflated prices –which later fell- relying upon 'dressed up' financial statements, showing unrealistic earnings on the part of the corporation, made by the co-defendants. Notice was given to the broker within a week of each action but the reinsurers received notice more than 72 hours after the reinsured was aware of the original claim.[109]

The issue before the court was to determine exactly whose actual or alleged losses the policy wording was referring to, in order to know when the 72 hours period to give notice to the reinsurers, might have started. Despite both parties agreeing that the word 'loss' meant actual and not alleged loss, disagreement arose as to the correct interpretation of the reinsurance policy. The reinsurers contended that the reinsured had knowledge of the loss sustained by the third parties, who bought shares at an inflated price and subsequently brought class actions for compensation as soon as those class actions were brought; accordingly, the reassured was at fault in failing to notify the reinsurers within the 72 hours period from that date, so that the reinsurers were not liable. The reinsured on the other hand alleged that the interpretation of the policy wording in regard to the word 'any loss or losses' – for the purpose of reinsurance - which was incorporated by the claims control clause, was loss or losses sustained by the reassured 'Coca Cola group' and not by the victims of the buying of inflated shares. This argument led to the conclusion that the 72 hours period started form the moment Coca Cola and its directors' losses were ascertained; and that took place where their liability was established by settlement or judgement in the original court rather than when the claims were filed. The reinsured further argued that, should the court treat the filing of the claim as the date of the loss, the reinsured could not know that a loss had been suffered until a judgment had been given in favour of the

[109] Ibid.

claimants. The two issues before the court were, therefore, the meaning of loss and the meaning of knowledge.

In regard to the first issue , the learned judge was of the view that the word loss referred to those losses sustained by the third party in the original insurance - Coca Cola - and not by the insured. The issue of reinsurance is analysed later in this thesis,[110] but it may here be pointed out that this decision represents a significant advance in understanding the effect of incorporating into the reinsurance policy the wording of the original policy. Had the reinsurance policy incorporated the terms of the original, it might have been possible to construe both policies as written on identical terms. In this case the reinsurance policy incorporated all the terms of the original, having the effect of transferring to the reinsurance the original wording and meaning of the clause. The direct policy was a third party policy written on a claims made basis, which undoubtedly referred to third party losses. It could be argued that reinsurance is triggered upon a series of events which flow from the original claim, that of the third party against the insured, who in turn claims against his insurers and so on until the end of the chain, is reached. Notwithstanding, incorporation albeit recognising the existence of two different contracts, has the effect of attributing to both exactly the same policy construction. This interpretation, without doubt influenced the learned judge in reaching his conclusions.

The decision on the second issue was more complex. Aikens J held that, despite his ruling that loss meant actual loss suffered by Coca Cola, it was not possible for the reinsured to know that Coca Cola had suffered an actual loss until the claimants against Coca Cola had obtained a judgment against it. The court denied that the two parts of the judgment were not fully consistent, but the overall result seems to be a curious one.

On appeal, the Court of Appeal contented itself with focusing on the meaning of the word "knowledge" and agreed with Aikens J that there could be no knowledge of anyone's losses until there had been a judgment against Coca Cola's directors. Although the point was redundant in the light of this finding, the Court of Appeal commented that it would have agreed with Aikens J that the relevant losses were those of the claimants against Coca Cola. Of particular interest is the Court of Appeal's comment that the notification clause was utterly inappropriate to this type of

[110] Infra Chapter IX: The Reinsurance of D&O Policies.

reinsurance, in that it prevented the reinsurers from obtaining the relevant information until it was too late, but the Court of Appeal felt that it was no part of the judicial function to rewrite the parties' agreement.

2.3.3 Who Might Give Notice?

It is obvious that the assured bears the initial burden of notifying to the insurer any of the circumstances previously highlighted. However, the policy properly construed may impose specific requirements. For example it is the practice at Lloyd's to require both directors and officers to give notice and it is arguable that the duty to notify is also imposed upon the company.[111] In practice, it is only when the policy offers entity cover that notification is required on the part of the corporate entity. The issue is therefore to ascertain whether notification given for an executive director embraces both himself and the company or whether it must be done by each in turn. It is necessary to draw a distinction between those directors who form part of the decision-making executive of the board and those who do not; it is suggested that a notification given to the insurer by an executive director should normally be deemed sufficient to encompass the company itself, due to his representative powers. One could discharge this duty by simply notifying in writing in a single means of communication to the insurer and saying that a claim has been made against both the company and one or more of its directors.

Nevertheless, the situation might be slightly different where the director at issue is a non-executive who despite his involvement in company's affairs does not represent the entity on a day to day basis. The author's view is that a single notification on the part of this type of director does not discharge the company's obligation as to give to underwriters immediate notice in writing of any claim. It is up to executive directors to comply with this contractual duty on behalf of the company. This leads to the possibility that as soon as a non-executive director has been the subject of a claim, he must immediately communicate it to the corporate body in order to prevent himself for being personally liable to the company. Consequently, it is safe to say that notice must be given both by the assured and/or his agent and not by any other person

[111] Lloyd's form 736. 6. Claims Provisions.

including the victim of the wrongdoing.[112]

2.3.4 To whom Such Notice Must Be Given

Having highlighted the fact that claims made policies are triggered when claims are notified, it is of crucial importance to ascertain who must be the recipient of such information. Notification clauses are generally expressed to be conditions precedent, so that non-compliance means loss of the claim.[113] The first person in contact with the assured is usually the broker. In the commercial contact he will be first point of contact between the assured and the insurers, having placed the risk and having – in accordance with market practice – been authorised to administer the contract. Thus any claim will almost certainly be notified by the assured to brokers. However, notice to brokers who - by law are deemed to be the assured's agents - does not discharge the assured's duty since they do not represent the insurer in this regard[114] unless the contract otherwise provides. This of course does not mean that a broker can escape personal liability by not providing appropriate advice to the insured as to determine whether or not a claim should be duly notified;[115] and by not passing on a notification to insurers. What should be clear for directors and officers is that it is not enough to notify brokers; they must ensure such information reaches, on their behalf, the insurance companies. Ascertaining to whom such notice must be given is not easy. It is commonplace in this sort of insurance to nominate just the company as the recipient of notification and this puts the matter beyond doubt.

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[112] See also *Spriggs v. Wessington Court School* 2004, unreported, which holds that negotiations between the insurer and a third party victim are not binding on the assured. If, however, the insurers are aware of the loss, it may be that notice is not required at all: see *Lickiss v. Milestone Motor Policies at Lloyd's* [1966] 2 Lloyd's Rep 1.

[113] If the clause is not expressed as a condition precedent, then the claim will be preserved despite non-compliance: see *Friends Provident Life & Pensions Ltd v. Sirius International Insurance* [2005] EWCA Civ 601, overruling *Bankers Insurance Co v. South* [2003] Lloyd's Rep IR 1, which reviews the authorities on the matter. See n 56 supra Chapter II.

[114] Bordon, op cit at 72 quoting *Virginia Surety Co. v. Moll,* No. 93-M-127 (D. Colo. Aug. 30, 1994) "the court held that because the agent was an independent agent who represented the interests of the insured before those of the insurers, and who needed the insurer's specific authorization to sign insurance binders, he was not an 'authorized agent' of the insurer and notice to him was not effective as notice to the insurer." See also *Tioxide Europe Ltd v. CGU International Insurance plc* [2005] Lloyd's Rep IR 114, where notice to the broker was held to be insufficient.

[115] Netherway, op cit at 361.

In *Brook v. Trafalgar Insurance Company Ltd*[116] an insurance policy provided that notice should be given to a nominated insurer's representative and the Court of Appeal was of the view that policies containing this type of wording impose upon the insured the burden to notify this specific representative and not some other person or office, in order for the contractual duty to be discharged. The wording of the policy contained the following provision: "notice of any accident or loss must be given in writing to the company at its head office immediately upon the occurrence of such occurrence or loss.."[117] The claimant insured a car with the defendant through a provincial agent; after having an accident the insured reported to the provincial agent who in turn sent notice to the head office in London. The insurer successfully contended- in accordance with the wording set out above- that the insured failed to duly comply with notification and that all the rights under the policy were forfeited. The learned judge was of the view that there was no evidence to prove that the provincial agent had the authority as to waive the express conditions of the policy. [118] The situation gets more complex where policies do not nominate a specific person to whom notice must be given. From the outset it should be said that insurers must make sure they provide the relevant information and notice of facts that might affect more than one policy to the relevant agents for that policy.[119] Thus if insurance has been provided in layers, for example, or the policy is a market subscription policy with a number of insurers involved, notification should be given to each insurer under the relevant policy or each insurer should there be more than one, although in practice there will be express provision requiring notification to the leading underwriter on each layer.[120] In *Mahli v. Abbey Life Assurance Co*[121] the Court of appeal dealt with the issue of whether an insurer could be said to have knowledge of misrepresentation if one agent is provided with false information but another is told the truth. Here, a husband and wife contracted a joint life policy, with the proceeds payable to the survivor. In 1985 the policy lapsed due to premiums not being paid. In October 1995 the insurance was reinstated following a declaration of good health by the husband.

[116] (1946) 79 Ll. I. Rep. 365.
[117] Ibid.
[118] Ibid.
[119] Francourt, *Utmost Good Faith Rescission*. [1994] Int. I.L.R 159.
[120] See *Friends Provident Life and Pensions Ltd v. Sirius International Insurance Corporation* [2005] Lloyd's Rep IR 601, where it was held that notification to the primary layer leading underwriter was sufficient to amount to notice to excess layers, as the excess layer wording incorporated that of the primary layer and was to be construed in the same way.
[121] [1996] L.R.L.R 237

He died in 1988, having failed to disclose to the company that he was an alcoholic and had previously contracted malaria, but the insurers were aware of his alcoholism as they had, before reinstatement, declined a proposal by him for an endowment policy on that very basis. After his death, the widow sought payments under the life insurance policy but this was contested by the insurer on the grounds of misrepresentation and non-disclosure. The widow suggested that refusing to give cover under the endowment policy- due to the deceased previous alcoholism- might have provided the insurance company with sufficient knowledge as to his past and that by continuing to receive payments under the life policy the insurer had waived his rights to avoid the policy for non-disclosure. The Court of Appeal was, by a 2:1 majority, of the view that whether or not an insurance company had imputed knowledge enough to constitute a waiver by election depended on the circumstances surrounding notification and not just the fact that such information was available elsewhere in the company. In this state of affairs, the relevant information should be given to a person capable of understanding its implication; on the facts the insured was at fault in failing to do so.
Hence, giving information to claims department or to another department within the company would not be enough as to comply with notification to the insurer if the rule in *Mahli* is applied accordingly.

2.3.5 Deeming Provision

Once the insured has complied with notification duties in the form set above, claims made policies are triggered on a contingent basis which means that it is not necessary for the insured to maintain, renew or enter into new insurance agreements to be indemnified under his original liability policy. This principle proper of policies of this nature is known as 'claims made policies deeming provision' and constitutes on its own the feature without which this sort of cover would be ineffectual.
Some wordings found in the market may illustrate the point namely: 'Any claim or loss to which that circumstance has given rise which is subsequently made or sustained after the expiration of the period specified in the schedule shall be deemed for the purposes of this policy to have been made during the subsistence

thereof'.[122] Also Lloyd's form LSW 736 6(b) "...Such notice having been given as required by 6(b) hereof, any subsequent claim made shall be deemed to have been made during the Period of Insurance".

A situation which might lead to misunderstanding arises by reason of the fact that apparently the insured is in an advantageous position where policies have been subject of subsequent renewals or where policies have been issued by different insurers and run immediately after the other. In this state of affairs it is necessary to ascertain -for the purpose of a deeming provision- which policy is enforceable where notification was made, for example, in year one but the claim only matured in year two. In this regard the decision in *Hamptons v. Field*[123] clearly establishes that the policy which provided cover was that of year one since it was in that period of time when insurance was triggered.

In conclusion, compliance with both substantive and procedural triggers of cover put the insurer on risk of liability when the claim is reported. Nevertheless, the actual contractual obligation to indemnify the insured does not arise until his precise liability is ascertained by means of settlement, award or legal proceedings.

2.4. D&O: Insurer Primary Obligation

It is not enough for directors to perpetrate a wrongful act cover under the policy and notify it to the insurer within the agreed time, since the primary obligation on the part the insurer arises once directors' liability to third parties or the company is ascertained by way of judgment, settlement or award. Mere allegations as to directors' potential liability do not activate the indemnity under a policy of this nature; it is 'Liability at Law', which forces the insurer to comply with its duties and keep directors and officer harmless in terms of financial stability.

The answer to the question -why the insurers' primary obligation arises after liability at law is determined- lies in the nature of professional indemnity insurance policies in general and D&O policies in particular. Professional indemnity insurance has been

[122] Netherway, op cit at 359
[123] [1998] 2 Lloyd's Rep 248

developed to protect the insured against the risk of becoming liable to compensate third parties for pure economic loss as a result of the insured's professional activity. As explained in Chapter V, the relationship between the company and its directors impose upon the latter a very complex code of conduct and it is precisely the breach of this code which is the subject- matter of D&O indemnity insurance. The consequence (damages) arising from such lack of commitment is the insurable risk. Thus D&O covers potential damages that the insured could be compelled to pay to third parties, so the meaning of damages is crucial for the purpose of this debate.

Damages are the remedy available at Law as a result of loss inflicted due to breach of contract, tort or common law duties of skill and care. Hence, it is the consequence of the transgression of law and being liable thereupon. Consequently, it is *sine qua non* requisite that wrongdoer's liability is ascertained by any means. The practical benefit of a D&O policy may be achieved by following at least four cumulative steps.

(1) A wrongful act committed for the insured, which helps to ascertain both insured's identity and subject matter covered under the policy.
(2) A notification made by the insured against the insurer regarding any claim or potential claim which may expose the directors to liability. This notification which technically is to be deemed as the claim within insurance context, establishes the identity of the insurer on risk under the D&O policy.
(3) The cause of action or the nature of third party's claim must be founded in one or more of the contingencies described as within the insuring clause which defines the categories of wrongful act in respect of which cover is provided. This requires in addition that: third parties pursue an action against the directors and seek compensation directly from them as directors and not by means of ancillary or complementary action against them; that directors resist proceedings qua directors and not in a different capacity; and that the cause of action is assessed for its real nature and not for what the claimant freely and knowingly decide to allege.[124]
(4) The insured must be found to be liable as a matter of law to the insured.

As indicated earlier, there is an exception regarding defence costs cover. This feature

[124] *MDIS Ltd v. Swinbank* [1999] Lloyd's Rep IR 98.

which has been the European Market contribution[125] to the development of D&O insurance, embodies the possibility of advancing legal costs to the insured to guarantee his/her adequate defence, before his liability is established. It is thus possible to advance, as part of a legal costs cover, amounts of money to pay for lawyers' fees and collection of evidence. As long as the defence succeeds in defending his/her liability no further problem arises. The obvious difficulty here is where the insured's defence fails at trial. If this is the situation it seems logical that the insurer may seek reimbursement unless the insured has become insolvent.[126]

[125] Parsons, op cit at.78.
[126] This issue is analysed in depth in Chapter VIII 'Defence Costs Cover and Allocation'.

CHAPTER III

PERSONS COVERED

3.1. Directors: who are they?

Companies are required to appoint[1] a number of persons, designated as directors, whose function is to carry out – by acting jointly or individually – the functions imposed on them by the company's legislation. Subsequent appointments are made by shareholders in general meetings, following whatever procedure may be agreed in the articles of association or in the default provisions of article 73 of table A[2] which establishes a rotation system. While it is the case that companies acquire personal and legal capacity[3] through the issuing of the certificate of incorporation by the registrar of companies, they inevitably need to be represented by human beings who might achieve their goals. Such individuals are the company's directors[4] as appointed under the company's legislation.

Although the Companies Act 1985 is far from giving a clear definition of directors, section 741(1)[5] emphasises that the position of directors is not recognised merely because of the title given to them since the test is functional.[6] As a result, any name given to the persons operating the business of the company does not represent an obstacle to them being regarded as directors and therefore assuming the role, duties and liabilities which such position embodies. Consequently, directors might be called for example: governors,[7] trustees and even council members, without affecting their relationship with the company or the level of liability they could incur.

There are few limitations on the persons who may become a sole director or a

[1] Companies Act 1985, s 10(2).
[2] At subsequent annual general meetings one-third of the directors retire by rotation, determined by length of service since appointment or reappointment.
[3] *Salomon v. Salomon & Co* [1897] AC 22.
[4] *Ferguson v. Wilson* (1866) LR 2 Ch App 77, Cairns LJ: "The company itself cannot act in its own person...it can only act through directors".
[5] Companies Act 1985, s 741(1) "In this Act, director includes any person occupying the position of director, by whatever name called".
[6] Davies: *Gower and Davies', Principles of Modern Company Law*, 7th ed, Sweet & Maxwell 2003 at 379.
[7] Farrar, *Farrar's Company Law*. Butterworths. 1997. p 329.

member of the board of directors. The main limitation is the requirement that the person appointed enjoys full legal capacity. This is why an undischarged bankrupt is not able, in accordance with the law, to carry out activities demanding the performance of high level of fiduciary duties.[8] Furthermore, it is assumed that a person reaching the age of 70 might not be able to meet the demands of directorship, and the law states that a person reaching this age may not act as a director unless a special resolution is passed in a general meeting.

Special attention needs to be given to the issue of appointing corporate bodies as directors. In fact, contrary to the opinion of some scholars in this field, English legislation does not forbid companies from becoming directors of others, for example in cases of parent and subsidiary companies and even in Joint Venture enterprises. The question of imposing fiduciary and diligence duties on a corporate director may provoke a different approach in case of any breach of common and statutory duties to which directors are exposed, since the parent company might have acted as agent of the subsidiaries. This is why policy wordings in the vast majority of cases exclude from the meaning of "Directors and Officers" any legal person or corporate body. Such scope is followed by form LSW 736 of Lloyd's by establishing:

"3(a)(i) Director or Officer shall mean: (i) any natural person who was or is or may hereafter be a Director or Officer of the Company.."[9]

The number of directors is governed by Section 282 of Companies Act 1985,[10] which provides that every private company must have at least one director and every public company at least two. Where there is more than one director, problems arise under D&O policies in relation to the allocation of defence costs. In fact, whether or not the board is insured as such, where directors take individual cover, whether they are individually or joint and severally liable to the victim of the damage, allocations between insured directors, uninsured directors and the company itself in practice lead to very complex issues in law.

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[8] Company Directors Disqualification Act 1986, s 11(1).
[9] Form LSW 736, Lloyd's.
[10] Companies Act 1985, s 282(1).

3.2. Types of Directors

3.2.1 *De Jure* and *De Facto* Directors

It is important in this research to make clear the variety of roles which directors may undertake. Accordingly, some practical definitions are given.

The real difference existing between *de jure* and *de facto* directors is based purely on their appointment. *De jure* directors are those designated according to the rules governing such appointment,[11] to undertake the affairs of the company. An express appointment is thus required for a person to become a *de jure* director. Additionally, it is required that the appointed director has agreed to hold office, enjoys full capability by not being disqualified and has not vacated office.[12]

On the other hand, *de facto* directors[13] are unappointed persons who are treated as directors by reason of their assumption of directors' duties. In other words, *de facto* directors are not appointed by the company but they nevertheless assume the role of those and act on behalf of the corporate body. In accordance with the decision in *Secretary of State and Industry v. Deverell*[14] the facto directorship can be determined by proving:

- The person was involved in the company's more important financial decisions or at least expected to contribute with the way such decision should have to be taken.
- The person performed his functions that were consistent with only acting as a director in other words, that such functions could have not been performed by a person on a lower level within the company.[15]

By acting as such, *de facto* directors could be held liable to the same extent as those properly appointed and in accordance with the decision in *Re Hydrodam (Corby)* they

[11] Mayson, *Mayson, French & Ryan On Company Law,* 21st Edition, Oxford, 2004-2005 at 463.
[12] Ibid.
[13] Ferran, *Company Law and Corporate Finance.* Oxford. 1999 p 155.: "A de facto director is a person who acts as a director but who has never been validly appointed to that position". See *Re Hydrodam (Corby) Ltd* [1994] BCC 161.
[14] [2001] Ch 340. See also *Re Kaytech International plc, Secretary of State for Trade and Industry v. Kaczer* [1999] 2 BCLC 351 CA; and *Secretary of State for Trade and Industry v. Tjolle* [1998] 1 BCLC 333.
[15] Ibid.

owe fiduciary duties to the company[16] whenever they control its affairs.[17] Additionally, they may be entitled to remuneration since the court can order the company to pay for benefits conferred by their provision of services on a *quantum meruit* basis, as it was held in *Craven-Ellis v. Canons Ltd.*[18]

Regarding insurability, there is nothing in principle which prevents a de facto director from insuring against liabilities incurred in that capacity. Nevertheless, the policy itself may require, by way of a contractual provision, that only appointed directors are covered in order to avoid the inconvenience of having to ascertain in the first instance who is a director in order then to activate the potential indemnity. In some cases insurers agree to cover the board as such and in this situation, whoever – irrespective of being or not being appointed – carries out the functions of directorship may be deemed to be the assured for the purpose of D&O insurance. In the absence of such deeming provisions, the position is plainly open to doubt.

3.2.2 Shadow Directors

Section 741(2) of Companies Act 1985 establishes the parameters upon which persons who have not been appointed as directors are deemed to be shadow directors as follows:

"In relation to the company, 'shadow director' means a person in accordance with whose directions or instructions the directors of the company are accustomed to act".

This definition has been incorporated within two of the most important statutory provisions namely, the Insolvency Act 1986 s 251 and the Company Directors Disqualification Act 1986 s 22(5).

By reason of the fact that a shadow director controls the board and the company habitually acts under his directions and recommendations, shadow directors practically rule the company and its affairs. The power of shadow directors could be so strong that without their instructions, the appointed directors may be impeded in their attempts to act on behalf of the company. These considerations have resulted in

[16] [1994] BCC 161.
[17] *Morris v. Kanssen* [1946] AC 459.
[18] [1936] 2 KB 403.

English company law making shadow directors liable for potential corporate losses and damages to the same extent as are *de jure* directors. However, as section 751 (2) stands, giving advice in his/her professional capacity may not be sufficient to deem a person as to assume a shadow directorship.[19] In this regard the recent decision in *Secretary of State for Trade and Industry v. Deverell*[20] - by applying a strict test – assessed the definition of shadow concluding on the following principles.
Basically the purpose of the legislation is to identify those, apart from professional advisers, who really influence the decisions and the way company's affairs are to be carried out. This argument marks out from the concept of shadow director any isolated or professional advice given without the intention of influencing the board's own decision.
It has been additionally emphasised that it is not necessary for a shadow director to exercise a complete influence upon the whole corporate activities. It would be enough to prove that in certain matters, he holds a determining influence as to the way that those matters have to be conducted or carried out.
The assessment of whether a shadow director has given directions or instructions has to be objective – what was said or done rather than what was believed to have been said or done– in order to ascertain his function within the company.
It is unnecessary to prove that appointed directors 'cast themselves in a subservient role or surrendered their discretion'[21] to the alleged shadow director.
Finally, a shadow director could be deemed as such, despite the fact that he/she might act quite openly and not reside in the shadows. A good example is when a one man company who lives abroad, decides to operate the entity through a local board and from time to time he/she gives instruction as to the way business has to be done.[22]

The question which arises from all of this is, to what extent shadow directors could be personally liable to the company and possibly to third parties? The issue is commonly connected to insolvency and the application of section 214 of the Insolvency Act 1986 or wrongful trading and disqualification orders under Companies Directors

[19] Companies Act 1985 s 751 (2).
[20][2001] Ch 340. Followed by the decision in Secretary of *State for Trade and Industry v. Becker* [2002] EWHC 2200 Ch D.
[21] Ibid
[22] Ibid.

Disqualification Act 1986[23] to say nothing to implications of the Financial Services and Markets Act 2000.

In regard to wrongful trading[24] the Insolvency Act 1986 has widened the scope of its application to shadow directors who may be liable to the same extent as to appointed or *de facto* directors of the company, to either account profits or compensate the corporate entity in accordance with section 214(1). Wrongful trading has been subject to extensive debate, and practice shows that it is very common in claims in which banks and parent companies are involved.[25] This issue –albeit significant in company law – is of less importance within the scope of a D&O policy since insurers refuse to extent cover to entities acting in their capacity as director.[26]

The second important area concerning shadow directors is that of disqualification[27] since in accordance with section 22(5) of the Companies Directors Disqualification Act 1986, shadow directors could be disqualified in the same extent as appointed or de facto directors. Even though the sanction under the scope of this statutory regulation is – by its nature – uninsurable as explained in Chapter IV, there is nothing to prevent the possibility of directors being indemnified in respect of defence costs incurred by successfully (or indeed unsuccessfully) contesting a proceeding of this nature. Thus it cannot be said that disqualification proceedings are strangers to D&O coverage.

Finally, the Financial Services and Markets Act 2000 s 417(1)(b) is to be interpreted as to include a shadow director and therefore identifying this form of directorship as potentially liable under its scope. Its repercussions are analysed below under the heading Persons Covered: the Company.

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[23] Gregorian, "Shadow Director and Wrongful Trading: Shadow Directors". [1997] I.B.F.L. 125.
[24] Supra Chapter V: Liability Under the Insolvency Act 1986.
[25] Davies: Gower and Davies', op cit at 197.
[26] Infra Chapter II : In what Capacity the Wrongful Act must be executed?.
[27] Griffin, *"Evidence Justifying a Person's Capacity as Either a de Facto or Shadow Director: Secretary of State for Trade and Industry v. Becker"* [2003] Insolvency L.J 127. See also Gregorian, op cit.

3.2.3 Executive and Non-Executive.

Once appointed, directors may either be required to work and manage the company's affairs on a full-time basis or they may merely be required to pay sporadic attention to the company. In the former case directors are deemed as executive since they carry out executive functions, commonly under contracts of employment, in addition to their common law and statutory duties, expanding the risk of liability. Executive directors are in charge of the management of the company and exercise the powers conferred upon them by the articles of association.[28]

Conversely, non-executive directors will not be in charge of the daily management and are unlikely to have any responsibility for the employees of the company. They are appointed because of the degree of skills, knowledge and prestige that they may bring to the board of directors[29] and might be entitled to small directors' fee.[30]Their role is believed to ensure that the board of directors acts in the best interest of the company as a whole and not for the benefit of the members of the board itself.[31]Non-executive directors thus assist the board whenever crucial decisions are to be taken; as a result they are not exempt from personal liability and could be compelled to honour directors' duties.

These ideas were the aim of both the Cadbury Report[32] and the subsequent Combined Code as a result of the Hampel Committee on Corporate Governance[33] review on the matter. The combination of executive and non-executive directors was thought to be the formula to prevent company scandals and to avoid financial disasters to the detriment of whoever gets involved with the company. Basically, the role of non-executive directors was made more influential within the corporate governance hierarchy in order to contribute to the board by undertaking crucial functions such as reviewing the performance of the board, serving as potential leaders in those cases of deadlock situations within the board and even in setting the remuneration of executive

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[28] Farrar, op cit at 332.
[29] Grier, *UK Company Law*. Wiley.1998, p 346.
[30] Mayson, French & Ryan *on Company Law* at 457.
[31] Ibid.
[32] Cadbury Committee set up in May 1991 by the Financial Reporting Council
[33] Committee on Corporate Governance, Final Report, London, January 1998.

directors.[34] Additionally, the Combined Code required listed companies to include within their annual report how the application of the principles set up in the Code had been implemented.[35]

Nevertheless, the outcome showed the contrary, giving rise to two new reports carried out by Sir Robert Smith and Derek Higgs which seem to be more accurate as to the role, liability and protection that non-executive directors should or must experience. Some of the relevant aspects of the Smith Report are the following:

- Basically the role of non-executive directors – in the form of the audit committee – is to ensure that a body independent from the executive is responsible for protecting the interests of shareholders in relation to financial reporting and internal control.[36]
- Directors' liability, irrespective of being executive or non executive, remains intact, as all directors are equally responsible for the affairs of the company in accordance with the applicable law in the matter.
- The number of non-executive directors should be no less than three, with the chairman of the company being precluded from membership of the audit committee.

However, it is the Higgs review which come closer to the aim of this research, forcing a more detailed analysis as follows:

- Basically, there are two main roles: the monitoring executive activity and the development of strategy. Regarding the first, it could be suggested that non-executive directors provide the same function as two tier boards do in other jurisdictions - mainly Germany and Netherlands - which act as supervisory board and guarantee that executive directors put their best endeavour for the benefit of the company. Yet, supervisory duties might be accompanied by real participation in company's strategy, which means that the role of non-executive directors should be more active – albeit without interfering – in respect of the management of the company.
- It is true that company's business could be affected by overlapping non-

[34] For a more comprehensive explanation see Ferran, *Company Law and Corporate Finance.* Oxford.1999 at 208-209.
[35] Rule 12.43A of the Listing Rules.
[36] Audit Committees Combined Code Guidance, by Sir Robert Smith, January 2003.

executive directors' duties with those of the executive management, undermining shareholders confidence in the efficiency of the corporate governance. This requires a mutual recognition and respect on the one-tier board, acknowledging the contribution of both executive and non-executive directors to company's strategy and good functioning.

- In respect of their duties non-executive directors have the same legal duties to the company and might incur the same sort of liability. This has two implications. First, given that non-executive directors are not involved in the day-to-day business of the company, they may well be ignorant of crucial issues and of how in practice the company's affairs are carried out. As a result it is likely that non-executive directors may make recommendations which in one way or another do not comply with practice and even contradict the perfect functioning of the company. Therefore it is proposed - since their role is not only to support but only to monitor the board - that directors must acquire the necessary knowledge to discharge their responsibilities, which mean to understand and assess, the exact environment, kind of business and potential problems that the company might face. Secondly, and as a consequence of the first, the post of non-executive director demands certain skills and integrity alongside personal attributes in order to fully comply with the inherent role. However, due to the fact that the time devoted to the company is considerably less, the test to be applied should be also less rigorous. This last argument raises once more the issue that director's common law duties of skill and care are moving toward the application of a standard objective test.[37]
- One of the suggestions of the Higgs review which certainly impacts the outcome of this research is Insurance and Indemnification. Due to its relevance it is analysed in the following paragraphs.[38]

As it has been previously considered, section 309 of the Companies Act 1985, allows a company to insure its directors' liability in respect to third parties and the company itself. Additionally, it is legal to indemnify directors in respect of third party claims

[37] To this regard see Chapter V: Common Law Duties of Skill and Care.
[38] Review of the Role and Effectiveness of Non-executive Directors. The Higgs Review. January 2003.

where the latter succeeds in the action. What is not possible for the company is to previously agree upon indemnity clauses against liability or defence costs. It is understood that any provision in the articles of association to this regard contradicts the purpose of section 309 and therefore is unenforceable. The Higgs review proposes in accordance with the Company Law Review (paragraph 6.3)[39] that companies should be allowed to indemnify its directors in advance against the cost of contesting proceedings, in respect of claims[40] – including those brought by the company – without the successful completion of the case being a preliminary requirement. Where the director's liability is ascertained he must repay the costs. The review even went further by saying that D&O insurance is necessary – almost compulsory – and in clear contradiction with section 310 – now 309(a)- as actually stands, that the company should also indemnify directors against any uninsured loss by way of insurance deductibles or caps on liability.

Obviously, the Higgs review is a very interesting and accurate research in an area of a great degree of difficulty. That said, the author considers that there are five conclusions – relevant to D&O policies- as follows.

Firstly, the evaluation of level of skill and care required in the exercise of non-executive director's duties should not be subject to the same test. It is suggested that due to the fact that non-executive directors do not run the company in a day-to-day basis their level of diligence and accuracy tends to be lower than that of executive directors. This does not mean that non-executive directors are excused from knowing the company's business and affairs, as in fact the dominance of internal information and the way businesses are carried out might successfully reflect in the outcome of the company. How might this double test affect a D&O cover? The answer seems to be less complex that it appears at first sight, D&O policies offer cover in one of the two following forms. The first is board cover – which is usually the case – protecting whoever holds the functional position of director. Under this perspective, the issue of

[39] Company Law Review: Modern Company Law for a Competitive Economy. Final report URN 01/942 and URN 01/943. Paragraph 6.3 "….the insurance exception should be extended to allow indemnity in advance against the cost of defending proceedings, or for a section 727 relief application, provided that the decision is made by disinterested members of the board on the basis of appropriate legal advice that the prospects of success are good, and that if the outcome is adverse the director is to be bound to reimburse the company".

[40] Including the Court relief under section 727 of the Companies Act 1985.

to what degree non-executive directors are potentially liable to the company is less important. What does matter is the fact of being liable and that such liability is insurable. The second form is individual cover suitable for those who hold office - as non-executive directors- in more than one company or as ancillary protection to his/her personal liability insurance. It seems that this type of cover needs a better assessment on the part of insurers - in order to fix the premium and allocate the risk - by taking into consideration amongst others company's size, whether or not it is public, listed or private, the type of business and of course the level of skills demanded for that position. Only by looking into these aspects could a D&O policy be tailor-made and effective. Consequently, it could be said that the nature of a D&O policy remains intact: the only real impact of having a different test for non-executive directors lies in the insurers' perception of the risk.

Secondly, it is thought that by imposing standard duties upon non-executive directors, the distinction between them and executive directors might be no longer useful, since they both might be deemed directors with the only difference of performing distinct duties. This last argument motivates some scholars to think that the distinction has no significance in company law[41] but only in employment law.

Thirdly, it is very improbable that company law would take the step forward of allowing the company to indemnify directors for wrongs committed in their capacity and to advance defence costs without being cleared of intentional or fraudulent breach of duty. Issues of moral hazard continue to be of the most importance against mitigating directors' liability. Reality shows that even under very restrictive duties, companies have been the subject of financial scandals in which – most of the time- directors become insolvent and unable to indemnify the victims of the wrong. It might be thought that a relaxation in this respect was very unlikely. Nevertheless, there have been new developments in this regard since the coming into force of the new Companies (Audit, Investigations and Community Enterprises) Act 2004 which reformed section 310 of the Companies Act 1985 by introducing new sections 309(a)(b)(c), has relaxed the prohibitions of provisions protecting directors form liability. Under the new legislation the company can effectively indemnify its

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[41] Mayson, French and Ryan, op cit at 457.

directors against liability pursuant to a 'qualifying third party indemnity provision' as long as the company does not use this way to indemnify directors' personal liability.[42]

Fourthly, the Higgs report could be interpreted as an invitation for the implementation of a two- tier-board within the UK. This is a choice which EU members might have under the EC Council Regulation No 21/572001 art 38 which came into force on August 2004. The only difference would be that of calling the 'administrative organ' in case of one-tier board or 'supervisory and management organ' in case of a two-tier board.[43] Of course the implementation a two-tier board- albeit very unlikely in the UK- may force a revision in D&O policy wordings regarding definitions, aggregate limits and deductibles but in essence the author is the opinion that the nature of D&O insurance would remain unaltered.

Finally the review emphasises the need for D&O cover, which it believes to alleviate those who suffer financial detriments by guaranteeing director's solvency. Whether D&O insurance is necessary depends on how keen judges, insurers and parliamentary bodies assume the real impact and effectiveness of this sort of insurance to be, by providing financial protection to those who in reality benefit from it, namely the general public, including shareholders and consumers.

3.2.4. Nominee Directors: Nominee as such, Alternate or Additional.

It is a generally accepted principle that one of the class rights attached to shares is to nominate one or more directors, who may take into account the interests of those who have nominated him/her. Nominee directors are common in large companies, mostly banks representing majority shareholders or major creditors,[44] where huge investments are put into the business and therefore worries about profitability can arise. Notwithstanding this consideration and the source of the nominee director's authority, the liaison between the nominating shareholders and the nominee breaks up as soon the director is appointed because the general interests of the company prevail

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[42] Companies Act 1985 s 309B as amended by the Companies (Audit, Investigations and Community Enterprises) Act 2004.
[43] Ibid at 458.
[44] Ferran, op cit at 160.

over the limited interest of the nominating shareholders and the director must act accordingly.[45] This is thought to be a strict view[46] which is incompatible with the modern practice, since nominee directors are placed in a dual and conflicting position, on the one hand to have regard for the interests of the company and on the other to have regard for the interests of the appointor. As a result a novel interpretation was laid down by the decision in *Re Broadcasting Station 2GB Ltd*[47] in accordance with which it is possible to reconcile both duties provided the appointee regards the interest of appointor but in so doing does not disregard the interests of the company as a whole.

As to the liability of nominee directors, the law imposes upon them full responsibility and they owe to the company not only fiduciary and statutory duties but also the same degree of skill and care common to all directors.

Alternate directors, in accordance with section 308 of Companies Act 1985[48] and table A art 65 to 69, are those who temporarily replace a director who is absent, ill or on vacation. As far as the responsibility of an alternate director is concerned, he is not an agent of the absent director but owes duties to the company as a whole: consequently he assumes personal liability while holding office. Alternate directors may follow the absent director's instructions as to the way some decisions are to be taken and by doing so both the absent director and his alternate can be regarded as jointly and severally liable for direct losses and any consequential damage inflicted on the company.

3.3. Persons Cover: The Company

A company is a legal person formed by means of the association of two or more individuals who have decided to create, with the provision of capital[49] and for a lawful purpose, a legal entity with a personality independent[50] and distinct from that of

[45] *Scottish Co-operative Society v. Meyer* [1959] AC 354 and *Kuwait Asia Bank EC v. Mutual Life Nominees Ltd* [1991] 1 AC 187.
[46] Crutchfield, *"Nominee Directors: The Law and Commercial Reality"*, (1991) 12 Co Law 7.
[47] [1964-65] N.S.W.R. 1648.
[48] Companies Act 1985, s 308.
[49] Albeit this is not a condition since it perfectly legal the setting up of Private Companies Limited by guarantee in which the provision of capital is not necessary. See the Companies Act 1985 s 1(2)(b).
[50] *Salomon v. Salomon* [1897] AC 22.

the human members who founded, control and administer the organisation.[51] Such legal personality is achieved by the registration of the memorandum and articles of association in accordance with Section 1(1) of Companies Act 1985 and the issuing of the certificate of incorporation by the registrar of companies, which enables a *persona ficta* to be deemed and treated to the same extent as to any natural person in respect of its powers, rights and duties.[52]

D&O policies seem to follow the idea of defining companies in a very wide way without drawing any distinction between the different forms and types that companies might take. To this respect the form LSW736 of Lloyd's defines very simply a company by establishing in section 3(b) that it shall mean "the company stated in the schedule and shall include subsidiary companies." Now it is true that a definition of this nature implies that as soon as the entity acquires one of the available forms of a corporate body the policy attaches. However, it is important to emphasise that companies -- depending upon the form they acquire- are not subject to the same sort of regulations and statutory provisions, on the contrary, being for example a Listed Public Limited Company forces the application of the Financial Services and Markets Act 2000 with the result of imposing new norms of conduct and thus sanctions upon directors in addition to those contained in the Companies Act 1985. The idea is therefore to briefly classify and analyse the types of companies and scrutinise the relevance of the classification in regard to D&O insurance.

3.3.1 Types of Companies

Companies can be classified in a number of general ways, e.g., whether they have limited or unlimited liability, whether they are constituted for profit or not for profit, whether they are registered or not and whether they purport to offer their securities to the public or remain private. It is the aim of the following paragraphs to highlight the repercussions of assuming one or another form for the scope of D&O insurance. Thus special attention is addressed to registered Private and Public Companies, not because the other forms are less important but because these types are the most popular, their annual turnover is of great significance to the economy and basically it is from those

[51] De Cruz, *Comparative Law in a Changing World.* Cavendish Publishing Limited. 1999, p 346.
[52] Ferran, op cit at 81.

companies that D&O insurance has been developed.

3.3.1.1. Private Companies

Private companies as their name suggests are those which are not permitted to offer their securities to the public essentially because their memorandum of association does not contemplate such a possibility. Being public therefore is an activity that could not be freely chosen to be carried out without any special provision in the articles and the subsequent registration.[53] Private Companies are the most numerous in the UK and it is shown that this is the popular form chosen for those who want to set up a commercial enterprise without risking the totality of their assets. Such a shield in terms of protection is provided by the principle of limited liability. There is no limitation in respect of the number of shareholders and it is perfectly legal for one person to hold the totality of the share capital of a company.[54]

In accordance with Section 1(2)(a)(b)(c) of the Companies Act 1985, Private companies could be divided as to belonging to one of the following three groups:

- Private Companies Limited by Shares, in which the liability of their shareholders is limited by the memorandum, up to the unpaid amount of the shares held by them. This is the most popular adopted form.
- Private Companies Limited by Guarantee, in which the liability of their shareholders is limited by the memorandum as to the amount that shareholders undertake to contribute to the assets of the company in the event the it is wound up. Shareholders thus guarantee company's solvency in any case.
- Unlimited Private Companies, in which the liability of their members, has not limit to contribute to the assets of the company.

The repercussion of this sort of companies in regard to D&O insurance could be analysed from a triangular perspective namely legal, economical and social.

As far as its legal framework is concerned it is very common to find a lack of demarcation between Corporate Governance and Membership and the way the

[53] Companies Act 1985 s 1(3)(b).
[54] Ibid. S 1(3A).

Company is controlled. It is a feature of this sort of company that their share capital is held – most of the time- by a small number of shareholders usually family members, who do not demark the boundaries between corporate governance and being a member of the company. This means that very often in private companies shareholders become directors as well and control the company at their own will. This close relationship implies that corporate governance operates in an environment in which judicial proceedings are not commonplace, basically –as explained next- because the *locus standi* to bringing an action against the board lies in the company itself; thus it very unlikely that shareholders acting on behalf of the company will sue themselves. This does not mean that directors are not exposed to the risk of personal liability, it means that because of the ownership status of the corporation directors tend to believe- albeit erroneously- that they are in an advantageous position of avoiding litigation.[55] Whilst directors are in control of the board or simply influence its decisions the situation seems to be under control but this scope might change in a number of cases such as: when a new set of directors replaces the old ones or when the company becomes insolvent and the board is replaced by an insolvency practitioner.[56] Consequently directors of private companies should not underestimate their exposure to personal liability and the legal costs of contesting it.

A second issue within the legal scope is with regard to what kind of protection is offered to the shareholders of a private company? The principle that directors do not owe duties to shareholders is well established and supported in the English legal system; this is why a shareholder has no option other than seeking a remedy through the company on the supposition that protecting the former might serve as an indirect protection for his investment.[57] To this end Company Law basically offers three actions to minority shareholders, namely, the derivative action, a claim for unfairly prejudicial conduct and an application for winding up when it is just and equitable. It is not the aim of this research to deal with types of remedies as research of this size could not efficiently cover this matter; this is why emphasis is given to the relevant aspects concerning insurability. For this reason the just and equitable winding up remedy – which does not give rise to liabilities on the part of directors – is of no

[55] Parker, *Private Companies Must Be Aware Of Liability Risks*, Dallas Business Journal. 13/09/99. American City Business Journal Inc. 1999.
[56] Davies*: Gower and Davies'*, op cit pp 444-445.
[57] This to some extent is confirm by the report of the Jenkins Committee 1962.

significance in the present context.

Derivate actions[58] are all but unheard of nowadays and in any event have never featured in relation to private companies, at least in part due to the disproportionate cost of legal proceedings and also the potential availability of the alternative statutory remedies applicable to the locked-in shareholders of private companies. The derivative action is based on the notion that a wrong has been done to the company by those in control of it and that the controllers have refused to allow the company to bring an action to correct that wrong. However, there can be a derivative action only in respect of conduct which is not capable of being ratified by the general meeting as a whole, so that where ratification is possible there can be no derivative action[59]: thus 'the greater the possibility of effective ratification, the less scope there will be for any derivative action'.[60] Assuming that a derivative action is possible, the question becomes whether a D&O policy would bring its financial protection to the directors. Regrettably, the answer is unclear. The *locus standi* to bring a derivative action is vested in company members – shareholders – who proceed on behalf of the company against the wrongdoers, in this case directors.[61] Understanding this procedural point is crucial for the enforcement of a D&O composite policy within a scenario in which both the company and its directors are insured under the same insurance policy. Even though this issue is analysed later on,[62] it is worth noting here that if the requirements for a derivative action are met and the claimant is successful the company would be classified as the third party as it is nominally the victim of the wrong. This conclusion is reached because despite the fact that the action is brought by a shareholder or a number of them, they just act as companies' representatives and anything they achieved would be for the benefit of the company not for themselves. This means that the company is the claimant in the action so it is the company itself which is entitled to the relief sought. The issue here is whether the company can be treated as the third

[58] For a better explanation of derivative actions see: Davies: *Gower and Davies'* op cit Chapter 17. Mayson, op cit Chapter 18. Farrar, op cit Chapter 28.
[59] Law Commission Consultation Paper No 142. Shareholders Remedies A Consultation Paper p 41: "...the underlying wrong of which the minority shareholder complains can, as a matter of substantive law, be cured by ratification. Where the ratification is effective in this way it will inevitably have an effect on a minority shareholder's action".
[60] Hannigan, *Limitations on a Shareholder's Right to Vote- Effective Ratification Revisited.* [2000] JBL 493.
[61] This is basically what the rule in *Foss v. Harbottle* addresses.
[62] Supra: Corporate Cover: Is the Company a party or a third party to D&O insurance?

party under a policy to which it is itself a party, although it may be thought that as the policy is one against the company's liability rather than its first party loss, the company should be in no different position to any other third party.

Another important aspect relates to the issue of costs in respect of derivative actions and whether or not shareholders pursuing any action of this nature would sustain legal costs or whether it is the company who should meet them. The answer is contained in the decision of *Wallersteiner v. Moir*[63] where it was held by the Court of Appeal that a court might in a minority shareholder's action order the company to indemnify the shareholders against the cost of the action incurred by them in mounting proceedings on behalf of the company.[64] What is the relevance of this argument in the context of D&O insurance? The answer is far from easy. Let us suppose that entity cover[65] is provided, so that both directors and the company are insured under the same policy and the outcome is that the derivative action succeeds. In these circumstances it is the director – the wrongdoer- who will be ordered to pay the costs but if he cannot make them good, then the court may order the company to indemnify[66] its agent, in this case the shareholder. This analysis leads to the conclusion that whenever entity cover in offered and the insuring clause provides defence costs cover for both of the assureds - director and company - the insurer might have no choice but to pay defence costs to the shareholders, provided the claim attaches to the contractual terms and it is not excluded[67] by the policy.

What is not possible in a derivative action is for a shareholder to recover a 'reflective loss', that being a loss to him/her which is the result of company's loss. This was so held in *Prudential Assurance v. Newman Industries*[68] and confirmed in *Johnson v Gore, Wood & Co.*[69] It might be thought that the rationale behind this prohibition is to

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[63] [1975] Q.B 373

[64] Ibid. 391 " ... the minority shareholder , being an agent acting on behalf of the company, is entitled to be indemnified by the company against all costs and expenses reasonably incurred by him in the course of the agency. This indemnity does not arise out of a contract express or implied, but it arises on the plainest principles of equity". Additionally, the Civil Procedure Rules 19.9(7) now provide the requirements for the Court to give indemnity to the claimant out of the assets of the company such as the Court's approval for the continuance of the action 19.9(3).

[65] Supra Corporate Cover: Is The Company a Party or a Third party to D&O Insurance?

[66] *Wallersteiner v. Moir* [1975] Q.B 373 at 392

[67] This issue is to be analysed in more detail in Chapter VIII 'Defence Costs and Allocation.'

[68] [1981] Ch 257

[69] [2001] 1 All E.R 481, HL

prevent any shareholder from effecting double recovery or to prevent the director from being required to indemnify both the company and the shareholder.[70] It follows that, in the absence of liability of this type, reflective losses are outside the scope of D&O cover.

The second remedy available for minority shareholders is that contained in section 459 of The Companies Act 1985 concerning unfairly prejudicial conduct. This section is in the following terms:

"(1) A member of a company may apply to the court by petition for an order under this Part on the ground that the company's affairs are being or have being conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial".[71]

This provision, which has been subject of a number of decisions and which replaces an earlier and far more limited provision,[72] throws upon the petitioner the burden of proving that the way in which his/her company's business has been carried on is unfairly and prejudicial to his interests.[73] The real meaning of 'shareholder's interests' must not be confused with that of shareholders' rights in the sense that any conduct on the part of those who control the company – irrespective of being either directors or shareholders or both – could be to some extent legal but nevertheless actionable under section 459 of the Companies Act 1985. This conclusion could be reached by noting that the unfair prejudice action applies to two different situations. The first is an action against the wrongdoers who contravene the company's constitution. If this is the case, it could be suggested that the controllers have acted unlawfully by breaching what company's constitution establishes; this assessment is objective[74] and is independent of any harm inflicted on the claimant. The second is that where what the directors or the majority have done could be legal – in accordance with company's constitution - but nevertheless in breach of an informal agreement (or understanding)

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[70] Davies: *Gower and Davies'*, op cit, pp 455-456. See *Giles v. Rhind* [2002] 4 All E.R 977 and *Heron International Ltd v. Lord Grade* [1983] B.C.L.C 244. See Hirt, *Companies in General*, [2003] JBL 420-429.
[71] Companies Act 1985 s 459(1).
[72] Companies Act 1948, s 210.
[73] Hannigan, *Annotated Guide to the Companies Act*, Butterworths, 2001 p 915.
[74] *Re Bovey Hotel Ventures Ltd*, unreported, July 31 1981 followed by *Re RA Noble & Sons (Clothing) Ltd* [1983] B.C.L.C 273.

involving the claimant and the controlling wrongdoers.[75] Such agreement, according to the decision in *O'Neill v. Phillips,*[76] is indispensable for an action on these grounds to succeed. This second scenario leads to a different type of action under section 459, known as breach of 'equitable considerations'.[77] Section 459 is of relevance only to small private companies, and unfair prejudice actions have taken the form of proceedings involving – amongst others - the following matters: a member's exclusion from the board of directors[78] (a very interesting issue regarding D&O),[79] increase of issued share capital, alteration of articles of association,[80] misappropriation of company's assets, excessive remuneration to directors and non payment of dividends.[81]

In practice section 459 is unlikely to give rise to liability issues concerning directors. Its primary purpose is to give protection to a locked-in shareholder in a private company who is – by reason of some internal dispute – unable to exercise management control in the fashion that was originally anticipated when the company was formed and is unable to dispose of his interest in the company. There may or may not be a formal breach of duty by the directors in this process and accordingly section 459 operates irrespective of a breach of duty. The main difference between the unfair prejudice action and the derivative action is that the former is motivated by the inability of the shareholder to realise his investment whereas the latter is motivated by a breach of duty by the controllers of the company against the company as a whole. The remedy sought under section 459 is against the company rather than against the directors and what is generally wanted is an order from the court regulating the future conduct of the company or, as an alternative, the imposition on the majority of an obligation to buy out the dissenting shareholder.

[75] Hirt, "In what circumstances should breaches of directors' duties give rise to a remedy under ss. 459-461 of the Companies Act 1985", (2003) 24 Co Law 100.
[76] [1999] 1 W.L.R 1092 HL
[77] Ibid. This is the appropriate expression used by Lord Hoffmann in *O'Neill v. Phillips* which seems to resume the correct approach in *Ebrahimi v. Westbourne Galleries Ltd* [1973] AC 360.
[78] *Re Guidezone Ltd* [2000] 2 B.C.L.C 321 and *Brownlow v. GH Marshall Ltd* [2000] 2 B.C.L.C.
[79] This aspect is analysed in Chapter IV: Insured v. Insured Claims. Is the claimant claiming as shareholder or as member or former member of the board? If the answer to the second argument is affirmative the exclusion of Director vs. Director claim may apply.
[80] *Re Estate Acquisition & Development Ltd* [1995] BCC 338
[81] *Re a Company (No 004415 of 1996)* [1997] 1 B.C.L.C 479

3.3.1.1.1. Repercussions for D&O Insurance

D&O insurance is of limited relevance where minority shareholder remedies are sought. In the case of a derivative action, D&O insurance is potentially of significance. The action is brought against the wrongdoers who are in control of the company and who have caused it harm. The issue here, however, is the capacity in which liability has been incurred. If it is accepted that directors are likely to be in control of a private company, almost inevitably by virtue of a majority shareholding, it is far from obvious that any liability which they have incurred arises as a result of their directorship as such, but rather because they control the company. However, it should here be pointed out that the subject matter of the action is not the directors' control of the company but rather the wrongful act in respect of which their control has precluded an action by the company. Thus, in principle, a D&O policy should respond to a derivative action, subject to the doubts expressed above where the policy is taken out by the entity.

The position is different where the action is brought under section 459. Such an action is not necessarily related to any wrongful act on the part of the directors and may simply be an attempt by the minority shareholder to achieve the release of his investment. There is indeed no mention of the word "director" in the section, and it is clear that the targets of the action are the controllers and not the directors (even though they will inevitably be the controllers). This situation perfectly matches the issue dealt with early in this research[82] that implies that the wrongful act which attaches to D&O must be executed *qua director* and not in any other capacity, in this case *qua majority shareholder*. It is a well accepted principle in company law that directors are not members[83] of the company simply because they are directors and thus they are not bound by the contractual effect of the articles of association in accordance with section 14 of the Companies Act 1985. Consequently, the mandatory purchase of shares resulting from the successful allegation of unfair prejudice is not a remedy executable upon *qua directors* but upon directors if it results from the facts that they are also shareholders controlling the majority. Therefore, any liability which may be incurred is not sustained as director and this is a *sine qua non* requirement for

[82] Chapter II: In what Capacity must the wrongful Act be executed?

[83] Weddenburn, *"Company Law-Effect of Articles as Contract-Remedy against Directors"*. [1975] CLJ 194. Contrast with *Rayfield v. Hands* [1958] 2 WLR 851.

the enforcement of a D&O policy.[84] This argument forces the conclusion that the role of D&O insurance is of little significance in relation to section 459. It could be suggested that a director might suffer loss if he is forced to purchase minority shares by reason of a court order under section 461 of the Companies Act 1985, but it would first have to be established that compulsory purchase amounts to a "loss", which must be extremely doubtful given that shares are gained, and in any event there remains the problem that the capacity in which the order is made is against the controlling shareholders and not against the directors as such.

The question of defence costs cover is nevertheless a live one. As noted above, the insurers' liability for defence costs usually takes the form of a separate undertaking under the insurance policy. Section 461 of the Companies Act provides a variety of remedies applicable to unfair prejudice, one of those being the following:

"(2)(c) authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct"

Basically the courts may allow the petitioner to bring a derivative action on behalf of the company, forcing the completion of two full sets of trials before the final redress is obtained. Albeit these actions are infrequently ordered there have been decisions in this regard.[85] The question which arises is whether the policy would cover the two sets of legal costs or just those regarding director's breach of duty. The author is of the opinion that an issue of allocation of legal costs takes places with the purpose of determining what part of the costs is to be met by the defendant qua member – unfair prejudice costs- and what part is to be apportioned as part of the defence of the derivative action. Thus it could be suggested that only legal costs regarding the second scenario may be covered under D&O and in line, with the decision in *Clark v Cutland,*[86] such costs following a relief sought under section 461 of the Companies Act 1985, could be payable by the company- giving rise to subrogation rights- unless they could be recovered directly from the agent of the wrong.[87]

Finally, private companies should be economically and socially assessed. They

[84] Lowry, "*Unfairly Prejudicial Conduct- The scope of Section S,461 Orders*". [1992] JBL 186-188.
[85] *Re Cyplon Developments Ltd* 3 March 1982 (unreported, CA) and *Re Hailey Group Ltd* [1993] B.C.L.C 459.
[86] [2004] 1 W.L.R 783
[87] Ibid at 795-96.

represent the majority of corporate bodies registered in the UK,[88] playing an essential role for the general economy, and it is thus necessary to ensure that their financial stability should be considered, assessed and protected. D&O insurance might be important in this regard so the issue is to make shareholders of private companies aware that directors' liability should not be underestimated. Generally, the first target is the company itself and it is when the latter cannot meet the costs of litigation or indemnities that attention is transferred to directors; what practice shows is that irrespective of who meets the costs, these can result in excessive sums – usually unaffordable – which lead to both directors' and companies' insolvency.

The author is keen to believe that these policies are gradually becoming all but compulsory, with potentially lower premiums. Even though the effect of insurance is to raise the costs of companies' final products paid for by consumers, that increase should be relatively small compared with the benefit provided. This benefit represents the social assistance in terms of consumer protection that these policies offer. As it has been said throughout this research attention must be given to the fact that the solvency of directors and even the company itself are protected by this sort of cover.

3.3.1.2 Public Companies

There are a number of important differences between private and public companies, the most important being that the latter are permitted to offer their securities to the public albeit it is not compulsory for them to do so.[89] Public limited companies may belong to two different groups depending upon their securities being allowed to be offered in the London stock exchange as primary market or in the Alternative Investment Market (AIM). In both circumstances the interests of the general public are under the Financial Services and Markets Act 2000 through the Financial Services Authority by imposing ancillary and more intricate duties upon such companies in addition to those contained in the Companies Act 1985.

Being authorised to offer its securities in the primary market imposes upon the company the obligation to comply with the Financial Services and Markets Act 2000

[88] Davies: *Gower and Davies'*, op cit p14: the register of companies showed by march 2001 the number of register companies were nearly 1.5 million.

[89] What is needed it is the due authorization by the Financial Services Authority in accordance with the Financial Services and Markets Act 2000.

(Official Listing of Securities) Regulations 2001 (the Listing Rules).

It is necessary though to assess to what extent assuming the form of plc affects the effectiveness of D&O policies. Once more this may be analysed from a triangular perspective.

It has been said that, in addition to the Companies Act 1985, the Financial Services and Markets Act 2000 imposes extra duties upon both the plc and its directors. Basically these supplementary obligations aim to protect the investors against – amongst other things – two main types of detrimental acts on the part of those who act on behalf of the corporate body namely, misleading promotion and market abuse. Third parties, in this case investing shareholders, may be affected by the non-disclosure of vital information regarding company's financial health and economic stability. The aim is therefore to compensate by way of indemnity all the losses incurred as a result of the provision of misleading information.[90] Yet corporate representatives may wrongfully influence and affect the market, making it appear more or less attractive than it is in reality. Such conduct, known as market abuse, is penalised by fines imposed by the Financial Services Authority in order to protect the investor once the securities have been purchased; the aim is not other than that of keeping the securities at their real price in the market.

The issue of minority protection within Public Companies is of great concern since, although in principle the derivative action and the unfair prejudice remedy are available, it would appear from their requirements that it is very unlikely for either of them to prosper. It was earlier noted that the substantive requirements of a derivative action include the effective control of the board and the subsequent impediment – by way of ratification – of any attempt to initiate proceedings. Given the widespread distribution of the capital of a plc, it would be a rare case indeed where a shareholder could derive any appreciable benefit from initiating a derivative action on behalf of the company. Thus, there is virtually no prospect of the directors of a plc facing personal liability to the company, as derivative actions simply do not exist in practice.

In regards to the unfair prejudice remedy it is clear that it is unsuited to minority oppression within a plc.

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[90] In accordance with the structure of this research, misleading prospectus and market abuse and its legal repercussion is analysed in Chapter V as Director's Statutory Duties and Liability.

- As explained earlier, it is almost impossible to allege and prove the existence of any informal agreement and thus to identify legitimate expectations or equitable considerations which have been said to have been disregarded by the controllers. A plc, listed or not, because of its nature and mechanisms of raising capital, is designed to invite and have a considerable number of shareholders (a figure which may be in thousands). Therefore the possibility of achieving the informal agreement demanded for the substantive requirement of unfair prejudice may be unfeasible. This point of view has been supported lately in *CAS (Nominees) Ltd v. Nottingham Forest Plc.*[91]
- It has been noted earlier that directors could in some circumstances face liability for breaching their duties to the company by means of this mechanism. It has also been stated that the requisites for this type of action to succeed are a breach, a failure on the part of the majority to initiate proceedings and the prejudice to the claimant's interests. It was also concluded that the only possibility of fulfilling the first two requirements was by a director being either a majority shareholder or exercising a de facto control on the majority. Once again in a plc this specific situation is very unlikely to arise due to the vast number of shareholders and more importantly due to the amount of capital and the economic empire they often represent.
- The most pragmatic argument against its application is the fact that the remedy usually sought under section 461 of the Companies act is the purchasing of the claimant's shares at a fair price, something that could be easily achieved by offering such securities in the stock market or alternative market, avoiding therefore the intricacy of legal proceedings.[92]

Lastly - and no less important from a legal perspective - the assessment of potential liability of directors to third parties may here be noted, although it is fully considered in Chapter VI. As a result of the decision in *Williams v. Natural Life Health Foods*[93] the likelihood of a director of a plc company of assuming personal responsibility to the customer – due to a close relation with the latter - is remote in the extreme. As previously noted the size of these companies and the way they are managed impedes

[91] [2002] 1 B.C.LC 613. Also see *Re Astec (BSR) plc* [1998] 2 B.C.L.C 556; *Re Tottenham Hotspur plc* [1994] 1 B.C.L.C 655 and *Re Blue Arrow plc* [1987] B.C.L.C 585.
[92] Hirt, op cit p 110.
[93] [1998] 2 All E.R 577.

the chance of personal or direct relations between directors and the third party and this is a *sine qua non* substantive requirement to legally force any director to compensate the victim of his tortious act. It is thus correct to say that any personal liability is almost certainly confined to directors of private companies: as such directors are more likely to have a closer relation with clients giving rise to claims in which personal assumption of responsibility would be easier to prove.

To what extent does the above analysis affect D&O insurance? If, as has been submitted, that the available actions - derivative and unfair prejudice- are of almost no significance within the universe of public limited companies, the obvious conclusion is that a policy of this type would provide its benefits only in the following matters:

- Where the company faces insolvency and it is proved that there has been negligent wrongful trading on the part of directors. The reasoning here is that the *locus standi* to sue – despite being vested on the company itself - is exercised by a liquidator on its behalf; thus the board's control and shareholders economic rights are displaced in favour of those of creditors, thereby overcoming the hurdles of derivative and unfair prejudicial actions.
- Where the policy offers defence costs cover as a separate undertaking to that of the insuring director's personal liability. This appears to be a risk which directors of public limited companies are most afraid of.[94]

Economically and socially D&O insurance represents a real option to guarantee directors' solvency to third parties when things go wrong. Its benefits would not be assessed form the assured perspective only but from that of consumer or general public protection.[95] By way of example, Vodafone is understood to have a capital reaching £200 Billion and its capital is held by thousands of shareholders. Its customers or potential claimants are many millions as one of the leading companies on the provision of this sort of service. Two questions are readily apparent. The first is whether its directors are economically able to meet the cost of indemnity? It is clear that, without D&O insurance, few would be able to do so. The second is who is to pay for the costs of protection? Based on percentages and risk perception these policies may demand the payment of massive premium. The premium for D&O

[94] Supra: Chapter VIII: D&O Defence Costs Cover and Allocation.
[95] To this regard see Dean, *"Stakeholding and Company Law"*, (2001) Co Law 3.

policies is based on turnover and 0.5 percent of the above corporate capital may result in premium of £100 million. The question that needs answering therefore is whether the company, its shareholders by way of extra investment or the consumer by resisting rises in the service or product price, are willing to meet this cost.

3.3.1.3 Subsidiary or Holding Company

A subsidiary company is a company controlled by another company.

Section 736(1) of the Companies Act 1985 states that

"(1) A company is a 'subsidiary' of another company, its 'holding company', if that other company
(a) holds a majority of the voting rights in it, or;
(b) is a member of it and has the right to appoint or remove a majority of its board of directors, or;
(c) is a member of it and controls alone, pursuant to an agreement with other shareholders or members , a majority of the voting rights in it, or if it is a subsidiary of a company which is itself a subsidiary of that other company".

D&O policies are generally written so as to cover the directors of the parent company and the directors of its entire subsidiary and associated companies. What is excluded is the coverage of corporate bodies acting as directors, for example shadow directors of the subsidiary company. This in inferred from the wording of the policies by defining directors as any natural person.

3.4. Who is the Insured? - Composite Policies

Insuring clauses might take different forms and wordings, the form LSW 736 at Lloyd's in two separate headings, describe the insuring clause in the following terms:

"Underwriters agree, subject to the terms, conditions, limitations and exclusions of this policy to:
(a) Pay on behalf of the Directors or Officers of the Company Loss arising from any claim first made against them during the Period of Insurance and notified to Underwriters during the Period of Insurance by reason of any Wrongful Act committed in the capacity of Director or Officer of the Company except for and to the extent that the company has indemnified the Directors or Officers.
(b) Pay on behalf of the Company Loss arising from any claim first made against the Directors or Officers during the period of insurance and notified to underwriters during the period of insurance by reason of any Wrongful Act committed in the

capacity of Director or Officer of the Company but only when and to the extent that the Company shall be required or permitted to indemnify the Directors or Officers pursuant to the law, common or statutory, or the Memorandum and Articles of Association".[96]

This insurance policy contains at least two different parts, commonly known as Side A and B.[97] On the one hand it offers cover for individual directors or officers. On the other hand it offers reimbursement to the company itself to the extent that the company has indemnified the wrongdoer. Some insurers offer in addition a Side C[98] cover, which overlaps with the basic forms of cover and insures against both the company's liability and that of its directors and officers. This type of cover is known as 'Entity' or 'Corporate' Cover and because of its importance it will be considered separately subsequently.

The directors, under Side A, and the company, under Side B, are each insured under the policy. It is immaterial for this purpose that only the company has paid the premiums, as such payment can be regarded as consideration for the insurers' promise to indemnify both the directors and the company. It is also likely that there is no common law issue of privity of contract, as the directors and the company are joint promisees. However, to the extent that a privity problem does arise, in that the company has taken out the policy in its own name with the directors simply as named beneficiaries,[99] the Contracts (Rights of Third Parties) Act 1999 has removed all difficulties[100] as it allows a named or identifiable person to rely upon a contract as if he were a contracting party in his own right. Accordingly, whatever the position may have been prior to the 1999 Act, the directors are entitled to claim under the policy as if they were insured persons in their own right, as long of course as the policy does not exclude the operation of the 1999 Act.[101]

The fact that the policy provides cover both to the directors and to the company when

[96] Lloyd's of London LSW 736: Directors and Officers Liability Insurance and Company Reimbursement Liability Insurance.
[97] Parsons, *Directors' and Officers' Liability Insurance: A Target or a Shield?*. (2000) 21 Co Law 77 at 79.
[98] Ibid. at 80.
[99] See Campbell and Campbell, *International Liability of Company Directors*. LLP. 1993, p 231.
[100] Unless the Act has been excluded, in which case it will be necessary to rely upon the common law. It would seem that it is not the practice of insurers to raise privity issues in D&O cases.
[101] Some policies which confer third party rights do exclude the 1999 Act, although this would appear to be motivated by a fear of the unknown rather than any attempt to limit the intended rights.

it has indemnified the directors raises the question of whether D&O policies are structured on a joint or composite basis. The answer to this question is of major significance. The parties to a joint policy have indistinguishable rights which stand and fall together, so that if one joint insured is unable to claim then the same bar applies to other joint insureds. By contrast, in the case of a composite policy the legal analysis is that each of the parties has a separate contract of insurance with the insurers, albeit embodied in a single document: a composite policy is thus a bundle of parallel bilateral contracts. The point here is that each composite insured has a separate claim against the insurer, and the insurer for its part may have separate defences against the insured: if one co-insured has failed to disclose material facts, broken a condition or warranty or submitted a fraudulent, claim,[102] the rights of innocent co-insureds are unaffected.[103]

In answering this question it is necessary, as is the case with all other forms of insurance, to consider the insurable interest of the parties in the subject matter of the insurance and not simply the words used by the policy. In general terms, a policy is joint where the insurable interests of the parties are indivisible and it is composite where the insurable interests of the parties are separable.[104] It may be that the only true instances of joint insurance are policies procured by spouses on their mutually owned property or by partners whose ownership of assets and whose liabilities are joint.[105] It is, based on this definition, generally accepted that D&O insurance assumes the form of composite cover, so that each of the directors is insured separately and the company is also an insured person to the extent that coverage is extended to it. This principle was applied in *Arab Bank Plc v Zurich Insurance Co*,[106] Rix J affirming that whenever a company and its directors enter in contract of this nature, everyone must be deemed as separate insured, each for their own interest. Hence, any dishonesty on the part of one director would prejudice neither the innocent company nor the remaining innocent directors, as to their rights to be indemnified under a liability

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[102] See, for these propositions: *Samuel & Co Ltd v. Dumas* [1924] AC 31; *General Accident Fire and Life Assurance Corporation v. Midland Bank Ltd* [1940] 2 KB 388; *Eide UK Ltd v. Lowndes Lambert Group Ltd, The Sun Tender* [1998] 1 Lloyd's Rep 389; *FNCB v. Barnet Devanney (Harrow) Ltd* [1999] Lloyd's Rep IR 459.

[103] Although the position will be different insofar as the guilty co-assured is the authorised agent of the innocent co-assured: *Direct Line Insurance v. Khan* [2002] Lloyd's Rep IR 364.

[104] See *North Atlantic Insurance Co Ltd v. Nationwide General Insurance Co* [2003] EWHC 449

[105] *State of the Netherlands v. Youell.* [1997] 2 Lloyd's Rep 440.

[106] [1999] 1 Lloyd's Rep. 262

policy. This case is considered in more detail below.

It is obvious that the interest of the individual directors and officers in a D&O policy is to protect their personal liability and their assets, so that the interest of these regarding side A of the cover is to have a peace of mind as to the possibility of becoming financially vulnerable to third parties. Where, however, does this leave the company itself under Side B of a typical D&O policy? Assuming that the company itself is not a party to any legal proceedings against the director, but it chooses to reimburse the director for any damages awarded against him in favour of a third party,[107] it is clear that the company is not accepting primary liability to the third party and is making payment to the director only because it is required to do so under a contractual arrangement with the director under the articles. The company's insurable interest in a D&O policy drafted in the terms considered here is thus quite different to that of the director[108] and as a matter of law it has entirely separate rights. It follows that if insurers have the right to refuse to pay one or more of the directors under the policy, they may nevertheless be obliged to indemnify the company if the company has itself paid the directors by virtue of contractual arrangements between them. It is to be noted that there is no link between Side A and Side B of the cover, so that Side B may be relied upon by the company even though Side A is inapplicable in the circumstances. A clear example is represented by what is now section 337 of the Companies Act 1985 which establishes that the company is not prohibited to provide a directors with funds to meet the costs incurred in defending either civil or criminal proceedings. In this scenario and giving the composite nature of D&O policies, a company which lawfully advances costs to its directors is entitled to rely upon Side B cover to recover from insurers regardless of the fact that the latter might successfully contest liability in regard to Side A or directors' liability.

[107] It is unlikely that Side B provides indemnity for *ex gratia* payments: although the point has not been tested, it may be assumed that the company is entitled to indemnification only where it has made payment on the basis of the director's actual or compromised legal liability.
[108] The memorandum and articles of association may have included a specific term, allowing directors to be reimbursed in case they incurred costs by contesting third parties' claims.

3.4.1 Corporate Cover: Is The Company a Party or a Third Party to D&O Insurance?

In principle D&O insurance may take three different forms. First, it may provide an indemnity for individual directors only, and – as noted above – to the company if it chooses to indemnify the director for any sums paid by him to third parties under legal liability. This type of cover will protect those directors who perform their duties in more than one company within the corporate group so that the insurance follows them wherever they are at the relevant time.[109] Secondly, the insurer might offer cover to solicitors or accountants who hold office in their clients' companies, thereby exposing them to personal liabilities not necessarily covered by their professional indemnity insurance.[110] In other words, D&O insurance may be an ancillary protection or extended cover for professionals who become directors or assume their position. Thirdly, by offering "corporate cover" the insurer may extend coverage to the insured entity for claims brought against the company itself.[111] Such cover will in any event be necessary given that the company may face primary or vicarious liability for the acts and defaults of its directors and is normally provided under ordinary public liability insurance. However, D&O cover may be extended in this regard.

Special attention should be given to the consideration that D&O insurance has been developed to cover the liability of directors and officers to third parties and not to cover directors' and officers' liability to the company itself. Nevertheless, there is no rule of law which requires this outcome, and whether the company is entitled to the benefit of a D&O policy depends upon the terms in which it is drafted. Two possibilities may here be distinguished. The first is that the company itself has been directly harmed by the actions of the directors acting beyond the scope of their authority and may wish to bring proceedings against them. In principle there is no reason why a D&O policy should not cover this form of liability, as the company is

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[109] Finch, *"Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance"*. [1994] MLR p 880-898.

[110] Ibid. Some policies on the market do protect employees irrespective of the capacity in which they happen to be working at the time, eg, as directors in client companies. There is commonly overlapping cover in such circumstances.

[111] Bordon, *Directors' and Officers' Liability Insurance. Deskbook*, American Bar Association 1998 at 40

simply in the position of a third party who has suffered harm at the hands of the directors. The fact that the company is itself the assured, or at the very least a party to the policy in that it has protection under Side B coverage, would not seem to be an insurmountable obstacle to its recovery under the policy. While there is generally an implied term in first party insurance contracts that one co-assured may not sue another,[112] that principle operates only where the parties have intended that loss suffered by one of them at the hands of the other should be satisfied by a first party claim against the insurers so that the insurers cannot exercise subrogation rights against the wrongdoing co-assured: that cannot be said of the situation in which the policy is one against liability and the company has no possibility of a first party claim against the insurers.

The second situation is where the company faces primary or vicarious liability towards a third party[113] by reason of the activities of its directors. Here, in principle the company may make a claim against the directors who may in turn recover the sums payable to the company by them from their D&O insurers. The question whether a company can claim to be a third party victim in this way is far from easy to answer, but it might be commented that the effect of this approach is to convert a D&O policy which insures just the liability of the directors into a liability policy which is indirectly for the benefit of the company. However, it is generally accepted that if a wrongdoer inflicts harm upon a third party, e.g. by the supply of defective products and the third party incurs liability to its own customers on the resale of those products, the third party is able to claim damages against the supplier in contract or tort and the insured's liability insurers will be liable to indemnify him in respect of those damages.[114] In this way, the third party is in effect utilising the insured's liability policy to cover his own liability in much the same way as the company as a claimant against the directors in respect of its liability in damages to third parties.

[112] *Co-operative Retail Services* v. *Taylor Young Partnership Ltd* [2001] Lloyd's Rep IR 555.
[113] Including, potentially, shareholders who may bring a derivative action on behalf of the company where the directors are in control, or who may initiate proceedings under s 459 of the Companies Act 1989 for unfair prejudice.
[114] The cases go on to say that the policy will not cover the assured's liability to the third party for consequential loss, eg, the third party's future loss of contracts with those to whom he has supplied defective goods. See, most recently *James Budgett v. British Sugar* [2003] Lloyd's Rep IR 114.

3.4.2 Problematic Areas

The composite nature of D&O insurance leads to complex legal issues concerning the validity of the contract and concerning compliance with contractual terms. The question which arises is the extent to which any breach of duty by a director – e.g. non-disclosure, misrepresentation, breach of condition or warranty – can affect the rights of other directors or indeed the company to make a claim against the D&O insurers. As noted above, in *Arab Bank v. Plc v Zurich Insurance Co*[115] Rix J held that the policy is truly composite, so that misconduct on the part of one director does not affect the right of the other parties of the policy to make a claim. From a logical perspective, D&O insurance would be of very little use if the answer were otherwise,[116] and indeed some insurance policies specify that any contravention of any contractual or extra-contractual obligation on the part of one director leaves the rights of the others unaffected.[117] In *Arab Bank* the policy was silent on the issue, but Rix J nevertheless reached the same conclusion. In *Arab Bank* a professional indemnity policy was incepted for the benefit of a company and its directors, surveyors. The policy was placed by the managing director with the authority of the company and the remaining directors. The policy required disclosure of events known to the insured and likely to give rise to a claim. The managing director unsurprisingly failed to disclose that he had participated in a series of mortgage frauds involving overvaluation of properties to be used as securities for loans. One of the victims obtained judgment against the company, although it had by this time gone into liquidation, and the victim accordingly claimed compensation from the individual directors: the directors in turn sought indemnity under the policy. The insurers denied liability on the ground that the fraudulent withholding of information on the part of the managing director prevented any of the directors from recovery. Rix J construed the policy as a composite cover, so that each of the directors was individually insured under the policy: this meant that a personal bar affecting the managing director could not affect the claims of the others. The decision has added significance, in that Rix J held that the guilty knowledge of a director – including the managing director – is not to be regarded as imputed to the company itself, as the whole purpose of a composite liability policy is to give protection to individual directors and to the company. This

[115] [1999] 1 Lloyd's Rep 262.
[116] Parsons, op cit at 81
[117] Ibid.

is an application of the decision of the Privy Council in *Meridian Global Funds Management Asia Ltd v. Securities Commission*,[118] which lays down the principle that there is no single rule of attribution of knowledge within a company and that the answer in any one case depends upon why the question is being asked. Rix J further held that the insurers did not have the right to avoid the policy on the basis of the principle that an agent to insure is required to disclose all material facts to the insurer:[119] leaving aside the vexed question whether anyone other than a placing broker could be an agent to insure for these purposes, Rix J held that the law did not expect an agent to disclose his own fraud[120] and accordingly that the policy was not avoidable on this basis.[121]

[118] [1995] AC 500.
[119] See s 19 of the Marine Insurance Act 1906.
[120] On the principle in *Re Hampshire Land* [1896] 2 Ch 743.
[121] See generally *PCW Syndicates v. PCW Insurers* [1996] 1 All ER 774 and *Group Josi Re v. Walbrook Insurance Co Ltd* [1996] 1 All ER 791.

CHAPTER IV

D&O EXCLUSIONS

Policies of this nature are complex documents usually forming part of blanket or umbrella cover undertaken by the company, aware of its financial exposures. It is commonplace though to agree upon a series of different wordings, sometimes either overlapping or contradicting each other in respect of construction and enforceability. One could think it is inappropriate to say this under the heading 'exclusions' but the idea is not meaningless. Despite existing common sets of exclusions developed by the market in respect of D&O cover, it is possible to find that a director's or officer's wrongdoing -excluded under special provisions- may be covered under some other provision in the umbrella or blanket cover. Some examples might illustrate the point. Ordinary D&O policies exclude actual or alleged damage to or destruction of property in regard to either directors, officers or the company, had the latter been protected by entity cover. This does not mean the company is precluded from recovering under the fidelity provisions of the policy where there has, for example, been theft of corporate property by the directors. Again, excluding pollution liability under the D&O heading might prevent the company from insuring against such liability under the blanket cover-, albeit subject to special burdens or payments. The point could even be more important if the post of director was not to be regarded as a profession in its own right,[1] as this would have the effect of preventing directors from being protected by the professional liability section of the policy. The same argument applies if directors are no more than well paid employees of the company to whom employment practices liability cover 'EPL'[2] and fidelity provisions – if any- apply accordingly.

Previous arguments denote the importance of analysing market practice exclusions on their own in order to evolve answers to the following questions:

- What is the rationale behind the exclusion?
- What sort of exclusions could be contractually covered?
- What sort of exclusions stem from the proper features of D&O insurance?

[1] Supra Chapter II Directors: are They Professionals?

[2] Herman & White, *D&O What You Need to Know*. USA: Nonprofit Risk Management Center, 1998 at 72 " Insurance that provides coverage for claims arising out of employment practices. EPLI policies generally cover the organization, its directors, officers and employees".

In order to consider the answers to these questions, exclusions could be classified as belonging to one of the following groups. Firstly, illegal contingencies or public policy considerations to which general accepted principles of insurance apply. Secondly, contractual exclusions characterised by those which attempt against proper nature of D&O insurance. Thirdly, negotiable exclusions or that sort which are neither expressly prohibited nor against D&O common principles of law.

4.1. Illegal Contingencies- Public Policy Considerations- Fraud and Deliberate Breach of Duty

The maxim *'ex turpi causa non oritur actio'* prevents any director or officer from being indemnified if their claim is based on grounds which contravene general principles of insurance. As a result of public policy limitations and the overlapping notion that insurance covers only losses or liabilities which occur outside the control of the assured, the insurer's liability under a professional indemnity policy-from which D&O was developed- is confined to acts of negligence, that is to say a failure to exercise the level of skill and care required in the performance of a professional activity.[3] In other words, fraudulent and/or deliberate misconduct, wilful default or deliberate breach of statutory provisions prevents recovery under an insurance policy.[4] Therefore, the author is of the view that it is irrelevant, for the purpose of determining what could or could not be covered; the inclusion in the policy wording of any sort of exclusion regarding illegal contingencies since in any case, a court may intervene and prohibit the insured from enforcing the insurance contract. This last argument may disagree- to some extent – with the decision in *Euro-Diam Ltd v. Bathrust*[5] where *Staughton* J was of the opinion that in a non-marine insurance contract there was no implied term that the undertaking was lawful or ought to be carried out lawfully, contrary to what happened in marine insurance contracts bound by section 41 of the Marine Insurance Act 1906, where such a term is implied.[6]

[3] *Lanphier v. Phipos.* (1838) 8 C. & P. 475. "Every person who enters into a learned profession undertakes to bring to the exercise of it a reasonable degree of care and skill".
[4] *Borrows v. Rhodes* [1899] 1 Q.B 816: "If an act is manifestly unlawful, or the doer of it knows it to be unlawful, as constituting either a civil wrong or a criminal offence, he cannot maintain an action for contribution or for indemnity against the liability which results to him therefrom".
[5] [1990] 1 Q.B. 1
[6] Marine insurance Act 1906 s 41: "There is an implied warranty that the adventure insured is a lawful

It is thought nevertheless, that the idea behind market practice[7] – which opts for incorporating exclusions on this respect- is not only to reaffirm general accepted principles of insurance but also to illustrate and warn the insured from acting in a fashion which may preclude cover.

The following propositions may be derived from the cases and represent real scenarios in which D&O policies would be of no assistance. Firstly, a director may not recover in respect of his liability for loss of property which he has misappropriated. This principle stems from the decision in *Geismar v. Sun Alliance and London Assurance Ltd*,[8] in which the court refused to allow the insured to recover for the confiscation of goods which had been smuggled into the UK by him: Talbot J's view was that allowing recovery in such circumstances would permit the insured to profit from his own wrongdoing.

Secondly, if the director has brought about his own loss by reason of fraud or misconduct, he has no claim. A director who has deliberately or recklessly exposed himself to liability is to be taken to have intended the consequences of his conduct and he cannot look to the insurers for reimbursement.[9] However, mere negligence is not enough. As noted earlier, a line has to be drawn between losses caused by carelessness and losses caused by recklessness or fraud. Misleading or deliberate inaccuracy in making company financial statements or prospectus linked with the intention of deceiving investors[10] is a wrongful act embraced by this exclusion.

Thirdly, illegal profits and subsequent accountability are subject to this exclusion indeed. Thus director's expectation of being covered vanishes, when they seek to

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one, and that, so far as the assured can control the matter, the adventure shall be carried out in a lawful manner".

[7] Few wordings may illustrate the point. For example Lloyd's form 736 s 4 "Underwriters shall not pay any loss arising from any Claim (v) brought about by or contributed to by or consequent upon any dishonesty, fraud or malicious conduct of the Directors or Officers…." Chubb wwtcall 99-2002 Section D –Directors & Officers Liability, Exclusions 8 "The insurer shall not be liable ….on account of any claim (a) based upon, arising from, or in consequence of any deliberately fraudulent act or omission or any wilful violation of any statutory, civil or common law by such Insured Person if a judgement, or other final adjudication adverse to such insured Person, establishes such fraudulent or wilful act or omission".

[8] [1978] QB 383

[9] Cf Marine Insurance Act 1906, s 55(2)(a): " The insurer is not liable for any loss attributable to the wilful misconduct of the assured, but, unless the policy otherwise provides, he is liable for any loss proximately caused by a peril insured against, even though the loss will not have happened but for the misconduct or negligence of the master of crew".

[10] Finch, *Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance*. [1994] MLR at 880.

obtain a profit to which they are not entitled;[11] this preclusion may have its foundations in two separate but correlated principles as follows. The idea of illegal profits as it stands is, on its own an adventure controllable by the insured; no one could suggest that a director –acting in his capacity as such- might have profited in complete unawareness of the cause of his gains. It does not mean such benefit needs to be fraudulent, on the contrary –as explained later on[12]- it could be quite innocent nevertheless punishable since it is believed that the insured might have taken advantage of his position; or in other words, had not been the assured holding office would have prevented him from becoming involved in such a negotiation in the first place. Additionally and maybe crucial to the point, is the fact that both opportunities and information are company's assets,[13] thus misappropriating them is an adventure incapable on its own of being insured under third party insurance. First party insurance might assist the company in these circumstances.[14]

Fourthly, a director may be caught by the common law rules of public policy, if the director has carried out an act which is frowned upon by the general law and there is clear proximity between the unlawful act and the loss suffered by the director, public policy may disallow recovery. The general principle here is that if the director has to rely upon his own illegal act in order to substantiate his claim, he will be unable to recover.[15] However, if the insured is able to establish his rights without relying on such illegality he might be entitled to recover under the policy following the decision in *Tinsley v. Milligan.*[16] This seems to be the approach and consequent practice at Lloyd's by covering any loss where " the final judgement or other final adjudication of the court hearing proceeding against any Director or Officer determines that he/she is legally liable in respect of a Wrongful Act on some cause of action which is not dependent on the existence of a dishonest, fraudulent or malicious purpose or intend and makes no finding that he/she was guilty of dishonesty, fraud or malicious conduct

[11] Youngman, *Directors' and Officers' Liability Insurance. A Guide to International Practice.* Woodhead Publishing Limited, 1998 at 37.
[12] Infra Chapter V Conflict of Interest and Non-Profit Rule.
[13] Ibid.
[14] This is why it is commonplace to find in the market wordings as follows: the insurer shall not pay any claim "based upon, arising from, or in consequence of such insured Person having gained in fact any personal profit, remuneration or advantage to which such Insured Person was not legally entitled". Chubb wwtcall 99-2002 Section D -Directors & Officers Liability, Exclusions 8.
[15] *Gray v. Barr* [1971] 2 Q.B. 554 and *Euro-Diam v. Bathurst* [1990] 1 Q.B. 1.
[16] [1993] 3 All ER 65

in relation to the Wrongful Act in question".[17]

Finally, legislation may directly or indirectly prevent recovery on an insurance policy where a particular activity prohibited by statute is carried out. However, the mere fact that a law, including an Act of Parliament, has been contravened is not enough to preclude recovery under a liability policy:[18] The insurer has to go further and show that the legislation was designed to have civil as well as administrative or criminal consequences.[19] Market manipulation[20] and fraudulent trading[21] perfectly match examples on this regard.[22]
Additional examples belonging to this sort of exclusions are amongst others: fines and penalties, punitive or exemplary damages;[23] and the rationale behind it, does not go further than affirming that these are the result of reprimands against the wrongdoer, thus they are not economical damages arising out of unexpected happenings. Allowing indemnity in this scenario may contravene the proper aim of the law: 'castigate the guilty'.

All of this is of major significance to D&O policies and helps in illustrating to what sort of director's liability this type of insurance attaches.[24] If the director has been guilty of fraud, his conduct is such that public policy demands that a claim for indemnity be refused; if he has infringed regulatory legislation which is regarded as having penal effect or if he has caused his own loss, then a D&O policy will simply not respond to the claim. In every case, therefore, it is necessary to consider the nature of the director's breach of duty to determine whether he is precluded from making a claim against his insurers.[25] Relevant to this point is the fact that these exclusions apply only to dishonest directors and it does not affect innocent ones who could still

[17] Lloyd's form 736 s 4 (v) (b).
[18] *Charlton v. Fisher* [2001] Lloyd's Rep IR 287.
[19] *St John Shipping Corporation v. Joseph Rank Ltd* [1957] 1 Q.B. 267.
[20] Financial Services and Markets Act 2000 s 118 (2)(a)(b)(c).
[21] Insolvency Act 1986 s 213.
[22] Supra Chapter V: Directors' Statutory Duties and Liability
[23] Awarding punitive damages in English law is not a commonplace practice and whether they could be granted in either contract or tort depends upon exceptional circumstances. For a comprehensive explanation see Merkin, *Colinvaux's & Merkin's Insurance Contract Law*, Sweet & Maxwell. At 20709
[24] Infra. Chapter V: The Source of Liability And The Consequential Loss : D&O Covered Risk.
[25] Ibid.

recover from their insurer.[26]

4.2. Liability in Contract

It is a well established principle in the law of contract that failing to comply with either warranties or conditions exposes the party in breach to contractual liability resulting –amongst other remedies- in having to indemnify the other party for loss accruing thereupon. Such breach could be the result of deliberate and fraudulent acts as well as negligent and the available remedies depend very much upon the circumstances. D&O carriers are usually reluctant to offer cover for pure contractual liability and the repercussion of this sort of exclusion is to confine D&O cover to claims against the directors in tort by reason of not exercising due care and skill in the performance of their duties.[27]This seems to be the conclusion reached by the Californian court in *Stanford Ranch Inc v. Maryland Cas. Co*[28] where in applying California law the judge was of the opinion that exclusions of this type were enforceable where the allegations depended upon the existence of an underlying contract so that the claim sounds in contract only, as opposed to both contract and tort.[29] Now, tort liabilities are well defined by the general law and are well known; hence, insurers can anticipate what their liability might be in order to predict the risk and fix the premiums. Conversely, contractual liabilities are voluntarily undertaken and could relate to anything, making impossible such prediction and estimation. Furthermore, the measure of damages is greater in contract than in tort, as loss of profit- which is the most likely form of loss in pure contract claims- is recoverable in contract but not in tort; consequently, virtually all liability policies exclude responsibility arising under contract only.

However, not only technical grounds support the exclusion of this sort of liability, the rationale goes further in matters of public interest. For obvious reasons the entire market would be affected by providing indemnity in cases of deliberate, fraudulent or wilful breach of contract. No legal system could allow a party under a contract to financially escape and remain unhurt for not complying with agreed terms. Principles

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[26] Youngman, op cit at 37.
[27] Infra. Chapters V and VI.
[28] 89 F.3d 618, 625(9th Cir.1996) in Bordon, op cit at 120.
[29] Bordon, *Directors' and Officers' Liability Insurance Deskbook*. American Bar Association, 1998 at 120.

of moral hazard deter such practices: the understanding is that as soon as a party feels safe in not honouring whatever has been agreed upon, the other party could be in the position of not getting what had been promised purely because, the party in breach is assured and, therefore face no worries.
A good example of this sort of exclusion is represented by the following wording: "except for claims for Employment Practices Wrongful Acts, Aetna shall not pay Loss, including defence expenses, for claims for any actual or alleged liability under any contract or agreement, except for liability which would have attached even in the absence of such contract or agreement".[30]

4.3. Contractual Exclusions

4.3.1. Insured v. Insured Claims

Companies have become very complex structures in size and form, difficult to manage and control, forcing the appointment of a number of individuals with wide powers. This leads to the not surprising point of offering cover for a considerable number of individuals who by means of their functions and responsibilities, interact on a constant basis. Such interaction increases the likelihood of conflicts and internal disputes which may involve the insured in both sides of the controversy. The insured v. insured exclusion aims to avoid not only the fact of having to finance litigation tainted by this particular situation but also to prevent the company, had entity cover been provided, from recovering at the expense of the insurer as a remedy for loss caused by erroneous management decisions. Consequently, this exclusion works against indemnity for claims arising from one insured alleging wrongful acts or misconduct by another insured.[31]
Apparently, the idea behind the exclusion was originally to avoid cover when insuring close held corporations where family disputes are commonplace. Afterwards the exclusion was used in a wider sense, specifically following large financial scandals involving for example Chase Manhattan in 1984, where the company intentionally

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[30] Aetna, Endorsement N-302.7 (4-94) in Herman & White, op cit at 53.
[31] Herman & White, op cit at 52.

discharged the persons liable for the losses and then claimed against D&O carriers;[32] the insurer, by settlement, agreed to pay 32,5 million American dollars. Two other examples are: Bank of America in 1985, $60.4 millions; and Seafirst Corporation where the insurer paid up to $110millions. Nevertheless, the market has understood that limiting and squeezing the risk cover may make D&O insurance unattractive and this is why nowadays insurers tend to be more flexible albeit the exclusion is still commonly used.

When construing the exclusion it will be necessary to look at policy definitions to ascertain whether or not both parties fall within the description of 'the insured',[33] and it is understood that the exclusion applies only to those insured under the same policy and not to directors and officers covered by different policies or carriers. In this respect, a non-executive director holding office in more than one corporate body might have contracted individual cover, even with the same insurer as the company, but nevertheless he is not embraced by the exclusion in the light of the consideration that his insurance is independent and enforceable on its own. The same principle may apply -for example-in motor insurance if the insurer is to deny liability purely because after a collision, it happens that both drivers were insured with the same company.

By analysing common policy wordings one might think that the extent of the exclusion is such that it may leave D&O insurance with very little role to play in practice. An ordinary wording will provide:

"The insurer shall not be liable to pay any loss in connection with any claim: by the entity or derivatively on behalf of the entity by any directors or trustees of the Entity, or by any Affiliates or derivatively on behalf of any affiliate".[34]

Within the same scenario Lloyd's follows similar wording:

"Underwriters shall not pay any Loss arising from any claim:
(x) made by or on behalf of the Company or by or on behalf of any Director or Officer and at the instigation of any person who is or was also a Director or Officer or Agent of the Company however this Exclusion shall not apply to any Claim made by or on behalf of any employee of the company (except one who is or was a Director) in

[32] Parsons, op cit at 81.
[33] See supra Chapter III: Persons Covered.
[34] CNA G-20717-A (ed. 2/94) in Herman & White op cit at 53.

respect of employment disputes"[35]

All of this means that the insured v. insured exclusion is closely connected with minority shareholders protection and their available remedies,[36] to say nothing of the composite nature of D&O insurance and the possibility of deeming the company both insured and third party victim.[37] It is crucial for the effectiveness of the exclusion to corroborate and ascertain once more who is vested with the *locus standi* to bring either derivative or unfair prejudicial actions. In fact – as noted earlier- [38] either of these remedies is precluded from indemnity; it being the first an action intended on behalf of the company and the second on that of the shareholders- against the controllers- whose interest could have been prejudiced by the way company's affairs have been conducted.[39] In the first situation both the claimant and the defendant are insureds and in the second the wrongdoer is not acting *qua director* and thus is not acting in his insured capacity. Consequently, little appears to be left to which the cover can attach.

Although this point is the subject matter of the two following chapters, it is necessary to point out here that most –if not all- breaches of fiduciary duties on the part of directors are on public policy grounds, uninsurable. It is very unlikely – following recent authorities- that a director may incur personal liability to third parties by acting as such and not assuming personal responsibility; and in addition insurers limit cover against claims from the company and directors *inter se*. If this is the case, it would be difficult to conclude other than that D&O policies offer their benefits only against claims by employees of the company and by shareholders whose investments have been affected by –what they think- is a negligent breach of directors' duties provided they seek relief, not on behalf of the company, but in respect of their personal interest only.

From these arguments interesting issues arise. Firstly, a director could be a shareholder as well – in fact it is very common- thus he may be entitled to exercise against the wrongdoers any shareholder's remedy. Undoubtedly, any insurer facing this situation might try to enforce the exclusion by affirming that in any case the

[35] Lloyd's Form LSW 736 s (4) Exclusions.
[36] Supra Chapter III Private Companies.
[37] Supra Chapter III: Who is the Insured? - Composite Policies and Corporate Cover: is the Company a Party or a Third party to D&O Insurance?
[38] Supra Chapter III: Persons Cover: The Company.
[39] Ibid.

claimant is insured under the policy; conversely the latter might allege that his is exercising a right *qua shareholder* and not in his insured capacity so the exclusion does not attach. These arguments are of major significance in construing the exclusion. Is a director an insured under policy definitions just because he is holding or exercising office? Or is he/she deemed as such not only for so acting but also by reason of the nature of the claim at issue? If the answer to the first question is the affirmative, any director who is also shareholder is prevented from indemnity -by insured v. insured exclusions- regardless of the nature of the claim.

Now, if the nature of the claim is relevant in construing the exclusion, a director's claim might not be rejected purely on the grounds that he is an insured; on the contrary, the interpreter in construing the real effect of the policy is under the burden of drawing a line between actions that could only be exercised *qua director*- excluded- and those actionable *qua shareholder*- potentially covered. All of these mean that if the claimant sustains his plea upon grounds that could only be exercised *qua shareholder* and not for the sole purpose of board's disagreements, the insured v. insured exclusion could not be enforced. Thinking the contrary may prevent an innocent director, who does not control the board and who happens to be a shareholder as well, for not claiming in his latter capacity despite the fact that the remaining members of the board are abusing the company's assets or otherwise affecting the value of his shares.

The second important point relates to company insolvency. In *National Union Fire Ins. Co v. Resolution Trust Corp*[40] a receiver who was appointed for the insured Bank sought indemnity against the bank's D&O insurer. The policy wording expressly excluded insured v. insured claims. The judge was of the opinion that since the receiver initiated proceedings on behalf of the bank against its directors the exclusion attached and precluded cover. Had the action been brought on behalf of shareholders, creditors or other non-insured parties, the insurer would have been prevented from relying on the exclusion.[41] Although there is no English decision on this issue, it could be suggested that in this jurisdiction the issue is of major importance. English

[40] No H-92-1157, 1992 U.S Dist Lexis 14914 (S.D. Tex. Aug. 12, 1992) in Bordon, op cit at 131.
[41] The same conclusion was reached in *Continental Cas. Co v. Allen*, 710 F. Supp. 1088 (N.D. Tex. 1989) where the court was of the opinion that the exclusion barred cover since the claimant 'stepped into the shoes of the insured'.

company law recognises the appointment of receivers by two different mechanisms namely: by the court or by debenture holders of the company, although the latter possibility has been severely restricted by the provisions of the Enterprise Act 2002.[42] The first procedure is under court's directions and the receiver must act impartially for the advantage of all the parties. The second, where it is still permitted, has as its aim the realisation of debenture holder's security.[43] In either case receivers are vested with the power to bring or defend any action or other legal proceedings in the name of and/or on behalf of the company[44] and insured directors may not escape as to be the subject of a claim on this basis.

It is the case that receivers appointed by the court are not deemed agents of the company and thus do not step into the shoes of the assured company for the enforcement of the insured v. insured exclusion. They act independently and impartially for the benefit of all the parties involved namely: company, shareholders and creditors.

On the contrary, receivers appointed out of court are commonly company's agents[45] and even administrative receivers are statutorily deemed as such by section 44(1) of the Insolvency act 1986.[46] Acting as agents for the company may place receivers within the boundaries of the insurance exclusion, giving insurers strong arguments to successfully contest liability.

In either compulsory or voluntary winding up, the issue is very much the same; the appointment of liquidators who are company's agents[47] activates the insured v. insured exclusion irrespective of insurers' defence of relying upon the nature of the wrong imputed to directors, if liquidators decide to bring proceedings in any of the available grounds.[48]

Cases of insolvency and insured v. insured exclusions have attracted the attention of many practitioners and have been the subject of a number of proceeding in US; there have been suggestions that this sort of exclusion should be construed narrowly on the

[42] Adding section 72A of the Insolvency Act 1986.

[43] Hannigan, *Company Law*, Butterworths, 2003 at 728.

[44] Insolvency Act 1986 schedule 1 (5).

[45] Hannigan, op cit. See also *Gomba Holdings UK Ltd v. Homan* [1986] 3 All ER 94

[46] "The administrative receiver of a company- (a) is deemed to be the company's agent, unless and until the company goes into liquidation".

[47] Hannigan, op cit at 808 "when carrying out his functions, the liquidator acts as an agent of the company. Any contracts entered into by him are entered into by the company and the liquidator incurs no personal liability unless the terms of the contract show that he is undertaking a personal liability". See also Steward v. Engel [2000] 2 B.C.L.C 528 and Stead, Hazel v. Cooper [1933] 1 K.B. 840.

[48] For example: Wrongful or Fraudulent Trading .

ground that its main purpose is to avoid internal litigation or merely to allow a company to unlawfully recover at the expense of insurers. However, the question of its enforceability is at issue when as a result of the company's insolvency, shareholders, depositors, creditors and the public at large are all prejudiced.[49] It is the author's view that to some extent the interests of those dealing with insolvent companies – especially banks - ought to be considered in deciding whether or not to prevent recovery by the company; but it is also true that insurance companies are not registered charities, set up for the purpose of benefiting third parties - on the contrary they are companies seeking profits for their members. Thus, the enforcement of insured v. insured exclusion in this scenario is perfectly acceptable and its effectiveness should not be undermined merely because of the company's precarious financial position.

4.3.2 Directors' and Employees' Dismissals

As it is noted below,[50] the relationship between the company and a director may involve the creation of a contract of employment: this is most likely in a case involving a full-time remunerated executive director, who will normally operate under a service contract. A director who breaks his contract of employment or is otherwise performing unsatisfactorily may be dismissed, and as long as there is good reason and the company has acted reasonably the dismissal will be regarded as fair.[51] A common wording would exclude liability in regard to "employment claim brought or maintained by an insured person".[52]

Plainly a director has no claim under a D&O policy in respect of his dismissal, although there may be an issue as to whether he can seek to recover from his insurers the cost of bringing proceedings for unfair dismissal: this is unlikely, as the coverage is likely to be confined to defence costs. A D&O policy may nevertheless be relevant to an unfair dismissal claim where the policy offers entity cover so that it extends to

[49] Suomala, *Bankrupcy and the Insured versus Insured Exclusion*. Peterson & Ross. April 2002 in www.irmi.com/expert/articles/suomala001.asp
[50] Infra Chapter V: Relationship Between the Company and its Directors.
[51] *Maintenance Co Ltd v. Dormer* [1982] I.R.L.R 491. In this case it was held that a breach of fiduciary duty was a good and fair reason for the dismissal of a director.
[52] Chubb, wwtcall99-2002.

the liability of the company as well as to the liability of its directors.[53]

In practice even an entity cover will not extend to sums awarded against a company by way of compensation for unfair dismissal and instead the company will procure independent insurance (which may form a separate part of a D&O cover) known as Employment Practice Liability Insurance (EPL), to deal with liabilities which arise from unfair or wrongful dismissals.[54] It should also be said that D&O cover is third party rather than first party, so that a company with entity cover cannot claim under a D&O policy for potential losses caused by the dismissal of a director. All of this leads to conclude that EPL cover might be of assistance where prospective, current or past employees – other than directors- make a claim against the entity, its directors or fellow employees.[55]

4.3.3 Claims for Personal Injury or Material Damage-Product liability-Professional Liability.

The company is required by law to hold employer's liability insurance [56] and may be expected to take out general public liability cover. The latter form of insurance provides protection for the acts or employees, servant or agents of the company and the consequential vicarious liability which might result thereupon, [57] including liability arising out of copyright, patent or trademark infringement.[58] Events such as bodily injury, sickness, disease or death suffered by directors or any other company's employees, alongside damage to property are the subject matter of long-established commercial policies.[59]

Product liability Insurance might be suitable to cover losses caused to persons or other property by defective products. Finally, D&O policies may be of no assistance in respect of professional liability due to the fact that this sort of liability is the subject

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[53] Parson, op cit at 80.

[54] Kean, *"Should I Buy EPL Cover?"* Barlow, Lyde & Gilbert, Directors' and Officers' Liability Review. 1999, p 19. It is here pointed out that this form of cover was originally devised as an add-on to protect directors against employment-related claims by employees: such cover was developed for the US market, but probably has little value for directors in the UK. However, it is of significance where there is entity cover, as the company itself may be protected.

[55] Parsons, op cit at 82.

[56] Amongst others: Employers Liability (Compulsory Insurance) Act 1969;The Health and Safety at Work Act 1969; Employers' Liability (Defective Equipment) Act 1969.

[57] Jess, *The Insurance of Commercial Risks Law and Practice*. Butterworths London 1986 at 141.

[58] Youngman, op cit at 38.

[59] Youngman, op cit at 38.

matter or professional indemnity insurance and the exercise of directorship is not a profession on its own.[60]

4.4. Negotiable Exclusions

4.4.1 Prior Acts - Retroactive Cover - Tail Cover - Discovery Period-

It has been noted above that D&O policies are 'claims made' thus covering claims made and reported to the insurer within the period of insurance. This means – at first sight- that it is of less importance when the contingency maturing into a claim happened since what triggers this policy is the notification to the insurer that a claim has been made or it is on its why to occur. However, these policies are often tailor-made, thus allowing the parties to negotiate certain terms amongst which, the period of insurance appears to be crucial to the point. In this regard, the insurer might agree to indemnify for claims preceding the inception of the policy- subject to full disclosure- or to extent cover beyond its expiry provided that the insured complies with additional burdens usually in the form of extra costs. Concepts such as: prior acts cover or exclusions, retroactive cover, tail cover and discovery period emerge from this negotiating process. Regarding prior acts occurring before the inception of the policy, it is understandable that insurers are unwilling to cover existing claims or losses[61] although in practice this is negotiable. This process might be complicated if directors or officers are uninsured or have gaps in their past insurance.[62] Prior acts exclusions bar coverage for claims arising out before a specific date and this usually corresponds with the cessation of coverage under previous insurance.[63]
Now the exact meaning of 'prior acts' must be correctly assessed in the sense that it should not be confounded with the nature of a claims made policy. Consequently, the exclusion refers to claims made before the inception of insurance and not to potential wrongful acts which later may develop into a claim. It is the author's view that a more precise drafting of these sorts of exclusions would be 'prior claims'; since it is against this circumstance that such a term effectively works. If one understands that claims

[60] Supra. Chapter II: 4.2.1 Directors: Are They Professionals?
[61] Herman & White, op cit at 34.
[62] www.eqgroup.com/pdf/claimsmade_expl.pdf, Professional Liability Update.
[63] Gische & Fishman, *Directors and Officers Liability Overview*, Ross, Dixon & Bell L.L.P in http://profs.lp.findlaw.com/insurance/insurance1.html.

made policies reach backwards in time, providing coverage for claims made today for wrongful acts occurred in the past, there would be no difficulty in appreciating that prior acts or claims- in the form set above- refer only to claims made or likely to be made before the policy incepted, otherwise claims made policies would be of no sense at all. The following wording might support the argument that the exclusion refers to past wrongful acts already claimed against the insured and not to mere wrongful acts:

"The company will not cover claims which are:

D. based upon, directly or indirectly arising out of, or in any way involving:
1. any wrongful Act, or any manner, fact, circumstance, situation, transaction, or event which has been subject of any claim made prior to the effective date of this policy or of any notice given during any prior policy of which this policy is a successor; or
2. any Wrongful Act whenever occurring, which, together with a Wrongful Act which has been the subject of such claim or such notice, would constitute Interrelated Wrongful Acts."[64]

In *Tilley v. Dominion Insurance*[65] the court considered the proper construction of a policy wording excluding insurer's liability for any claim "resulting from any circumstances or occurrence which is known to the insured at the inception of this policy and likely to give rise to a claim".[66] In this case, a firm of surveyors claimed against its insurer who in turn successfully contested liability for claims arising out of undisclosed property valuations made by a partner, since the firm knew about such valuations and had failed to disclose them to the insurer. [67] In *RHI Holdings, Inc v. National Union Fire Ins. Co* [68] a D&O insurer denied liability upon the grounds of a prior acts exclusion. The policy expressly excluded coverage for any loss arising out of wrongful acts occurred before June 1st 1987. Since the intended class action had its foundations in acts alleged to be perpetrated before that date, the exclusion barred coverage and was therefore fully enforceable.
At this stage it is important to say that prior acts are not necessarily the subject matter of exclusions, in fact, it is usually the case that insurers agree to provide cover for

[64] CNA, G-20717-A (ED.2/94) in Herman & White, op cit at 35.
[65] [1987] 2 E.G.L.R 34
[66] Ibid.
[67] Supra Chapter II: The Procedural Trigger of Liability: When notice must be given. See also *Rothschild Assurance Plc v. Collyear [1999] Lloyd's Rep IR 6.*
[68] No. CIV.A. 93-4249,1994 WL 167946 (E.D. Pa May 4,1994) aff'd, 47F.3d 1161 (3d Cir.1995) in Bordon op cit at 140

prior acts in the form of 'prior acts coverage' and this –obviously- requires full disclosure on the part of the insured of circumstances likely to give rise to a claim.[69]

It is commonplace to find in the market D&O insurance offering retroactive cover which paradoxically work in the form of exclusions and inject them with features of loss occurring policies. If the retroactive date is the earliest date on which an event giving rise to a loss under the policy can have occurred,[70] any wrongful act committed before such date is excluded from cover. All of this leads to the conclusion that clauses of this type work in very much the same way as loss occurring policies which -by nature- do no provide coverage for prior acts, since the insurer, to meet the cost of indemnity, is the one at risk by the time the event happened.

Now, whether or not a director agrees to such a clause, thus leaving a gap without cover depends upon the negotiating process; in any case, directors may be persuaded to obtain separate prior events cover if they decide to switch insurers unless the previous policy is written on an occurrence basis –uncommon nowadays-where by definition such claims are covered.[71] This is known as 'Tail Cover' which could be obtained from the original insurer -subject to extra cost-, from the new insurer under prior events cover in the form set above or from a different insurer.[72]The last two scenarios impose, once more –upon directors- the duty of full disclosure.

4.4.2 Discovery Period

D&O insurers often agree to provide cover for a period of time following the expiry of the policy when either it is cancelled or not renewed. This type of cover is expensive and the full amount of the premium may be charged.[73] It is generally accepted that the extended reporting period applies to acts prior to the expiry of the policy which matured in the form of a claim during such extension. A good example is represented by following wording:

"....The extended reported period applies only to Wrongful Acts prior to the expiry of

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[69] Supra Chapter: D&O Trigger of Coverage.

[70] Gold, King & Latham, *Liability Coverage-Whiter Claims-Made?*, Institute of Actuaries of Australia, 2003 at 2

[71] Ibid.

[72] Ibid.

[73] *Touche Ross & Co v. Baker* [1991] 2 Lloyd's Rep 230.

the policy period. This extended reported period shall only be available (a) if written notice of such election, and payment of the additional premium due, are received by the Insurer within 30 days following the expiry of the policy period; and (b) if this policy is not replaced or succeeded by any other policy affording directors and officers liability cover. Any claim made during the extended reporting period shall be deemed to have been made during the policy period immediately preceding the extended reporting period".[74]

The issue here is to construe the phrase 'extended reported period' in order to ascertain whether it covers claims resulting from wrongful acts committed within the period of insurance or if it also covers wrongful acts perpetrated within the extended period albeit reported afterwards. Based upon the nature of claims made policies and what it has been said above,[75]one may conclude that insurers are compelled to provide cover only where the claim is made within the extended reported period since it is the claim itself which triggers a policy of these features. In *American Casualty Co v. Barker*[76] the court was of the opinion that coverage does not extend to a notice of occurrences which has not yet matured in the form of a claim.[77]

4.4.3 Pollution Hazards

Although pollution liability is negotiable, it does not usually form part of D&O cover; Youngman[78] has noted that insurers' reluctance to provide pollution cover has the following justifications:

- The concept of environmental liability is moving away from the concept of negligence towards strict liability.
- The offender usually faces fines – by their nature excluded from coverage
- The costs for cleaning up contamination could be so large that no company might either predict or even meet the indemnity.
- Environmental legislation is commonly retroactive so that an action which was legal in the past could be made illegal with hindsight if it is now seen to be the cause of pollution.

[74] Chubb, wwtcall99-2002
[75] Supra Chapter II: D&O Trigger of Coverage.
[76] (1994) 22 F. 3d 880.
[77] See Picker, *"Discovery Coverage" and Directors' and Officers' Liability Insurance in the United States*, [1994] ICCLR 318.
[78] Youngman, op cit at 88.

Pollution liability is of major concern for both the company and its directors, where the former fails to comply with the law. The issue here is whether or not a director could be liable- as much as the company- by not complying with environmental regulation and whether the insured director ought to be personally involved by authorising or approving the action – the release of pollutants- which causes the damage. In *High Voltage Eng'g Corp v. Federal Ins Co*[79] the court rejected the argument that the exclusion related only to acts or omissions in which the insured directors or officers directly participated, authorised or approved the discharge of toxic or contaminating waste. This leads to the conclusion that the exclusion is enforceable where there is a claim regarding pollution against either the company or its directors, since what apparently matters is the nature of the claim and the level of participation in such activity by the directors.

Excluding pollution does not necessarily represent an obstacle to offering cover for the costs incurred in the investigation of pollution incidents. Lloyd's form LSW 736 expressly excludes liability for any alleged or actual seepage, pollution or contamination of any kind, but it goes on to confer cover in respect of directors and officers, the costs and expenses[80] accruing from any investigation, examination inquiry, court order or other proceedings in regard to this matter.[81]

[79] 981 F.2d 596 (1st Cir.1992) in Bordon, op cit at 139.
[80] This issue is dealt with later on in Chapter VIII: D&O: Defence Costs Cover and Allocation.
[81] Lloyd's form LSW 736 4 Exclusions (iv).

PART TWO

CHAPTER V

THE SOURCE OF LIABILITY AND THE CONSEQUENTIAL LOSS: D&O COVERED RISK

5.1. Relationship Between the Company and Its Directors

From the outset two questions which provide essential background to the operation of D&O policies need to be clarified: what is the notion of 'legal personality' and, what is the relationship between a company and its directors.

Turning first to the concept of legal personality, the key point is that the shareholders do not face liability for the company's debts since the company is deemed as *persona ficta;*[1] acquiring thus same legal rights and duties. Consequently, the obligation of the shareholders to make payments to the company cannot go further than the unpaid amount of their share capital,[2] limiting their liability to the company.

As to the question of the relationship between the directors and the company, there is a scholarly debate between the Organic theory and the Agency theory, the former of which – if correct – may inhibit the practicality of D&O insurance.

Supporters of the Organic or Alter Ego approach affirm that any company acts through its organs, the most important of which is the board of directors. The decision in *Lennard's Carrying Co Ltd v. Asiatic Petroleum Co Ltd*[3] removes from directors their personal identity and transfers it to the corporate body by treating them as the directing mind and will of the corporation "the very ego and centre of the personality of the corporation".[4] This means that the acts that could be attributed to the company

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[1] *Salomon v. Salomon* [1897] A.C 22 HL.
[2] Payne, *"The Attribution of Tortious Liability Between Director and Company"* [1998] JBL 153-168.
[3] [1915] AC 705 HL.
[4] Ibid. at 713.

are those carried out by the persons in charge of companies' business[5] who act as the company and not for the company.[6] Under this perspective, directors and officers can only be liable, in civil matters, to the company itself where some duty owed to the company is broken, but responsibility cannot arise in relation to third parties because "no personal consequences can result from their actions as the organ of the company".[7] Supporting the alter ego theory has the effect of reducing the practicability of D&O insurance, as it can only possibly cover liability to the company for breach of duty: third parties, namely, shareholders, creditors, employees and customers (whose protection, albeit indirectly, is guaranteed by this insurance) are left only with remedies against the company itself.

However, it would seem that English law has opted for the Agency theory. In accordance with this principle directors and officers act for the company, thereby preserving their separate identity[8] and permitting the application of agency rules to this relationship. This is determined by the usual rules of express, implied and ostensible authority and vicarious liability. As a result, those representing the company could face personal liability not only to the corporate body but also to third parties due to a personal assumption of responsibility or by acting in excess of their authority.[9]

What is free from doubt is that directors undertake the task of representing the company with respect to its dealings with third parties and are obliged to try to achieve the overall purpose[10] for which it has been brought into existence. Such activity involves a complex relationship between the company and its directors, imposing on the latter high standard levels of diligence, accuracy, prudence, honesty and good faith to meet corporate expectations. The complexity of the relationship arises from the fact that it embraces three different *sui generis* legal connections the

[5] Farrar, *Farrar's Company Law*. Butterworths 1998 at 147. " An employee who acts for the company in the course of his/ her employment will usually bind the company and his or her knowledge will be attributed to the company because he or she is the company for the purpose of the transaction in question".
[6] Payne, op cit at 157.
[7] Ibid.
[8] Ibid, at 164.
[9] Infra Chapter VI: Directors' and Officers' Liability to Third Parties.
[10] This purpose is closely related to the objects clause contained in the memorandum of association, in accordance with section 2(1)(c) of Companies Act 1985.

combination of which gives rise to considerable doubts in practice.

The first of these *sui generis* relations is the consequence of the fact that directors are in charge of company's assets, they are deemed to be fiduciaries[11] and as such, obliged to act with absolute loyalty and good faith for the benefit of the company. Nevertheless, "the nature of the obligation determines the nature of the breach";[12] hence, the fact that directors are fiduciaries does not mean that they are trustees in the full sense of the term.[13]The general understanding is just the result of the judicial juxtaposition of the terms fiduciary and trustee when describing directors' legal status.[14]

Secondly, directors may subscribe to service contracts with the company and fix the remuneration to be paid, thereby giving rise to a relationship governed by labour law. In fact, executive directors in particular could for some purposes be regarded as employees[15] of the company and therefore compelled to honour employees' duties: in other words, directors could be civilly liable for breach of the contract of employment,[16] potentially affecting their personal assets.[17] Additionally, the existence of master-servant relationship gives rise to the doctrine of vicarious liability, whereby the tortious acts committed by the employee in the course of his/her employment are binding on the employer/company and may give rise to liabilities to third parties.

Thirdly, by acting on behalf of the company in the company's dealings with third parties, directors are regarded as agents of the company. Agency obligations are thus imposed upon those holding office, requiring from them an exercise of duties with the

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[11] Ferran, Company Law and Corporate Finance. Oxford, 1999 at 154. " A fiduciary is someone who undertakes to act for or on behalf of someone else in circumstances which give rise to a relationship of trust and confidence between the parties". See additionally *Bristol and West Building Society v. Mothew* [1998] 1 Ch 18.
[12] *Bristol and West Building Society v. Mothew* [1998] Ch 18. Millett LJ: "The various obligations of a fiduciary merely reflect different aspects of his cores duties of loyalty and fidelity. Breach of fiduciary obligation, therefore, connotes disloyalty or infidelity".
[13] See Sealy, *"The Director as Trustee"*. [1967] CLJ.83 for a comparison between trustees and directors.See also *Re Lands Allotment Co* [1894] 1 Ch 616 at 631.
[14] Lowry & Dignam: *Company Law*, Butterworths, 2nd ed, 2003, at 290.
[15] *Rayfield v. Hands* [1958] 2 W.L.R 851. "..in that an executive, paid director is in similar position as regards rights and duties, to that any other employee".
[16] Baxter, Demystifying D&O Insurance. [1995] OJLS 537-556.
[17] Although, conversely, directors may benefit from employment protection legislation targeted at employees, e.g., the right not to be unfairly dismissed.

level of skill and care[18] expected from a person with similar knowledge or experience.[19] Such duties of skill and care, which are founded in the common law, require directors to act diligently and accurately, albeit seemingly only within the context of a limited subjective test. It may be, as is discussed below, that modern conditions have demanded a more stringent and objectively-based duty of care and skill.

What appears to be accepted as a feature of this relationship is the fact that, although by appointing directors to the company the shareholders may anticipate that the value of their investment will be maximised by the directors' dealings, the directorship is not a contract from which that result is required to be achieved.[20]

The amalgamation of all of these sources and classes of duties and liabilities provides the background against which the significance of D&O insurance is to be assessed. All of that said, it is clear that D&O insurance is primarily designed to protect directors against the consequences of their negligence and in the following paragraphs the various duties owed by directors will be considered in order to determine which of them are potentially insurable under D&O policies.

5.2. Directors' and Officers' Liability to the Company

It is not the objective of this research to explore in detail the nature and scope of directors' duties: numerous documentation has been produced on this matter by others. The purpose of the following paragraphs is to describe and classify the duties, in order to determine the nature of the liability which may be faced by a director – whether contractual, tortious, criminal or equitable – and whether such liability is potentially insurable under a D&O policy.

[18] In this regard , the root authority is *Re Equitable Fire Insurance Co* [1925] Ch 407.
[19] Ibid. A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience
[20] Enright, *Professional Indemnity Insurance Law*. Sweet & Maxwell, 1996 at 34. See also Fernandez del Moral Dominguez, *El Seguro de Responsabilidad Civil de Administradores y Altos Directivos de la Sociedad Anonima (Poliza D&O)*. Comares, Granada, Spain, 1998 at 80 ss.

5.2.1. Director's Fiduciary Duties

It is generally accepted that a director, as a result of his appointment, is under the general obligations both to preserve the company's assets and to achieve company's goals in terms of profitability. By conducting the affairs of the company, directors have control of a fund in which others are beneficially interested.[21] A director is thus regarded as a fiduciary and as such is compelled to satisfy the general requirements imposed on fiduciaries. There are basically two main obligations deriving from fiduciary principles namely, the duty to act in good faith for the benefit of the beneficiary and the duty to act honestly avoiding any personal advantage which might arise from the very nature of the fiduciary relationship in relation with the represented fund.[22]

5.2.1.1. To whom is the Fiduciary Duty Owed?

By analysing the content of the decision in Re *Smith & Fawcett Ltd*,[23] it could be assumed that a director has a good amount of discretion carrying on company's affairs subject to the requirement that the director cannot carry out such activities in his own interest. This last qualification forces a discussion about whose interests are to be taken into account for those holding office.

The law operates from the assumption that the directors are company's representatives rather than those of the shareholders, and that the fiduciary duties are owed to the company alone. In other words it is up to the company to enforce director's duties. This was so held in *Percival v. Wright*,[24] where the court took the approach that there was not fiduciary relationship between the directors and the shareholders individually and that they were not trustees for the shareholders.[25]

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[21] Sealy, op cit at 86

[22] See the restatement of principle in *Sphere Drake Insurance Ltd v. Euro International Underwriting Ltd* [2003] Lloyd's Rep IR 353

[23] [1942] Ch 304

[24] [1902] 2 Ch 421... "the directors of the company are not trustees for individual shareholders, and may purchase their shares without disclosing pending negotiations for the sale of the company's undertaking".

[25] Recently ratified in *Peskin v. Anderson* [2001] 1 B.C.L.C 372.

Despite the principle that there is no obligation owed to shareholders directors could be compelled to protect them where they act as their agents.[26] However, it cannot be said that some exception to what has been the laid down in *Percival v Wright* will not arise. In fact, in the decision of Re *Chez Nico (Restaurants) Ltd*[27] the court was of the opinion that directors owed the duty of disclosure to shareholders when they purchased shares in the company from shareholders.

Such duties do not arise from the relationship between the company and its directors but due to the fact that directors approach shareholders and agree to carry out certain transactions - as agents - on their behalf such as: acquisition or disposal of shares, to make material representations to them, to disclose permissible material information in cases of a take–over etc. A failure to comply with these arrangements may lead to breaches of fiduciary duty and the consequent liability, resulting in losses to the shareholder distinct from that of diminution in the value of his shares. This leads to the conclusion that shareholders have no option but to bring direct actions against directors since they may not have any cause of action to proceed, on behalf of the company.

The relevance of the previous argument to D&O insurance lies in the fact that the extra-corporate arrangement made by directors and some or all of the shareholders may lead to a common law relationship – agency – which does not relate to directors as such but as agents of shareholders outside their relationship with the company. Acting not *qua director* may preclude the D&O policy from attaching since the insured may have incurred liability other than in his insured capacity. Even if liability arises from failing to disclose to shareholders information which could only have been obtained by a director acting as such, the point remains that even in these circumstances director's liability arises *qua agent* and not *qua director* whereas D&O policies cover liability arising out of activities of directors acting as such.

In conclusion, it is generally accepted that fiduciary duties are owed by the directors to the company and for this purpose the company cannot be treated as an independent

[26] *Allen v. Hyatt* (1914) 30 TLR 444. The New Zealand Court of Appeal went further in *Coleman v. Myers* [1977] 2 NZLR 225 where it was held that because of the family character of the company, directors had a high degree of knowledge about company's internal affairs and the way in which they conducted the take-over thus, their duty was to disclose material fact concerning it.

[27] [1992] B.C.L.C 192.

or isolated entity existing apart from the interests of those in direct contact, dependency or business with it. The significance of these principles for D&O insurance is that the directors' legal responsibilities are owed to the company and not to the shareholders. Therefore, where insurers agree to provide an indemnity resulting for a breach of a fiduciary obligation, the cover is based on the assumption that the proper claimant is the company rather than the shareholders.[28]

5.3. Fiduciary Duties in Detail: Good Faith-Nature of Breach-Remedy-D&O Insurability

The duty of good faith imposed upon directors has been subject to a vast number of cases and opinions. The most important formulation of the duty is in *Re Smith and Fawcett Ltd*,[29] in which Lord Greene stated that directors "must exercise their discretion bona fide in what they consider – not in what a court may consider – to be in the interest of the company and not for any collateral purpose". This dictum as presented is ambiguous as to whether directors owe one or two different duties to the corporate entity, depending upon whether the word "and" is intended to be conjunctive or disjunctive. One view is that there is a single duty, which is mainly subjective, and which requires the directors to act honestly and to avoid any misuse of power.[30] A subjective test[31] is appropriate because of the fact that good faith is closely connected with personal appreciation[32] and with a 'minimum threshold of genuineness'.[33] However, the view which has come to be accepted is that there are two separate matters here: a subjective obligation to act honestly, and an objective obligation to exercise discretions and powers for the purpose of which they were granted.[34]

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[28] See supra Chapter III: Corporate Cover: Is The Company a Party or a third Party to D&O insurance?". Also Chapter IV: The Insured v. Insured Claims.
[29] [1942] Ch 304.
[30] Pennington, *Pennington's Company Law*, 8th Ed, Butterworths,2001 at pp 712-725
[31] *Regentcrest Plc v. Cohen* [2001] 2 B.C.L.C 80..."No doubt, where it clear that the act or omission under challenge resulted in substantial detriment to the company, the director will have a harder task in persuading the court that he honestly believed it to be in the company's interest; but that *does not detract from the subjective nature of the test*" (emphasis added).
[32] *Brady v. Brady*. [1989] AC 755, HL.
[33] Ferran, op cit at 158.
[34] Mayson. Op cit at 518 ss.

As to the former, it is generally accepted that directors have a 'free area of movement' referred to as the business judgement rule in other jurisdictions.[35] Nevertheless, directors cannot move to the prohibited zone in which, the interests of a company as a whole are disregarded.[36] Consequently, there is bad faith when directors proceed to act or perform an activity which they believe is not in the best interests of the company or simply for the benefit of third parties or themselves.[37] The fact that a company has suffered harm as a result of director's activities does not necessarily lead to a breach of good faith since the latter might have performed certain activity loyally yet the outcome might have resulted in substantial harm to the company.

The issue though is to ascertain whether the breach of the subjective duty of good faith depends upon a state of mind that might affect the availability of insurance cover. *Mala fide* as a concept or legal principle is imputable to a person who proceeds with the awareness of doing something wrong.[38] Involuntary or innocent *mala fide* is not a recognised concept. It follows, therefore, that if the director's degree of knowledge is such that his conduct can be regarded as *mala fide*, there will be no possibility of recovering under a D&O policy in respect of liability incurred as a result, since no one is entitled to recover under his own fraud or criminal conduct under the principle *ex turpi causa non oritur actio.*

5.3.1 Directors Must Not Fetter Their Discretion

A clear illustration of breach of the duty of good faith arises when directors bind themselves to exercise their powers in favour of a third party rather than in favour of the company.[39] In other words, directors must not enter into an agreement with a third

[35] This is the term used in United States as a result of developments under the legislation of the state of Delaware.
[36] Irrespective the director is acting for the benefit of a subsidiary company of the group *Extrasure Travel Insurances Ltd v. Scattergood* [2002] All ER 307. Contrast with the decisions in *Charterbridge Corpn Ltd v. Lloyds Bank Ltd* [1970] Ch 62 and *Facia Footwear Ltd v. Hinchcliffe* [1998] 1 B.C.L.C 218.
[37] Law Commission Consultation Paper 153, Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties.1998. See also *Neptune (Vehicle Washing Equipment) Ltd v. Fitzgerald (No 2)* [1995] B.C.C 1000.
[38] Burton, *Judging in Good Faith*. Cambridge Press. 1994. "Bad faith occurs ....when person uses discretion dishonestly or maliciously".
[39] See *Ringuet v. Bergeron* (1960) DLR 449. (Supreme Court of Canada). "The discretion of the directors to act in the administration of the affairs of the company cannot be fettered by agreement and

party as to how they will exercise their discretion.[40] This does not mean, on the other hand, that directors may not enter into an agreement as to the way they should make future decisions or vote in a certain manner[41] if such conduct is designed to benefit the company's affairs.[42] The duty not to fetter discretion is primarily related to nominee directors, who are in a dual position which may force them at times to choose between the interests of the person who has appointed them to the board and the interests of the company itself. The principle here is that a nominee director, once appointed, owes his duties primarily to the company.[43]

A deliberate fettering of discretion is clearly wilful misconduct and constitutes a clear breach of fiduciary duty. Insofar as such breach can give rise to an action for damages, there will be no prospect of recovery under a D&O policy, in accordance with the usual rules on public policy.

5.3.2 Proper Purpose: The Objective Test of Good Faith.

A series of authorities has established the existence of a "proper purposes" doctrine which does not depend upon proof that the directors were motivated by conscious dishonesty.[44] Instead, the absence of bona fide relates to the improper construction of the company's memorandum or articles of association by the directors rather than any intention to harm the company. The proper purposes doctrine states that directors must exercise their powers for the purpose for which they were granted[45] or broadly speaking, the kind of activities and the purpose for which the company has been established.[46] Consequently, whether directors use their powers to achieve a different

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accordingly the agreement in question is invalid and the penalty provisions thereof unenforceable".

[40] Law Commission Consultation Paper 153 p 239.

[41] Palmer, *Palmer's Company Law* ,Vol 1, Twenty Fourth Edition, p 954.

[42] *Thorbey v. Goldberg* (1964) 112 CLR 597; *Fulham Football Club Ltd v. Cabra Estates Plc* [1994] BCLC 363.

[43] *Kuwait Asia Bank Ec v. National Mutual Life Nominee Ltd* [1991] 1 AC 187.

[44] Davies: *Gower and Davies'. Principles of Modern Company Law*, 7th ed , Sweet and Maxwell, 2003 at 388.

[45] Ferran, op cit at 162.

[46] Campbell and Campbell, *International Liability of Company Directors*. LLP . 1993, p 217: "However, it is often necessary to look beyond the memorandum and articles of association to decide the rationale behind the granting of a power. In such circumstances the court has to decide from the information available the intention behind the grant. It is the dominant purpose that is significant".

goal,[47] the court may intervene[48] to restrain the directors from so acting.[49]

5.3.2.1. Nature of the Breach

It remains to consider the implications of the duty to act in the interests of the company for D&O insurance. As noted earlier, liability insurance policies do not cover deliberate misconduct on the part of the insured, as insurance is designed to protect against the consequences of unforeseen contingencies. The difficulty with the duty to act in the interests of the company and not for any improper purpose is that, to the extent that it is objective, it can be broken by fraudulent conduct, and also by innocent or negligent conduct. If D&O insurance is to provide coverage, therefore, the director must not have been acting in a fraudulent or reckless manner, although the burden of showing fraudulent misconduct is upon the insurer who – as discussed below - [50] is entitled to look behind in order to ascertain the exact nature of the breach and any relevant exclusion.

It follows that some, but not all, breaches of the duty are insurable as far as company law is concerned; breaking the proper purpose duty is not as such dependent upon intentional misconduct on the part of the directors. For example in the cases *Piercy v. S Mills & Co Ltd,*[51] *Bamford v Bamford*[52] and *Hogg v Cramphorn*[53] there was no suggestion of bad faith- in strict sense-involved and it was not asserted that the directors had acted with conscious dishonesty.[54] Nevertheless, in each case the opinion of the court was that the directors had broken their duty to the company, because of the application of a standard objective test. In both *Bamford* and *Hogg* directors had exercised their share-issuing powers to ensure, that the company did not fall into other hands or to control the company. It was not doubted that their intention had been to act in the best interests of the company, but in so doing they had used

[47] The leading case is *Howard Smith v. Ampol Petroleum Ltd* [1974] AC 821.
[48]This is why an injunction is the most plausible remedy where directors act or purport to act for improper purposes.
[49] Dine, *Company Law,* 4th Edition. Palgrave. 2001at 224.
[50] Infra: Classifying the Action.
[51] [1920] 1Ch 77
[52] [1970] Ch 212.
[53] [1967] Ch 524.
[54] Davies: *Gower and Davies',* op cit. p 388

their share-issuing powers not to raise capital – the purpose for which the court regarded the powers as having been granted – but to fight off a takeover bid and keep control. Accordingly, their breach of duty was not based upon fraudulent but nevertheless erroneous interpretation of the constitution of the company. As was noted in *Extrasure Travel Insurance and other v. Alan H Scattergood*[55] the proper purposes doctrine does not require the court to ascertain the motivation behind the improper purpose which the directors intended to achieve, and that it is enough that the purpose is improper even though ultimately beneficial to the company.

The memorandum and articles of association of a company are usually drafted in very wide terms making it more difficult to restrain directors' powers.[56] In many cases directors who purport to exercise the powers granted to them may be unaware of the fiduciary obligation embodied in the proper purposes doctrine and act in what they believe to be the interests of the company. For this reason, the concept of an innocent breach of fiduciary duty is perfectly plausible and in such a situation D&O cover should be applicable if the company has suffered loss. By contrast, if the directors appreciate that they are abusing their powers, there is no possibility of insurance cover.

The position is less clear when directors have acted for mixed purposes. Company directors may well have more than one purpose in mind by the time they exercise or purport to exercise their powers. Following Ferran's approach in this respect, the situation might be difficult where the directors have acted for both permissible and impermissible purposes.[57] As far as company law is concerned, the relevant test is that of the substantial purpose motivating the director[58] in order to determine whether the director's conduct is binding on the company. Let us suppose for instance that the mixed purposes feature, on the one hand, a perfectly valid objective hand and on the other a deliberate or intentional breach: the validity of the conduct is to be determined by asking the question whether the valid objective was the dominant objective or a mere ancillary consequence of an intentional breach of duty.

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[55] [2003] 1 B.C.L.C 598.

[56] Hannigan, *Company Law*, Butterworths, 2003 at 234.

[57] Ferran, op cit at 166.

[58] *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] AC 821

In *Howard Smith Ltd v. Ampol Petroleum Ltd*[59] it was alleged that the intention behind a new allotment of shares was not only to raise capital for the company but also to configure a real possibility for the directors to retain office and to continue exercising corporate powers. Effectively it was decided that the substantial purpose for issuing the shares was to dilute the voting power; the fact that company directors did not have self-interest in the new allotment was irrelevant.[60] The substantial purpose issue was recently reconsidered in *Extrasure Travel Insurance and other v. Alan H Scattergood*,[61] where the court was of the opinion that a four step test has to be applied to determine whether the duty has been broken:

(a) Identify the power whose exercise is dealt with;

(b) Ascertain the purpose for which that power has been entrusted to the directors;

(c) Discover the substantial purpose for which the power was exercised; and

(d) Decide if that purpose was or was not properly used.[62]

5.3.2.2 Remedy: Is There Any Damage?

Given, therefore, that there may be a breach of duty which is not deliberate and which may thus be covered by D&O insurance, a further consideration is whether a D&O policy could ever be called upon to respond to an action based on a failure by the directors to act for the correct purposes. It would appear that this form of breach is not one which – commonly- gives rise to a liability in damages; hence the remedies usually sought are the account of profits and injunctive or declaratory relief.

In regard to the latter, a declaration or an injunction is the most likely remedy to overcome any problem raised by an anticipated exercise of powers for improper purposes.[63] An injunction may also be appropriate where the breach has already taken

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[59] [1974] AC 821

[60] Ibid.

[61] [2003] 1 B.C.L.C 598.

[62] Following the dicta in *Howard Smith v. Ampol Petroleum Ltd* [1974] All ER 1126.

[63]. See generally: *Measures Brothers Ltd v. Measurers* [1910] 2 Ch 248; *Cranleigh Precision Engineering Ltd v. Bryan and Another* [1965] 1 W.L.R 1293.

place but is likely to persist.[64] Where an injunction has been granted, the company will be able to prevent any loss being incurred by it, so that any D&O cover held by the director will be of little relevance.

The cases on proper purposes indicate that the appropriate remedy will rarely be damages. In *Hogg v. Cramphorn*,[65] for example, the aim of the action was to set aside what appeared to be an improper exercise of the voting rights attached to shares. While it was the case that the claimant pursued an action to restrain the directors from acting beyond their powers, it was not contended that the company itself could have faced losses under those circumstances. In practice, the proper purposes doctrine has been used in cases connected with the allotment of shares[66] (which is independently governed by statute[67]), the refusal to register a transfer of shares,[68] the power to forfeit shares,[69] the power to make calls on shares[70] or the power to tie up the board by way of a management agreement.[71] This does not mean, however, that a D&O policy is irrelevant, for if the directors are the defendants in the proceedings the insurers may be called upon to indemnify them against defence costs. Whether such a claim against the insurers can be valid relies upon the correct construction of the separate obligation of the insurers to pay defence costs and in particular whether that obligation can attach where the claim against the directors cannot result in a call for indemnification for "liability at law".

5.3.2.2.1 The Possibility of Damages

The possibility of incurring damages does exist in this context and that is when directors, by improperly exercising their powers, wrongly transfer company assets. The issue was dealt with in *Bishopsgate Investment Management Ltd v. Maxwell (No*

[64] Davies: *Gower and Davies'* op cit *at* 425.
[65] [1967] Ch 254.
[66] See *Punt v. Symons & Co Ltd* [1903] 2 Ch 506; *Hogg v. Cramphorn Ltd* [1967] 3 All ER 420; *Howard Smith Ltd v. Ampol Petroleum Ltd* [1974] AC 821; *Bamford v. Bamford* [1970] Ch 212; *Piercy v. S, Mills & Co Ltd* [1920] 1 Ch. 77.
[67] Companies Act 1985. S 80 . See also Company Directors Disqualification Act 1986, s 8.
[68] *Re Smith & Fawcett Ltd* [1942] Ch 304; *Re Bede Steam Shipping Co Ltd* [1917] 1 Ch 123.
[69] *Spackman v. Evans* (1868) LR 3 HL 171; *Agriculturist Cattle Insurance* (1866) 1 Ch App 161.
[70] *Alexandere v. Automatic Telephone Co* [1890] 2 Ch 233; *Galloway v. Halle Concerts Society* [1915] 2 Ch 233.
[71] *Lee Panavision Ltd v. Lee Lighting Ltd* [1991] BCC 620. AC

2)[72] where the wrongdoer director was ordered to indemnify the company for transferring its assets, for no consideration, to a family company. Another decision involving damages is found in *Neptune (Vehicle Washing Equipment) Ltd Fitzgerald (No2)*[73] where a director was compelled to repay to the company a sum awarded to himself on termination of his employment with the company. A third example is represented by the situation in which a director personally acquires company's property by exceeding his powers. In this scenario the director is deemed to be a constructive trustee and the company has the *locus standi* to claim that property back.[74] As explained before this is a sort of liability excluded by nature of a third party liability insurance cover.[75]

Whether or not D&O insurance might provide benefits depends very much in the director's state of mind. There is no prospect that a director could claim in a situation like *Neptune* since it would be impossible to prove him innocent, even if not necessarily fraudulent, in awarding himself the money. However, if the director has innocently paid the sums to a third party, then in principle his liability could be covered by D&O insurance. A discrepancy might arise if the company opts to ratify the wrong. The possibility of ratification was established in *Bamford v Bamford*,[76] where it was held that even though the allotment of shares was for an improper purpose and therefore voidable, the conduct of the shareholders in general meeting in ratifying the allotment transformed it into a valid transaction.[77] Ratification does not, however, mean that the director is automatically exonerated from liability, for the company may choose on commercial grounds to ratify an act even though loss is incurred as a result. Accordingly, ratification may potentially expose the director to an action for breach of duty in respect of any loss suffered by the company.

5.3.2.2.2 Another Scenario for Misappropriation: Improper Distribution of Dividends.

Directors' liability for improper distribution of dividends is, somewhat surprisingly,

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[72] [1993] B.C.L.C 1282
[73] [1995] B.C.C 1000
[74] Hannigan, op cit at 242 . See *FF Harrison (Properties) Ltd v. Harrison* [2000] 1 B.C.L.C 162 CA.
[75] Supra Chapter IV : D&O Exclusions.
[76] [1970] Ch 212.
[77] See also *Winthrop Investment Ltd v. Winns Ltd* [1975] NSWLR 666. *Hogg v. Cramphorn Ltd* [1967] Ch 254.

not governed by the Companies Act 1985: only the liability of shareholders who receive improper distributions is the subject of statutory provision.[78] The common law has thus been forced to come to the rescue and this provides the appropriate remedies. It is necessary to emphasise from the outset that the rules governing this matter involve certain principles of public policy based on the fact that by restricting the unlawful distribution of dividends and forcing the recipient to repay their value, the company's capital is protected for the benefit of both creditors and shareholders.
The decision in *Re Exchange Banking Co,*[79] generally known as *Flitcroft's Case*, made it clear that directors who pay dividends out of the capital of the company are liable to repay such dividends if they been aware of the fact the funds of the company are being misappropriated. At first sight it could be suggested that the feature of dishonesty is present as requisite of the duty to repay.
This approach has gradually evolved to incorporate new important developments. Thus the fact that dividends could have been paid out of company's capital but the company has failed to do what is demanded by the Companies Act 1985[80] is enough to demonstrate the unlawfulness of the dividend as was held in *Precision Dippings Ltd v Precision Dipping Marketing Ltd.*[81]
Another important aspect is represented by the decision in *Allied Carpet Group Plc v Nethercott*[82]where it was held that the director of the company was liable as constructive trustee of the dividends paid to him, since he received those with the knowledge that they were unlawful.[83] The matter of ratification under section 727 of the Companies Act 1985 was inapplicable since the distribution was *ultra vires*.[84] However, no other decision has recently contributed to this field except that contained in *Bairstow v. Queens Moat Houses Plc*[85] from which the three following points stem:

1. The fact that the company is still solvent should not be a defence to a claim against the directors to make good the unlawful dividends.[86] Thus the repayment is likely to arise in cases of both solvency and insolvency because-

[78] Companies Act 1985 s 277.
[79] (1882) 21 Ch D 519
[80] Companies Act 1985 s 263-281.
[81] [1986] Ch 447, CA.
[82] [2001] B.C.C 81
[83] Also applied in *Re Cleveland Trust plc* [1991] BCLC 424
[84] Ferran, op cit p 424: "In this context this phrase means more than simply beyond the limits of the company's memorandum; it means beyond what, under the general law, companies are permitted to do".
[85] [2001] All ER (D) 211, CA: affg [2000] 1 BCLC 549.
[86] The statement follows the principle in *Flitcroft's Case.*

as noted earlier- not only the interest of creditors is protected but also that of shareholders.

2. Directors are in breach of fiduciary duty if they have allowed any unlawful dividend irrespective of the fact that no actionable loss has been suffered by the company. The fact that the dividends could have been declared and paid in a lawful manner is irrelevant.[87] Consequently, a director's liability arises not because the company has suffered a loss, but because he has breached a fiduciary duty by paying unlawful dividends.
3. The decision lays down the circumstances in which a director could be held liable to repay the dividends, as the following:

- If he knows that the dividends were unlawful, whether or not that actual knowledge amounts to fraud, or
- If he knows the facts that established the impropriety of the payments, even though he was unaware that such impropriety rendered the payment unlawful.
- If he is knowledgeable of the circumstances and the facts which render the payment unlawful.
- If he ought to have known, as a reasonably competent and diligent director, that the payments were unlawful.

The repercussion of this sort of liability is of a considerable significance for the purpose of D&O insurance since the nature of the breach, the subsequent cause of action and the effects of section 727 of the Companies Act 1985 have a role to play in its plausibility. Some conclusions are readily apparent:

1. The nature of directors' liability could be fraudulent, innocent or negligent,[88] giving rise - in respect of the last two possibilities - to insurability. The first situation arises when the director knows there are no profits and he/she also knows of the impropriety of the payment but nevertheless carries out the distribution. But the situation could be radically different consisting for example in an innocent failure to observe the statute which would render, in any case, the dividend unlawful (*Precision Dipping*) and therefore repayable; or it could

[87] Hannigan, op cit 535
[88] In any case the burden of proof if a dividend is correctly paid lies on the director. *Rance's Case* (1870) 6 Ch App 104 at 123.

simply be negligent under the modern objective test[89] if the director fails for example to investigate the accounts of the company or what has been done by the auditors. These last two scenarios give rise to the possibility of insurability.

2. There is no doubt that by ordering a director to repay unlawful dividends by way of compensation to the company a director may bear insurable losses since he may experience the risk of financially affecting his own assets. However, this picture must be clarified because a director could be compelled to repay in some capacity other than his insured capacity. In fact the director may influence the board to allow an unlawful distribution in a company in which he is a shareholder; in this situation the application of section 727 of the Companies Act 1985 provides the remedy against company's members (rather than directors) rendering them liable to repay the dividends. In this situation a D&O policy does not attach, not only due to the fact that the assured is not liable in his insured capacity but because the reimbursement to the company of what has been unlawfully received as dividends is merely a *restitutio in integrum* of company's property which does not cause any loss to the defendants. Thus the director, in order to be covered, must not have received dividends himself and yet must be liable to compensate the company.[90]
3. The relief to which section 727 of the Companies Act 1985 gives rise is of relevance. A court is entitled to grant relief in certain cases when it is satisfied that the director or officer has acted honestly and reasonably. Conversely, such relief may usually be unavailable when there has been inobservance of the statutory provisions which lead to the unlawful distribution.[91] Obviously such redemption makes useless a D&O policy in regard to the insured's liability; however, the costs of such proceedings at first sight might be cover under the separate defence costs undertaking. Additionally, new section 337(a) of the Companies Act 1985, allows the company to fund its directors in

[89] Infra: Common Law Duties of Skill and Care.
[90] Davies: *Gower and Davies'* op cit. p 287.
[91] *Precision Dippings Ltd v. Precision Dipping Marketing Ltd* [1986] Ch 447, CA.

successfully contesting liability under section 727 proceedings. This last possibility is of very much relevance from a twofold perspective: firstly, it reaffirms the importance of Side B or Company Reimbursement cover since this is a legal scenario in which the company is legally entitled to indemnify its directors. Secondly, it leads to complex issues of law as to whether or not the consent of insurers is required for the company to advance costs to its directors.[92]

5.4. Conflict of Interest and Non-Profit Rule

It is generally accepted that no person acting as trustee or otherwise holding a fiduciary capacity may place himself in a position conflicting with the interests of the *cestui que trust.*[93] Directors are thus precluded from taking part in contracts present or future which in one way or another are related to the type of affairs and businesses they are charged with administering[94] without disclosing to the company their contractual interest. This is why the conflict of interest and non-profit rule are deemed as disabilities[95] rather than duties since directors could discharge the statutory duty imposed by section 317 of the Companies Act 1985 firstly, by disclosing to the company their personal contractual interests, at a meeting of the directors of the company; secondly by means of exclusion clauses in the articles of association[96] or thirdly by a resolution of the company in general meeting.[97]

In general, the duty is represented by two different classes of prohibition. Firstly, directors may not enter into contracts with the company in the absence of full disclosure to the company –albeit they could be discharged from this duty-of their interest in the contract. Secondly, directors must not benefit from their position or take advantage of internal information for their own purposes.[98] These two scenarios in conjunction with the nature of the breach are the subject matter of following

[92] Infra Chapter VIII: 8.3 Insurer's Consent to the Incurrence of Defence Costs.
[93] *Aberdeen Rly Co v. Blaikie* (1854) 1 Macq 461
[94] *Fullwood v. Hurley* [1928] 1 K.B. 498 at 502
[95] *Movitex Ltd v. Bulfield* [1988] B.C.L.C 104
[96] Such as the one contained in Table A article 85 of the Companies (Tables A to F) Regulations 1985.
[97] Law Commission Consultation Paper 152 op cit p 240
[98] See *Regal (Hasting) Ltd v. Gulliver* [1942] 1 All ER 378. A good example of misuse of information can be found in *Industrial Development Consultants v. Cooley* [1972] 1 W.L.R 443.

paragraphs.

5.4.1 The First Limb: Conflict of Interest- Contracts with the Company: Rescission

The rules of equity preclude the director from making a contract with the company unless his interest in such an agreement is fully disclosed from the outset. It is readily appreciated that any director might otherwise consider first his personal interests rather than those of the represented company. This is the approach taken in *Aberdeen Railway Co v Blaikie.*[99] The fairness or otherwise of the contract is immaterial: the purpose of the rule is to remove all possibility of temptation from the director without full disclosure to the company.

If there is no disclosure, the company is entitled to rescind the contract. The contract itself remains enforceable unless and until the company decides otherwise. In *Hely-Hutchinson v Brayhead Ltd*[100] Lord Denning MR emphasised that non-disclosure does not render the contract void but voidable at the instance of the company. In other words where the company decides not to rescind, because of an express declaration or because of the limitation period expired, the contract is perfectly valid and enforceable. In some circumstances rescission is unavailable, most importantly where it is no longer possible to restore the parties to their pre-contractual position. This might be the case where, for example, property obtained by the directors from the company under contract has been sold to a bona fide purchaser for value without notice of the breach of duty:[101] in such a case the director is under the ordinary equitable obligation to account for any profits made by him. The principle of *restitutio in integrum* means that the parties must, on rescission, be restored precisely to their pre-contractual position. However, the courts have asserted wide powers to order financial adjustments on rescission where it is shown that the defendant has made profits from his dealings with the claimant.[102] The leading authorities on this point are

[99] (1854) 1 Macq 461. See also *Movitex Ltd v. Bulfield* [1988] BCLC 104 and *Boardman v. Phipps* [1966] 3 All ER 721. Additionally a good example of conflict of interests could be found in those subsidiary and parent companies where directors are placed in both boards of directors. Consequently, to comply with their duties to one of them might lead to a breach of duty to the other as it was held in *Scottish Co-operative v. Meyer* [1959] AC 324.

[100] [1968] 1 QB 549, CA. At 585

[101] Cf Sale of Goods Act 1979, s 23 (sale by seller under voidable title). See also *Transvaal Lands Co v. New Belgium (Transvaal) Land & Development Co* [1914] 2 Ch 488.CA

[102] Davies: *Gower and David's* op cit pp 426-427.

O'Sullivan v. Management Agency and Music Ltd,[103] *Spence v. Crawford* [104] and *Armstrong v. Jackson.*[105]

There would seem to be little scope for the application of D&O policies in this context for the same reasons which govern the position relating to secret profits.[106] A director is not entitled as a matter of equity to make any profits from his dealings with the company and allowing him to recover from D&O insurers sums payable to the company as a consequence of rescission would be to overturn the very principle that a director may not profit from his position.

5.4.1.1 Conflict of Interest and Statutory Provisions

It is clearly the case that any important transaction which may potentially impose liability upon a company must be approved by the company itself by means of a general meeting. Such a general meeting is able to either authorise the transaction or reject it, taking into account its own interest. Directors are therefore, subject to the will of the company who is entitled to concede exceptional powers to make the restrictions be respected.

One of the major exceptions concerns to those transactions between the company and its directors, when a reciprocal transfer of assets is agreed, situation which demands the calling for a general meeting. In fact this is the greatest possibility of abuse[107] on the part of directors who might be deterred by the wording of section 320 of Companies Act 1985.

The insurability of any potential liability of directors relies upon two grounds. First, the breach must lead to losses sustained by the company. Secondly, the breach itself must not be deliberate, wilful or fraudulent.

The first requirement is met by the wording of section 322(3) (a) (b) of Companies Act 1985 which provides as follows:

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[103] [1985] QB 428.CA.
[104] [1939] All ER 271.
[105] [1917] 2 KB 822. See also *Erlanger v. New Sombrero* (1873) 3 App Cas 1218
[106] Infra: Second Limb: Secret Profits-Nature of Liability-and its Equitable Remedy.
[107] Farrar, op cit at 409.

(3) "If an arrangement is entered into with a company by a director of the company or its holding company or a person connected with him in contravention of section 320, that director and the person so connected, and any other director of the company who authorised the arrangement or any transaction entered into in pursuance of such an arrangement, is liable-
(a) to account to the company for any gain which he has made directly or indirectly by the arrangement or transaction, and
(b) (jointly and severally with any other person liable under this subsection) to indemnify the company for any loss or damage resulting from the arrangement or transaction".[108]

It is necessary to emphasise that this section does not preclude any liability in accordance with common law[109] and it is possible to vary its context by way of the articles of association since it is basically a disability which entitles the company even to ratify and validate the transaction. The expression contained in the statute[110] 'voidable as the instance of the company' supports this argument. Based upon this, it has to be concluded that a director may face the liability only where *restitutio in integrum* is no longer possible, where the interests of a bona fide third party may be affected or where the arrangements entered into by the director are affirmed by the company in general meeting. Furthermore and in accordance with the decision in *Re Duckwari plc (No 2) and (No 3),*[111] the ground upon which the losses are recoverable, is equitable: in other words it refers to strict statutory liability and not liability for damages at common law.[112]

The second prohibition and perhaps the most important of the statutory provisions relates to the improper use of loans[113] and quasi loans on the part of directors. In accordance with sections 330 to 347 of the Companies Act 1985 the company is prohibited from making loans and quasi loans to, and entering into credit transactions with, directors. It could be argued that these statutory duties are imposed on the company rather than on directors, although the reality is that the directors may by virtue of their position be able to influence the company to enter into a prohibited

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[108] Companies Act 1985.S 322 (3)(a)(b).
[109] Ibid (4).
[110] Companies Act 1985 s 222.(2).
[111] [1998] 2 BCLC 315 and *Re Duckwari (No 3)* [1999] 1 BCLC 168
[112] Hannigan, op cit p 596-597
[113] Law Commission Consultation Paper on Company Directors, No 153, p 169: "The word "loan" only covers a situation where the company advances money on terms that it is to be paid in money or money's worth". See additionally Champagne *Perrier-Jouet SA v. Finch* [1982] 1 WLR 1359, at p 1363.

transaction. The prohibition embodies shadow directors[114] and directors of holding companies.[115] There are exceptions to the general rule where specified conditions are met: loans of small amount to a director or to a holding company are permissible, provided the loan does not exceed £5000;[116] a loan is permissible where there is a probability of entering into a business transaction and the sum involved does not exceed £10000;[117] section 336 enables the company to carry out transactions in favour of the holding company; the company is permitted to fund directors' expenditure incurred in the course of their duties;[118] and companies whose business object is to lend money may arrange loans with their directors provided they are made in the ordinary course of their affairs, in accordance with section 338.
Civil remedies available in accordance with section 341 are basically the same to those of section 322 with the only difference being that this sort of liability could result in criminal penalties under section 342.

Based upon the previous analysis[119] there is a strong argument against the possibility of D&O insurance offering coverage in the case where an account of profits is ordered. The basis of this exclusion is once again, that insurance cannot contradict the equitable rule that a fiduciary is precluding from profiting from his position and retaining any gain made therefrom. Consequently the state of mind of directors is irrelevant since the duty is objective, but it remains the case that the risk of such liability is not insurable.

However, subsection (3)(b) must be assessed under a different perspective since the available remedy for breaching the statutory provision, an award of damages,[120] is potentially insurable under a D&O policy. In the first place the director's state of mind must be evaluated, and it is generally accepted that a director could face liability for innocent or non-deliberate breach of statutory duties. In this situation there is no

[114] Companies Act 1985, s 330(5): "For purposes of sections 330 to 346, a shadow director is treated as a director".
[115] Ibid. s 330(2) "A company shall not (a) make a loan to a director of the company or of its holding company; b) enter into any guarantee or provide any security in connection with a loan made by any person to such a director".
[116] Ibid. s 334
[117] Ibid. s 335.
[118] Ibid. s 337.
[119] Supra : Conflict of Interest and Non-Profit Rule.
[120] The whole issue and liability under S 322 of the Companies act 1985 was addressed in *Duckwari v. Offerventure Ltd* (No 3) [1999] 1 BCLC 168.

objection to recovery under a D&O policy. Once more, the only limitation on this respect would be fraud, wilful or deliberate breach of duty.

One example of an insurable situation would be, when the director proceeds to carry out a transaction in the belief that he has been duly authorised to do so by the general meeting and it transpires that such authorisation had been wrongfully interpreted or passed. Certainly, it could be alleged that a director has broken a statutory duty and is liable thereupon, but his liability, not being the result of an intentional or fraudulent behaviour, might be legally covered.

In conclusion, it is clear from the wording of sections 322 and 341 of the Companies Act 1985[121] that the company is entitled to recover losses suffered as a result of breach of statutory duty.[122] Indemnity insurance may be suitable to cover innocent or non-deliberate breach of statutory duties, which may result in damages to the company; the key point is once again lack of intention. Whether contravention gives rise to damages is a matter of statutory construction and whether the damages are recoverable under a D&O policy may well – absent any express words in the policy – rest once again upon the director's state of mind.

5.4.2. Second Limb: Secret Profits-Nature of Liability- and its Equitable Remedy

The *cestui que trust* is entitled to require the trustee to account for any money or property obtained by the trustee without the full and informed consent of the *cestui que trust*. Directors therefore, cannot retain profits obtained by taking advantage of their position or of information or opportunities which belong to the company.[123] If that is the situation, the directors must account to the company for any profit made by them.[124] Once again it is irrelevant whether or not the directors have acted maliciously, since the test is objective and the breach of duty operates independently of a state of mind and does not require proof that the trustee intended to enrich himself at the expense of the *cestui que trust*: it is enough that a secret profit has been made or an opportunity which belonged to the *cestui que trust* has been appropriated

[121] Companies Act 1985, s (341) and (342).
[122] *Duckwari Plc* (No 2), *Duckwari Plc v. Offerventure Ltd* (No3). [1997] 2 BCLC 729.
[123] Law Commission Consultation Paper No 153.Company Directors: Regulating Conflicts of interest and Formulating a Statement of Duties, p 240.
[124] *Regal (Hastings) Ltd v. Gulliver* [1942] 1 All ER 378.

by the trustee.

It has been generally accepted that both opportunities and information are assets of the company for the purpose of the no-profit rule.[125] Now if it is understood that both opportunities and information are company's assets, the use of these assets for a director's own benefit could easily amount to a misappropriation of company's assets. The duty to avoid conflicts of interest is one which is in certain circumstances capable of being contractually modified.[126] Two different situations need to be distinguished. If the directors having been embarked on a transaction on behalf of the company use the opportunity for their own benefit, there is a misappropriation of company's assets: this is the situation dealt with in *Cook v. Deeks*.[127] On the other hand where the making of a profit is merely incidental, as a result of using internal information, there is not a misappropriation just a conflict of interest with the obligation to account for the profits made as it was held in *Regal (Hastings) v. Gulliver*.[128]

Following the decision in *Regal* it could be said that it is immaterial that the company itself is unable or unwilling to take advantage of the information or opportunity or that the company cannot preserve the opportunity or reject it, as the duty does not depend upon the company suffering any loss.[129] However, this argument can be contrasted with the decision in *Peso Silver Mines v. Cropper*[130] where it was held that although the directors acquisition was based upon the knowledge acquired in the performance of their fiduciary duties, the refusal on the part of the company to carry out in its own behalf the transaction, freed the directors to pursue their personal interest and therefore the defendants were not liable to account to the company. This seems to be a more flexible approach and it is necessary to say, more accurate.

In many cases of course there will have been a deliberate wrongdoing on the part of the trustee. This was clearly the position in *Cook v. Deeks*;[131] to a lesser extent in *Industrial Development Consultants v. Cooley*[132] and more recently in *FF Harrison*

[125] *Cook v. Deeks* [1916] 1 AC 554. For further information on this regard see Davies: *Gower and Davies'* op cit pp 439-440.
[126] See Hannigan, op cit 248 -249
[127] Ibid.
[128] [1942] 1 All ER 378.
[129] *Parker v. McKenna* (1874) 10 Ch App 96, 124-125.
[130] (1966) 58 D.L.R (2d) 1.
[131] [1916] 1 AC 554. See also *Re European Central Rly Co* (1872) LR 13 Eq 255.
[132] [1972] 1 W.L.R 443.

(Properties) Ltd v. Harrison.[133] However, the leading cases on breach of fiduciary duty demonstrate that the duty to account can arise even though the trustee genuinely believes that what he is doing either has the consent of the *cestui que trust* or at the very least that no harm has been inflicted upon him; this was plainly the case in *Regal Hasting Ltd v. Gulliver*,[134] where the directors took an opportunity which they believed was of no interest to the company and in *Boardman v. Phipps*,[135] where trustees obtained an incidental benefit as a result of their attempts to maximise profits for the beneficiaries of the trust. In these cases the default is not so much the making of the secret profit but rather the failure to obtain the consent of the company or beneficiary.[136] These principles may now be regarded as subsumed in the wider concept of "corporate opportunity".[137]

Before moving to insurability on this regard, it is necessary to ascertain in what circumstances a director is liable to account for profits which he has derived from his office. Where a director makes a profit from his position which has not been authorised by the company (irrespective of whether it is at the expense of it) the latter may seek a personal account of profits from such director. The prohibition is thus not against making profits, but against making secret profits. Accordingly, the director will not be liable to account if he has acted in a manner permitted by the articles, or if his conduct has been authorised before or after the event by the board or shareholders. If there is no authorisation or ratification, the principle is that the director must account to the company for any profit made from him which he has derived from his position whether or not that profit was made at the actual expense of the company. The issue gets more complex when the director has not only made a profit but also breached the duty of good faith. The perfect example is where directors misappropriate company's assets. In *FF Harrison (Properties) ltd v. Harrison*[138] the Court of Appeal was of the view that misappropriation of company's assets on the part of directors amounts to a breach of duty of good faith and thus it imposes upon the director a more severe consequence than merely accounting for profits. In fact, being a trustee for the company makes the wrongdoer liable as a constructive trustee

[133] [2002] 1 B.C.L.C 162
[134] [1942] 1 All ER 378.
[135] [1967] 2 AC 46.
[136] Boyle & Birds, *Company Law*. Fourth Edition . Jordans. 2000, p 524
[137] *Canadian Aero Service Ltd v. O'Malley* (1973) 40 DLR (3d) 371.
[138] [2002] 1 B.C.L.C 162

and therefore responsible not only for the purchase value but also for the major value acquired for the assets at issue.[139]

5.4.2.1 Bribes

A bribe is the clearest example of a secret profit. Bribes to directors are potentially of huge significance. Directors are exposed to numerous situations which might involve important investments and commissions, and the law has been formulated to remove all possibility of temptation from them. It has thus been held that whenever directors receive bribes or other secret commissions[140] in the performance of their duties, the company is entitled to bring an action to force the directors to account for their gains:[141] the most recent authority on the point is *Attorney-General for Hong Kong v. Reid*,[142] where the bribed agent was regarded as a constructive trustee of the proceeds of the bribe.[143] This needs further comment since the concept of constructive trustee refers to more than one situation. In the decision of *FF Harrison (Properties) Ltd v Harrison*[144], following *Paragon Finance Plc v. D B Thakerar & Co,*[145] it was emphasised that the constructive issue embraces two different scenarios. The first is where the trustee - in this case a company's director - has used his power in breach of his fiduciary duties, to transfer company's property to a *mala fide* third party. Here, the latter is treated as holding that property on trust for the company.[146] Following this principle if the director himself is the recipient of company's property he would hold it in trust for the company.[147]

The second scenario is different since it arises when the wrongdoer is involved in a fraud, such as a bribe. It is generally accepted that equity makes the offender accountable for the profits. In accordance with *Paragon Finance*, "such a person is

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[139] See also *CMS Dolphin Ltd v. Simonet* [2001] 2 B.C.L.C 704.
[140] *Boston Deep Sea Fishing and Ice Co v. Ansell* (1888) 39 Ch D 339.
[141] *Parker v. McKenna* (1874) 10 Ch App 96
[142] [1994] 1 AC 324.
[143] Earlier authority had regarded the bribe as a sum held as a debt rather than on trust, thereby prejudicing the principal in the event of the agent's insolvency: see *Lister v. Stubbs* (1890) 45 Ch D 1, CA.
[144] [2002] 1 B.C.L.C 162
[145] [1999] 1 All ER 400
[146] *Belmont Finance Corporation v. Williams Furniture Ltd and Others* (No2) [1980] 1 All E.R 393.
[147] *Harrison (Properties) Limited v. Harrison* [2002] 1 B.C.L.C 162 at par 27. Following LJ Millet in *Paragon Finance Plc v. D B Thakerar & Co* [1999] 1 All ER 400.

not in fact a trustee at all, even though he may be liable to account as if he were",[148] what in fact happens is that the court may use a 'remedial constructive trust' when a personal remedy is unlikely to make the fiduciary disgorge the unjustifiable income.[149] Additionally, the fact that the proceeds have been paid to a third party is clearly not enough to relieve the director from liability to account for an amount equivalent to the bribe obtained by him.

It is undoubtedly the case that a director may not recover from D&O insurers an indemnity for any sum which he has received as a bribe and which he has subsequently been required to pay over to the company. Public policy principles would clearly deny recovery and in any event the director can scarcely claim to have suffered a loss given that the sum claimed was never his in the first place. Further, as pointed out above, the company's action is not one for loss suffered by it, but rather one which demands the director to account for his unlawfully acquired profit.

5.4.3. Secret Profits: Is There an Insured Liability?

The question which arises from the above analysis of the rule against secret profits is whether directors are entitled to make a claim on his D&O insurers for any sum which they are required to pay to the company. This depends upon the nature of the claim made against them.

Where the directors have deliberately misappropriated property belonging to the company and have profited thereby, it is apparent that the obligation on them to account to the company in equity for their profits is not an insurable loss. One obvious reason is that D&O policies are against contingencies and not against deliberate misconduct. A second possibility is to argue that an obligation to account in equity is not a "liability at law" for the purposes of the insuring clause of a typical D&O policy. Thirdly, and more fundamental, however, is the principle that an insured person is not entitled to benefit from his own wrongdoing. But for the

[148] *Ibid* at par 28.
[149] Ferran, op cit 201.

misappropriation the directors would not have made any profit and the fact that they have to account for it is tantamount to permitting a thief to insure property which he has stolen and then to claim the proceeds of insurance when it is repossessed by the true owner.[150] Finally, the duty to account does not rest upon proof by the company that it has suffered any loss: some D&O wordings are drafted on the assumption that the insured's liability at law is to make good any loss which he has inflicted upon a third party, and where this form of wording is adopted it is clear that the policy will not respond.

A more difficult case is where the directors have acted wholly innocently in making their secret profits – the situations in *Regal (Hasting)* and *Boardman v. Phipps* – but are still called upon to account to the company for their profits. Plainly the public policy objections to recovery under a D&O policy do not arise in quite the same way, but it is nevertheless submitted that there can be no recovery even in this situation. The reason is that profits made in breach of duty ought not to have been made and belong to the company: a director who is required to disgorge his profits to the company but who can then seek indemnification from his D&O insurers is achieving the very result which the law seeks to forbid, namely the making of a profit from his position. This is equally the case whether the director's profit is one made at the expense of the company (so that the company has suffered a loss) or where the director's profit is made by the use of an opportunity which the company itself was unable to take (so that the company has not suffered a loss but has secured a windfall by reason of the director's duty to account). In each of these cases, allowing the director to recover confers upon him the very profit which the law forbids him to make. Indeed, it may be that an express policy term allowing recovery in such a case could be void on the grounds of public policy.

The issue which does of course arise in this scenario is whether the director is entitled to recover his defence costs from the insurers where proceedings are brought to require him to account for secret profits. This will depend upon the wording of the defence costs clause and the extent to which it is divorced from the underlying risk.

[150] See *Geismar v. Sun Alliance & London Insurance Co* [1977] 2 Lloyd's Rep 62, which accepts that a thief may have an insurable interest in stolen property by virtue of his immediate right of possession, but which goes on to hold that it is contrary to public policy to allow the thief to recover the policy moneys as he is seeking to profit from his own wrongdoing.

5.4.4 Classifying the Action

In practice D&O insurers commonly lay down an express exclusion from cover where the insured has through his deliberate misconduct made a secret profit for which he has to account to the company. However, the exclusion tends to relate to fraud or bad faith, and the question of innocent profits is left open, thereby indicating that such sums are recoverable. It was suggested above that this is not the case as a matter of law. The company itself may, however, be faced with an insolvent director, and in such a case it may attempt to formulate its action against the director in a way which does not offend public policy principles applicable to insurance contracts. Thus, rather than relying upon breach of fiduciary duty in equity, the company may assert that the director is in breach of contract and has caused loss to the company, so that the action is framed not as one which seeks to recover the profits made by the director but rather as one which seeks to require the director to make good the losses suffered by the company. There are indeed cases in which alternative formulations have been adopted. Thus in *Re a Company (No 005136 of 1986)*[151] Hoffmann J was of the opinion that an infringement of fiduciary duties on the part of directors also constituted a breach of contract.[152] In *Bishopsgate Investment Management Ltd v. Maxwell*[153] an action was brought for negligence and/or breaches of fiduciary duty and a director was held to be liable at law to compensate the company for the losses suffered by the company by reason of unauthorised transfers of some of the company's assets. The claims against the defendant were under two headings: failure by reason of negligence in preventing the transfer of the shares under a transaction in which he was not directly involved;[154] and the improper exercise of his powers by allowing a transfer of company's assets in the form of shares. Even though the court held the director liable to make good the losses to the company, the decision was

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[151] [1987] BCLC 82.

[152] Ibid. " where a shareholder alleges that the directors have breached their fiduciary duty by using their powers to allot shares for an improper purpose then whether the petitioner commences the action by writ, or seeks relief under section 459 of the Companies Act 1985, the substance of the complaint is that his rights as a shareholder have been infringed and therefore this is not an appropriate case for making of an indemnity order under the principle in *Wallesteiner v. Moir* as that procedure only applies where a shareholder commences a derivative action to remedy a wrong done to the company".

[153] [1994] 1 All ER 261.

[154] This is a good example of the significance of the role of a non-executive director..

largely based on breach of fiduciary duty[155] and not the negligent failure to enquire about the transfers.[156]

The question is whether a court will go behind the manner in which the company's action is classified. The answer appears to be given by the decision of the Court of Appeal in *MacDonnell Information Systems Ltd v. Swinbank*[157] where insurers were allowed to look behind the claimant's allegations and were thus able to take advantage of fraud exclusion even though the action was framed in breach of contract and no allegation of fraud was made. The case is particularly strong as the fraud exclusion was framed as applying only where the claim against the assured was one "alleging fraud". If this decision is followed generally, D&O insurers will be able to examine the true nature of the claim against the director, and may refuse to pay if they are satisfied that in reality the company is seeking to claim from the director profits which he ought not to have made.

5.5. Common Law Duties of Skill and Care

Directors are, by reason of their position, not only bound to their contractual and fiduciary obligations but also owe the common law tortious duty to exercise their functions with the level of care and skill expected from a person of their same knowledge and experience. Whilst fiduciary duties are generally concerned with negative obligations, restricting particular forms of conduct by the directors, common law duties emphasise the amount of willingness, diligence and prudence they must put into their task. The leading authority on the duty of care owed by a director seems to be the decision in *Re Barings Plc (No5)*[158] which attempts to modernise the principles laid down by Romer J in *Re City Equitable Fire Insurance Company,*[159] moving toward a stricter duty in negligence[160] in conjunction with the wording of section 214

[155] Nolan R, *"The Proper Purpose Doctrine and Company Directors"* in Rider, Barry AK, *The Realm of Company Law*, Kluwer Law.1998, p 11.
[156] *Bishopsgate Investment Management Ltd v. Maxwell* [1994] 1 All ER 261 at 265
[157] [1999] Lloyd's Rep IR 98.
[158] [2000] 1 B.C.L.C 523.
[159] [1925] Ch 425.
[160] Law Commission Consultation Paper No 153 on Company Directors, p 258.

of the Insolvency Act 1986.[161] Although this section refers only to companies in liquidation, it appears to be the first step for a future reform.[162]

The modern approach in this field differentiates between the duty of skill and the duty of care. While the duty of skill is necessarily interpreted in accordance with a subjective standard, as it was the approach in *Re Brazilian Rubber Plantations & Estates Ltd*[163] and *Re Denham & Co*,[164] the duty of care is now differently understood. This was the view taken in *Dorchester Finance Co Ltd v. Stebbing*[165] where two directors were held liable to the company for signing blank cheques, based upon the fact that they were qualified accountants. In other words, their personal skill as accountants was the crucial argument for the judge to hold them liable on the basis that an accountant is expected to know the potential risk involving cheques signed in blank. Another important development in this area, again in *Dorchester Finance Co ltd v. Stebbing*, has been the imposition on non-executive directors of the same duty as applies to executive directors.

Before embarking on the analysis of *Barings* it is necessary to emphasise that the duty of care and skill is one imposed by the common law, both as an implied contractual term and as a duty of care in tort. In accordance with section 309 of the Companies Act 1985, this sort of liability cannot be contracted out of since it configures a duty and not a disability as explained earlier on.[166]

Following the statements by Jonathan Parker J in *Re Barings* the director's duty of diligence seems to have taken a new path as it is revealed in the subsequent paragraphs.

"(1) Directors have, both collectively and individually, a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to

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[161] (4) For the purposes of subsections(2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both- (a) the general knowledge, skill and experience that may reasonable be expected of a person carrying out the same functions as are carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that that director has".

[162] There was an unsuccessful attempt at wider reform in the abortive Companies Bill of 1978, clause 45.

[163] [1911] 1 Ch 425.

[164] (1884) 25 Ch D 752, where it was held that a "country gentleman and not a skilled accountant" was not liable to the company for improperly exercising the skill to be expected of an accountant.

[165] [1989] BCLC 498

[166] Supra Chapter II: Legality - The Effect of Section 309 of Companies Act 1985.

enable them properly to discharge their duties as director
(2) Whilst directors are entitled (subject to the articles of association of the company) to delegate particular functions to those below to them in the management chain, and to trust their competence and integrity to a reasonable extent, the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.
(3) No rule of universal application can be formulated as to the duty referred to in (2) above. The extent of the duty, and the questions whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company."[167]

From these propositions some conclusions are readily apparent:

- This is a continuing duty which forces company's directors to be concerned in internal matters and to update their knowledge and understanding as company's business progress. It is no longer a duty owed on an intermittent basis as it was previously suggested, it demands a constant participation. The remaining question is how such participation is to be assessed for the discharge of the duty.
- It seems that two complementary types of factors need to be regarded namely, corporate and personal. In respect to the first, the size, business organisation and complexity of operations of the company might determine how demanding the directorship would be. As to personal factors, the director's experience and skills that were considered for his appointment, the role in the management of the company and the level of remuneration entitled to receive by discharging office[168] are all relevant. This means that cases are not alike; all the features of the case in course must be carefully scrutinised and only by so doing can the level of diligence and competence be correctly established. For example the decision in *Continental Assurance Co Plc (in liquidation)*[169] the judge dismissed the argument that the defendant directors were guilty of misfeasance because of years of keeping disorganised financial and accounting records and because they continue to trade after the crisis meeting to which the claim referred. The reasoning of the judge made it clear that had the directors been liable in this regard, the responsibility would have accrued to the finance director and not upon those who relied upon his assertions. Thus

[167] [2000] 1 B.C.L.C 523 , at pp 535 ss.
[168] Walters, *"Directors' Duties: The Impact of the Company Directors Disqualification Act 1986"*. (2000) 21 Co Law 110 at 116.
[169] [2001] B.P.I.R 733

the test is to be applied by considering individual duties and not upon the board as a whole because the role to be played may vary as between individuals.

- Therefore, the current theory in this field requires a distinction to be drawn between full-time salaried directors and executive directors on the one hand, and non-executive directors on the other. It is obviously the case that these days the complexity of a company's dealings may demand a high standard level of knowledge and skill on the part of its directors and this could be represented by the level of remuneration they have been offered. Thus, the appointment of an expert, as such, in a specific field may raise the level of diligence needed and as a result, make directors more vulnerable to be liable to the company. The earliest cases seemed to take into account that putting to much strength in such a duty could deter people from serving as directors: however; the reality today is quite different because of the services companies provide and the amount of money commonly involved. Additionally, non-executive directors have developed from individuals whose names and reputations confer plausibility on the company and are now in many cases just as responsible as executive directors in the management of the company's affairs[170] but in any case the features of the company and the way its businesses are organised will determine the level of skill and prudence demanded from its directors.[171]
- Directors are allowed to delegate and trust not only the other directors but also the remaining managing directors or officers. Trusting co-directors seems to be the only way that companies can achieve their aims, since it is almost impossible for a director to attend or manage all the complex activities in which a company may be involved.[172] However, directors are not excused from their duty to supervise those to whom special activities have been delegated, as was stated in *Dorchester Finance Co Ltd v. Stebbing.*[173] Reliance

[170] *Dorchester Finance Co Ltd v. Stebbing* [1989] BCLC 498, in which the lack of supervision on the part of two non-executive directors who left the affairs of the company in the hands of a third director rendered them liable to the company.
[171] Farrar, op cit p 393-4. See *Bishopsgate Investment Management Ltd (in liq) v. Maxwell.(No 2)* [1994]1 All ER 261: "the existence of a duty to participate must depend upon how the particular company's business is organised and the part which the director could reasonably have been expected to play..."
[172] *Dovey v. Corey* [1901] AC 477 at 485 *per* Lord Halsbury.
[173] At p 376: " Directors will be liable to the company for losses caused by the employee's negligence

on officers and others such as solicitors may of course be necessary where directors are under a duty to obtain expert advice or opinion and if they fail to consult appropriately they may be regarded as negligent. If that is the situation the ordinary principle of trust applies and directors may seek relief from liability whenever they rely upon solicitors[174] or officers[175] whose conduct had given none or not enough grounds, for concern.[176]

- In any case the method of assessment is both subjective and objective as it is suggested by section 214 of the Insolvency Act 1986, but this test cannot be static. As the duty is continuous, then a change in the size and complexity of the company's business raises the standard of diligence and competence on the part of directors. Directors must thus be aware that the days in which being a director did not require any special skill, that duties could be discharged on an intermittent basis and could survive carelessness by an obsolete subjective test, are definitely over.

5.5.1. Negligence and Insurance Implications. Damages

The basic coverage provided by any class of liability insurance is that for negligent performance of a task assumed by the insured. D&O insurance bears the same characteristic. Plainly, negligence on the part of the directors in the exercise of their duties, and the consequent personal liability which will ensure, is the primary ground upon which a D&O policy may be called upon to provide an indemnity to the directors.[177]

5.6. Directors' Statutory Duties and Liability

Besides contractual, equitable and common law obligations, companies legislation seeks to impose controls in specific areas where there have been found to be financial

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or ineptitude if they do not supervise his conduct of the company's affairs properly".

[174] *Norman v. Theodore Goddard* [1991] BCLC 1028. See also *Re D'Jan of London Ltd* [1993] BCC 646.

[175] *Huckerby v. Elliot* [1970] 1 All ER 189.

[176] Law Commission Consultation Paper on Company Directors No 153, p 260-1.

[177] Enright, op cit at 539.

abuses on the part of directors. Various offences are created by the Companies Act 1985, the Insolvency Act 1986, the Criminal Justice Act 1993 and the Company Directors Disqualification Act 1986, which are designed to protect the assets of the company and persons dealing with the company. As noted above, the mere fact that a director has committed a criminal offence in the course of conduct which gives rise to a loss does not necessarily preclude an action by the director under a D&O policy: a criminal offence will have civil sanctions in limited circumstances only, where the statute itself so provides or where the director can only make good his claim by praying in aid his illegal act. Thus a director who is in breach of a common law duty of care which renders him liable in damages to a third party will not be precluded from seeking indemnification from his D&O insurers simply because an incidental criminal offence has been committed, e.g., breaking the speed limit while driving to a meeting at which negligent advice is given.

Following the pattern used in assessing both fiduciary and common law duties in respect to D&O and its insurability, it is necessary to examine the exact nature of a statutory breach and the available statutory remedy. That said, three of the most important statutory duties are evaluated in the subsequent paragraphs.

5.6.1. Insider Dealing

Part V section 52 of the Criminal Justice Act 1993 establishes:

> (1) "An individual who has information as an insider is guilty of insider dealing if, in the circumstances mentioned in subsection (3), he deals in securities that are price-affected securities in relation to the information.
> (2) An individual who has information as an insider is also guilty of insider dealing if-
>   (a) he encourages another person to deal in securities that are (whether or not that other knows it) price-affected securities in relation to the information, knowing or having reasonable cause to believe that the dealing would take place in the circumstances mentioned in subsection (3); or
>   (b) he discloses the information, otherwise that in the proper performance of the functions of his employment, office or profession, to another person.
> (3) The circumstances referred to above are that the acquisition or

> disposal occurs on a regulated market, or that the person dealings relies on a professional intermediary or is himself acting as a professional intermediary."

In general insider dealing refers to the improper use of inside information[178] for the economic benefit of the tippee or any person related or otherwise connected to him/her. By definition this is only likely to happen in public limited companies. It is subject to an objective test[179] and it is regarded by the wording of section 61 of the Criminal Justice Act 1993 as an offence which attracts not just fines but also imprisonment.

Now the relevant point is to consider whether this statutory duty could impose civil liability and the answer seems to be in the negative, the reason being the fact that insider dealing frequently results in no loss and the rationale of civil liability is precisely to make good a loss.[180] This is why its relevance to directors and officers' liability insurance is limited. The sanction for insider dealing is criminal[181] and as such it is likely that public policy would operate to prevent a director from recovering an indemnity. It is noteworthy to emphasise that defence costs cover, whether offered as independent undertaking, might not be affected by any allegation of insider dealing, provided the director is found not guilty thereupon.

5.6.2. Liabilities Under the Insolvency Act 1986.

Whenever a company becomes insolvent and goes into liquidation, all attention is focused on its directors and the way they have conducted its affairs. As far as company directors are concerned the Insolvency Act 1986 imposes three different forms of liability namely, misfeasance,[182] fraudulent trading[183] and wrongful trading.[184] These provisions are applicable to companies which are already insolvent

[178] Criminal Justice Act 1993, s 56.
[179] Ibid.
[180] Band, *"Trustees and Insider Dealing"*. Priv. Client Bus.2000, 6, 361. Furthermore, "it is not altogether easy to see how civil liability could be framed, though various attempts have been made including misrepresentation, breach of statutory duty, breach of fiduciary duty and breach of confidence......because of the difficulty of establishing and quantifying loss, there are few claims brought in the civil law field".
[181] Criminal Justice Act 1993. s 52-64.
[182] The Insolvency Act 1986. s 212
[183] Ibid. s 213.
[184] Ibid. s 214.

and whose assets are administered by the liquidator appointed for that purpose. The *locus standi*, because of its insolvency, is vested in the company and the liquidator is deemed as its agent.[185]

Whether D&O insurance is available depends, once again, upon the nature of the breach and the available remedy and this has been assessed by considering the aforementioned classes of liability separately.

In accordance with section 212(3)(a)(b) of the Insolvency Act 1986, when any misfeasance or breach of fiduciary duty is proved, the Court may:

(3)….. " on the application of the official receiver or the liquidator , or of any creditor or contributory, examine into the conduct of the person falling within subsection
(1) and compel him-
(a) to repay, restore or account for the money or property or any part of it , with interest at such rate as the court thinks just, or
(b) to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the court thinks just".

The improper performance of directors' fiduciary duties, once the company is insolvent, leads to liability that is not necessarily to be regarded as excluded from D&O insurance cover. It is true that *restitutio in integrum* (the obligation to repay or restore money or property) might be outside the scope of cover insofar as the director's wrongdoing renders him a constructive trustee. Nevertheless, section 212(3)(b) is to be assessed under a different approach. By using the word compensation, the Insolvency Act 1986 introduces an equitable remedy which certainly might result in directors' loss. Such liability, if the breach is innocent, is insurable under D&O insurance as much as is the legal costs for contesting the legal proceedings.

Section 213 of the Insolvency Act 1986 sets out the rules relating to Fraudulent Trading. The nature of the breach is by definition fraudulent, which means that it is simply not possible as a matter of common law or indeed express policy exclusion to recover from liability insurers. It is true that such conduct may cause loss to the company and the directors could be compelled to contribute to the company's assets in accordance with section 213(2) up to the time they ceased their functions, but

[185] Supra Chapter IV D&O Exclusions: Insured v. Insured Claims.

because of the nature of the breach there is no insurance which may effectively protect them. The situation might be different in respect of defence costs.[186]

The third and last possibility is to incur liability for Wrongful Trading according to section 214. Whether or not this sort of liability is insurable under D&O policies is very difficult to assess. Wrongful trading implies the carrying on of business with the awareness that the company does not have a reasonable prospect of evading insolvent liquidation. In such a case directors could be forced to contribute to the company's assets for the benefit of creditors. However, directors can escape liability if they can prove that, after knowing the company was in financial difficulties, they took all the reasonable steps to minimise creditors' losses.[187]

5.6.3 Liability Under The Financial Services and Markets Act 2000.

The financial services market has been always concerned with the transparency of the stock market. The aim more than mere legality is social and economic, namely the regulation of the financial market in order to protect the investor. Trust, confidence and security are essential elements for the growth, stability and well functioning of public limited companies. How is the investor to be protected? Undoubtedly, by guaranteeing the following conditions: the existence, legality and permission of the corporate body to offer its securities in the public market; the due authorization and probity of the person in charge of the promotion and offer of securities; and by putting at the disposal of the investors all the information needed to show the real perspective of their investment. This last argument is the focus of attention of subsequent paragraphs.

The statute imposes liability - either civil or criminal - in regard to the use and promotion of inaccurate information. From these two propositions stem the rules governing false or misleading particulars; and market abuse.

The relevance of these provisions to this research lies in the fact that directors are amongst the persons responsible and consequently liable to meet the costs of indemnifying the victim of wrong. To this extent reg 6(1)(b)of the Financial Services

[186] This aspect is analysed in Chapter VIII.

[187] Insolvency Act 1986 S 214 (3).

and Markets Act 2000 (Official Listing of Securities) Regulation 2001 establishes:

"(1) ......the persons responsible for listing particulars (including supplementary listing particulars) are-
(b) where the issuer is a body corporate, each person who is a director of that body at the time when the particulars are submitted to the competent authority".

The issue is therefore to address the sources of director's liability and whether D&O policies may attach.

5.6.3.1 Liability Arising from the Duty of Disclosure.

In accordance with section 90(1)(a)(b) of the Financial Service and Markets Act 2000 any person could incur personal liability and be compelled to pay compensation to a person who has :

(a) acquired securities to which the particulars apply;
(b) suffered loss in respect of them as a result-
  (i) any untrue or misleading statement in the particular; or
  (ii) the omission from the particulars of any matter required to be included by section 80 or 81.

To the same extent subsection (4) imposes the same liability to a person who fails to comply with section 81.

Section 90 refers to listing particulars but its effects are extended to the prospectus. It is clear from the wording of section 90 that remedy of compensation has been introduced for the benefit of investors who have acquired securities and who have suffered loss as a result of a misleading statement or omission of a statutory provision.[188] It is not necessary to prove reliance on the misleading information or any assumption of responsibility on the part of the wrongdoer[189] and the statutory provision does not prevent liability arising in any other way.[190]

As far as insurability is concerned the author is of the opinion that general principles of misrepresentation apply within this context. Whether or not the misleading statement is the result of either intentional or negligent conduct demarks the boundaries of insurability on the grounds that no insurance policy may cover fraud or

[188] Davies: *Gower and Davies'*, op cit p 672.
[189] Ibid.
[190] For example liability for negligent misrepresentation.

wilful misconduct. This means that where a director incurs liability due to a misleading prospectus or listing of securities and such liability is the result of a non-deliberate or negligent breach of the statutory provisions, there would be no argument against insurability. In fact the two requirements would be met, namely insurable liability and financial detriment since directors, had they been held responsible may be compelled to make good the plaintiff's loss.

As far as insurers are concerned, it may be difficult to evaluate the risk, because a director may face liability to a considerable number of investors – very often thousands - and such liability may result in millions of pounds of compensation. It may be that insurers would be protected in such circumstances by reference to per claim deductibles or aggregate caps. In this instance all will here depend upon whether the insured "event" is to be regarded as an individual claim or the aggregate of claims arising from an originating cause.

5.6.3.2. Liability for Market Abuse.

The control of market abuse is equally important for the market. Its definition is found in section 118 of the Financial Services and Markets Act 2000 as follows:

For the purpose of this Act, market abuse is behaviour (whether by one person alone or by two or more persons jointly or in concert)- which occurs in relation to qualifying investments traded on the market to which this section applies; which satisfies any one or more of the conditions set out in subsection (2); and which is likely to be regarded by a regular user of the market who is aware of the behaviour as a failure on the part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or their relation to the market.

The available remedies include injunctions,[191] restitution[192] and criminal penalties[193] but the statute does not provide for the award of compensation as a result of market abuse.

D&O insurance is unlikely to be relevant to this form of liability. First, by looking at the nature of the wrongful act there is little likelihood that this conduct is insurable.

[191] Financial Services and Markets Act 2000, s 381.
[192] Ibid s 383.
[193] Ibid ss 118- 131.

The behaviour highlighted in the statutory provision requires intentional and deliberate misconduct, which is uninsurable. Along with insider dealing it is very unlikely to find effective cover; nevertheless, the issue as to defence costs cover – provided it is offered as separate undertaking – still gives rise to an enforceable claim against insurers if the director is shown to be innocent.
Secondly, it appears from the wording of section 381 and 383 of the Act that no private right of action is created. In fact the *locus standi* in pursuing injunctions as much as restitution is vested in the Financial Services Authority and the purpose is to correct the market rather than to indemnify any person who may lose out as a result of it. Nevertheless, in accordance with section 383(5), the final aim of the restitution order is to compensate those who have suffered loss. Investors are indirectly protected against losses suffered by reason of market abuse. The problem is that they must rely of the Financial Services Authority since investors themselves lack the *locus standi* to initiate proceedings on their own behalf. *Restitutio in integrum* prevents any insurance indemnity and within this context the principle is even stronger since the gain to be paid back is improperly made.

CHAPTER VI

DIRECTORS' AND OFFICERS' LIABILITY TO THIRD PARTIES

Professional indemnity insurance has been developed to indemnify the insured against damages awarded against him for failing to exercise reasonable care in the performance of his duties to a third party. Such policies cover actions for breach of contract and for liability in tort, although in practice the two causes of action stand and fall together as in each case what has to be shown is a failure by the professional to exercise reasonable care in the performance of the tasks entrusted to him. "Pure" contract claims are generally excluded, indicating that the policy is not concerned with liability under contracts which are additional to the ordinary obligation to carry out the promised service: thus a contract claim is covered only if it has a counterpart in tort.[1] The law in recent years has reformulated the test for liability in tort, and has developed the notion that there can be liability only if there has been a voluntary assumption of risk.[2]

Recently, the enactment of the Companies (Audit, Investigations and Community Enterprises) Act 2004 which amended the Companies Act 1985 by introducing the new section 309(a)(b)(c), seems to recognise a kind of statutory liability of directors to third parties by means of 'Third Party Indemnity Provisions'. Notwithstanding the nature and significance of these sorts of provisions still to be tested by the courts, they might represent a significant challenge as the role of D&O insurance. Two issues crucial for the functioning of these policies are: the nature of this sort of liability and the possibility of companies indemnifying their directors, which may make Side B or Company Reimbursement cover very popular indeed. Undoubtedly insurers might demand full disclosure whenever these provisions are agreed since the insurer's perception of the risk increases. Yet in line with principles of insurability and indemnity director's liability must be neither fraudulent nor deliberate.

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[1] Supra Chapter IV: D&O Exclusions: Liability in Contract.

[2] Watson and Willekes, *"Economic Loss and Directors' Negligence"*, [2001] JBL 217. The assumption of responsibility has been developed as a new tort which may procure the enforcement of a personal liability on the part of directors, without affecting the principle of separate legal liability. See most recently, *Customs and Excise Commissioners v. Barclays Bank* [2005] 1 Lloyd's Rep (forthcoming).

6.1. Directors Personal Liability to Third Parties

As it has been described earlier throughout this research, companies are considered legal persons separate in law from those who established them, and company directors are simply the persons empowered to represent the company in its dealings with third parties and to manage the company's affairs. Consequently, as corporate representatives, whenever directors act on behalf of a company, it is the company which in law is regarded as having entered into any contract with the third party and which is responsible in tort for any wrongdoing on the part of its directors.[3] This conclusion may be reached irrespective of whether the organic or agency theory of company law is adopted, although as the organic theory appears to be in decline the following comments are mostly concerned with the agency issues which arise.

As regards the liability of a director to his company, it has been seen above that to date the scope of liability is relatively narrow, and indeed it has been said that the present operation of the common law means that directors have had a remarkable freedom to run companies incompetently.[4] As far as third parties are concerned, cases involving corporate insolvency which have led to third parties suffering considerable losses have traditionally been decided on the notions of corporate personality and the organic theory, thereby absolving the directors from personal responsibility. More than a century after *Salomon v. Salomon*[5] there still is some obscurity and ambiguity as to whether directors may become personally liable without lifting the corporate veil or tampering with the notion of the limited liability of the company.[6] The answer to this complicated issue lies in the fact that an individual can operate in different capacities within a company,[7] thus assuming certain levels of responsibility as to the

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[3] Grantham, *"Company Directors and Tortious Liability"* [1997] CLJ 259. The difficulty arises because of the fact that "tort law imposes liability on the individual director as the actual torfeasor" whereas "company law places that liability exclusively on the corporate entity".
[4] Finch, *"Company Directors: Who Cares About Skill and Care?"* [1992] MLR 179.
[5] [1897] A.C 22.
[6] Bolas Alfonso, *La Responsabilidad de los Administradores de Sociedades de Capital.* Consejo General del Poder Judicial. Madrid. 2000, p138. Directors' liability to third parties in Spain is governed by statute which expressly establishes that directors are liable to the company, shareholders and creditors for the enforcement of company's contracts and obligations and also for the solvency of the company.
[7] *Lee v. Lees Air Farming Ltd.* [1961] N.Z.L.R 325.

consequences of the activities carried out. Consequently, the notion of corporate liability does not necessarily preclude the liability of a person who happens to be a director who is acting in some other capacity,[8] as is the case where it is proved that the director's participation was crucial for the successful completion of the transaction between the company and the third party. Under this perspective, directors may incur tortious liability without infringing the corporate personality principle.[9] What is required here is a voluntary assumption of the consequences of some failure in the transaction between the company and the third party.

The argument against directors' personal tortious liability based on the application of the organic theory is also of little weight. The organic theory states that directors are the physical element required for the corporation to enter into relations with third parties, and operates by deeming the company and its directors as constituting a single entity. Based on this idea, directors cannot become personally liable, since any obligations are undertaken only by the company. Nevertheless, it has been argued that this theoretical approach has been misapplied in the context of the personal liability of directors. Professor Farrar has pointed out that the organic theory does not preclude personal liability, and that such liability might arise under one of three tests: did the director "direct or procure" the obligation; did the director "make the torts his own" and did the director voluntarily assume responsibility to the third party.[10]

The law now seems to recognise that there are three possibilities arising from tortious behaviour on the part of a director in his dealings with a third party:

(1) The company alone faces liability.
(2) The company and the director are jointly and severally liable.
(3) The director alone is liable

Despite the fact that issues in which the company alone faces liability are by no means important, it seems that its relevance, for the purpose of this research, may be

[8] Watson and Willekes, op cit at 220.
[9] *Williams v. Natural Life Health Foods*.[1998] 2 All E.R 577. Lord Steyn: ".... Whether the principal is a company or a natural person, someone acting on his behalf may incur personal liability in tort as well as imposing vicarious liability or attributed liability upon his principal".
[10] Farrar, *"Personal Liability of Directors for Corporate Torts"* [1997] B.L.R 102.

of little use since the analysis relates to director's liability in the first place. The scenarios referred in (2) and (3) above, will now be addressed.

The issue of whether a company and the director could be jointly and severally liable in tort, has been comprehensively addressed in *MCA Records Inc v. Charly Records Ltd (No 5)*[11] where it was held that for a director or officer of a company to be personally liable, as a joint tortfeasor, it is necessary to find that he had procured or induced[12] those acts to be done by the company or that he and the company had acted jointly and in a concerted fashion to secure that those acts were done.[13] As a result, a director could not be held liable with the company as a joint tortfeasor if he does no more than carry out his constitutional functions: it is necessary though that he embarks or induces the company to exercise tortious activities.[14]
If there is joint liability, the question becomes whether it is covered by a D&O policy. The author is of the opinion that the nature of the policy might not be affected in these circumstances; the liable directors may still be covered – as long as the breach is not fraudulent. There is nevertheless an allocation issue between the company and the director, involving the court investigating what has been the real participation of the director in the wrong and what proportion of the loss is to be allocated to him.

6.2. Directors' Personal Tortious Liability

Focusing now on the director's potential personal responsibility, the precise legal approach to the question of when a director becomes personally liable to third party lies not only in the type of tort committed but also in rules of agency and vicarious liability.[15] Torts may be perpetrated on a third party by conduct (e.g., negligent driving) or by words (misrepresentation). As regards the first, if the tort is committed by a director in the course of his employment with the company, the company will be vicariously liable for the director's breach of duty and will face joint and several liabilities to the third party along with the director.[16] By contrast, if the tortious act is

[11] [2003] 1 BCLC 93.
[12] *Following C Evans and Sons Ltd v. Spritebrand Ltd* [1985] B.C.L.C 105.
[13] *MCA Records Inc v. Charly Records Ltd (No 5)* [2003] 1 B.C.L.C 93, at par 53.
[14] See also *C Evans & Sons Ltd v. Spritebrand Ltd* [1985] 1 WLR 316 at paragraph 15.
[15] Payne, *"The Attribution of Tortious Liability Between Director and Company"* [1998] JBL 153-168.
[16] Ibid.

committed outside the course of the director's employment, the company will not face liability although the director will himself be personally liable. In such a case D&O insurance may not be applicable as it may not be possible to say that the director has acted in his capacity as director when the liability was incurred.

The second possibility, that of liability arising from misrepresentation, will depend upon the scope of the director's actual, implied, usual or apparent authority to act on behalf of the company.[17] If the director has acted within the scope of his authority, the company will face liability in the event that the resulting agreement is found to be voidable for misrepresentation. However, if the company is insolvent and an action against it is worthless, the question arises as to whether the director may be personally liable for his own misstatements. The issue is particularly acute where the company is in effect controlled by the director. The most recent cases have approached this matter by developing the notion of the voluntary assumption of responsibility.

6.2.1. Assumption of Responsibility and the Relevance of Williams Case

The most important decision is that of the House of Lords in *Williams v. Natural Life and Health Foods Ltd.*[18] The case related to a franchise agreement under which the claimants, Mr Williams and Mrs Reid, established a health food shop by purchasing the franchise from the first defendant, a company formed by Mr Mistlin and of which he was the managing director. In the negotiations for the contract, conducted by Mr Mistlin on behalf of the company, very favourable forecasts of income were provided, thereby making the transaction very attractive in terms of profitability to the claimants. The agreement was duly entered into, but after a short period the claimants were forced to close the shop due to substantial losses and as a result, they brought proceedings against the company alleging that the income projection had been prepared negligently. Mr Mistlin was joined to the proceedings as second defendant, on the ground that his personal lack of care in the giving of the advice had induced the claimants to enter into the contract with the company. By the time the action came to

[17] Ibid.
[18] [1998] 2 All ER 577.

be heard the company itself had been wound up, leaving Mr Mistlin as the only effective defendant.

The High Court held that Mr Mistlin as managing director was personally liable due to the projections being negligently prepared. The High Court was particularly influenced by the fact that Mr Mistlin was an apparent expert in the field since he had run several successful enterprises of the type in question and accordingly the claimants had relied upon his knowledge and expertise. Immediate reaction to this ruling was the potential undermining of the notions of corporate identity and limited liability and it was duly reversed by the Court of Appeal. The Court of Appeal, applying the decision in *Trevor Ivory Ltd v. Anderson*[19] held that a director is not personally liable in tort where the tort was committed by him in his capacity as director and while acting on behalf of the company. It was nevertheless indicated that a director's personal liability to a third party might arise if there has been an assumption of a duty of care, actual or imputed[20] on the part of the director. In other words, there is no definitive principle that directors by acting as such, are not personally liable, since the relationship arisen between them and the company's customers could be sufficiently close so that the directors might have acquired personal duties of care and the third party might have been motivated to enter into the contract by reason of that relationship.[21] As a result the Court of Appeal in *Williams* case held that "a company director is only to be held personally liable for the company's negligent misstatements if the claimants can establish some special circumstances setting the case apart from the ordinary"[22] principle of relief from personal liability.

The House of Lords agreed with the Court of Appeal that there was no liability in the present case. However, their Lordships pointed out that an indirect relationship

[19] [1992] 2 N.Z.L.R 517.
[20] "An officer or servant of a company, no matter his status in the company, might in the course of activities on behalf of the company come under a personal duty to a third party, breach of which might entail personal liability. The test as to whether that liability had been incurred was whether there had been an assumption of a duty, actual or imputed. Liability depended on the facts, on the degree of implicit assumption of personal responsibility and the balancing of policy considerations".
[21] For the equivalent position in Spain, see Frades de la Fuente, *La Responsabilidad Profesional por Consejos Negligentes*. Dykinson . Spain. 1999, pp 83-85.
[22] *Williams v. Natural Life and Health Foods Ltd* [1998] 2 All ER at 580, applying the ordinary negligence principles in *Hedley Byrne & Co v. Heller & Partners Ltd* [1964] AC 465.

between the directors of the company and the victim of the tort is not sufficient to make the former personally liable. Instead, it is necessary that the parties have developed a special relationship under which "there has been an assumption of responsibility on the defendant's part and reasonable reliance on the plaintiff's part".[23] As a result the House of Lords has left open the door, albeit only slightly, for any director to become liable to a third party as a tortfeasor.[24]

It is apparent that personal liability for negligent misrepresentation under *Williams's* principles is perhaps the main thrust of a D&O policy in England. However, it will be appreciated from *Williams* that the scope for personal liability is relatively small, and accordingly that D&O policies – unless they apply to the liability of the directors to the company – are of relatively little utility.

6.2.2. After the Williams Case

Cases decided since *Williams* indeed indicate that it is perfectly possible to find a voluntary assumption of risk by a person dealing with a third party who is contemplating entering into a contract with another, although the courts have been unwilling to find a voluntary assumption of responsibility other than in the clearest of circumstances. In *Fashion Brokers Ltd v. Clarke Hayes*[25] the defendant, a firm of solicitors, acted on behalf of the claimant who wished to acquire the leasehold of premises for use as a retail clothing outlet. Before the contract was entered into, the defendants telephoned the local authority planning department to determine whether or not the projected use of the land would contravene existing planning permission. The planning officer, whose identity was not disclosed, orally confirmed that no limitations existed as to the intended use. After purchasing the property the claimant was prevented from carrying out his activities by reason of the limitations of planning permission. The claimant sued the solicitors and the solicitors joined the planning department to the proceedings. The preliminary issue for the Court of Appeal was whether the planning department had assumed responsibility by providing, by way of

[23] Mullender, *"Negligent Misstatement, Company Directors and the House of Lords"*, (1999) 20 Co Law 121.
[24] Stallworthy, *"Company Law-Liability of Directors"*, [1998] I.C.C.L.R 105.
[25] [2000] P.N.L.R 47

one of its employees, inaccurate information which led to the claimant's loss. The Court of Appeal dismissed the case against the planning department on the grounds that there had not been sufficient proximity between the defendant and the planning department as to generate a duty of care. The defendant was negligent in failing to warn the plaintiff of the danger of relying upon an oral assertion without knowing even the name of the employee who provided it. The case thus fell directly within the *Williams* principle.

In the same way, in *Electra Private Equity Partners v. KPMG Peat Marwick*,[26] a case concerning auditors' negligence, the *Williams* case was applied, and it was affirmed that a conscious assumption of responsibility is required whenever personal tortious liability is purported to be imposed upon the professional.

In *Noel v. Poland*[27] the claimant was an underwriting Name at Lloyd's, she joined through the agency of John Poland and Co Ltd. The claimant was placed in a number of syndicates (general non-marine and general marine). After resignation from her membership she found out that she remained exposed to liability to meet claims as the syndicate accounts had been kept open by reason of a number of environmental pollution and asbestosis claims. The claimant alleged that she has been deceived into becoming a Name for the relevant years by reason of fraudulent or negligent misstatements by the director and the non-executive director of the agency, and that they had become personally liable to her by an application of the ordinary tort rules in *Hedley Byrne*.[28] The claims were struck out on the basis of the ruling in *Williams*: the existence of a special relationship between the claimant and the defendants could not be shown and accordingly it could not be said that there had been the necessary assumption of responsibility by the defendants.

Merrett v. Babb[29] concerned an action by a mortgagor against a firm of surveyors and raised the issue of the personal liability of an employee. The case concerned the negligent valuation of a property carried out by the employee surveyor for a third party mortgagee. The surveyor had not entered into a personal contact with the

[26] [2001] 1 B.C.L.C 589
[27] [2001] 2 B.C.L.C 645
[28] *Hedley Byrne & Co Ltd v. Heller & Partners Ltd* [1964] AC 465.
[29] [2001] Q.B. 1174

claimant nor was the claimant a client of the firm of surveyors, although the valuation report – signed by the surveyor and stating his personal qualifications as well as the name of the firm – had been relied upon by the claimant. The Court of Appeal held that a professional valuer owed a duty of care to a mortgagor where two requirements were met: was it appreciated that the mortgagor would rely upon the valuation in order to enter into the transaction; and did the mortgagor intend to have an independent survey. The Court of Appeal held that these requirements had been satisfied and that a duty of care arose by reason of a voluntary assumption of responsibility.

Most recently, in *European International Reinsurance Co Ltd v. Curzon Insurance Ltd*,[30] the principles laid down in the earlier cases were codified by Gross J. The question in this case was whether two individuals employed by placing brokers had voluntarily assumed responsibility towards insurers for the placing of reinsurance, the producing brokers themselves having been appointed by the insurers' placing brokers under delegated authority. Gross J refused to strike out the claims against the individuals. The learned judge ruled that the test of *Hedley Byrne* liability for negligent misrepresentation was whether the defendant had made a conscious assumption of responsibility for the task, as opposed to a conscious assumption of responsibility to the claimant for its careful performance. There would normally be an assumption of responsibility where the relationship was equivalent to a contact, but the court would not willingly find such an assumption of responsibility where this was inconsistent with a contractual chain or contractual structure. Gross J further held that an individual employee acting in the course of his employment could incur *Hedley Byrne* liability, although it was equally the case that an agent could assume responsibility on behalf of another for the purposes of the *Hedley Byrne* rule without assuming personal responsibility. The question in every case was whether there had been reasonable reliance on statements made and conduct shown by the agent or employee: reliance in fact was not the test. This reformulation makes it clear that there is no rule against personal liability and that all depends upon an objective view of whether the agent's statements and conduct justified reliance by the claimant.

[30] [2003] EWHC 321 (Comm)

6.3. Directors: Personally Liable for Fraudulent Misrepresentation?

The House of Lords has recently confirmed, in *Standard Chartered Bank v. Pakistan National Shipping Corporation*,[31] that a director cannot escape personal liability for the tort or the fraud by merely alleging that he was acting fraudulently on behalf of the company. This case concerned the fraudulent backdating of a bill of lading in order to comply with bank requirements, so as to secure payment under a letter of credit opened by the bank. The director himself arranged the backdating of the bill of lading, thereby issuing a fraudulent misrepresentation. The issue was whether the director could be held personally liable for the tort or whether liability for his misdeeds could be shielded by means of corporate personality. The House of Lords held that a director could not avoid liability by relying on the fact that he was acting on behalf of the company: his liability was not imposed because he was a director, but because he carried out the deceit and contributory negligence is not a defence to an action based on such a tortious conduct.[32] In fact the term 'fault' to which the Law reform (Contributory Negligence) Act 1945 refers to must be interpreted as negligence , breach of statutory duty or other act or omission,[33] excluding therefore fraudulent wrongdoings.

Fraudulent misrepresentation seems to be outside the scope of the *Williams* case, since the latter was based on negligence rather than fraud, it was just the application of agency doctrines to the requisite of assumption of responsibility under *Hedley Byrne* principle.[34]This last argument leads to the conclusion that a director's liability for fraudulent misrepresentation arises not from breaches of fiduciary duty or negligence but from the tort of deceit, which means that a director becomes liable not *qua* director but *qua* individual or in other words he becomes liable for the fraudulent act irrespective of his/her position within the company. Thus the claim in *Standard Chartered Bank* succeeded because it was made against an individual who happened to be a director: if it had been otherwise, as the House of Lords emphasised, the defendant could easily have been shielded by the corporate veil.[35]

This ruling is of no significance for D&O cover, as it is clear that – irrespective of the

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[31] [2003] 1 All E.R 173.

[32] Law Reform (Contributory Negligence) Act 1945, s 1(1).

[33] Parker, *Fraudulent Bills of Lading and Bankers' commercial Credits: Deceit, Contributory Negligence and Directors' Personal Liability*. [2003] L.M.C.L.Q. 2003 1 at 2.

[34] [1964] AC 465

[35] [2003]1 All E.R. 173.

terms of the contract itself – such a policy will not respond to a claim where the director has to pray in aid his own fraud. Furthermore, had it been possible to provide coverage, the fact that a director could be held liable not *qua director* but *qua individual* contravenes the nature of a D&O policy.

6.4. Director's Duties to Employees and Creditors

The duty of company directors to take into consideration the interests of employees comes from the wording of section 309(1) of The Companies Act 1985.[36] In accordance with s 309(2) of the 1985 Act, the duty cannot be enforced by proceedings brought by employees.[37] Accordingly, the duty is owed to the company and it is only enforceable by the company. Section 309 is widely regarded as of little significance, and in any event failure to adhere to its terms appears not to be capable of giving rise to the personal liability of directors for D&O purposes since employees lack *locus standi* to enforce this provision. In any case – as noted above- the insured v. insured exclusion might of relevance in this scenario when entity cover is provided.

Creditors on the other hand are in a different position. While the company – as *persona ficta* - remains in existence and solvent, it is the company itself which owes duties to creditors. Where the company is in danger of insolvency, the directors may potentially owe additional duties in order to preserve the assets of the company,[38] and to preserve intact the interest of its creditors. This argument does not arise by reason of there being duties owed directly to creditors, but rather because the liquidation of the company will adversely affect their interests.[39] Insolvency grants to creditors though the power to displace the interest of the company and its shareholders vested upon the latter, by way of general meetings and minority shareholder protection. Hence the issue is to ascertain to what extent directors may owe duties to creditors[40], to what sort of liability is involved and whether D&O insurance could play its role.

[36] Companies Act 1985, s 309(1).
[37] "Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors".
[38] Prentice, *"Creditor's Interests and Director's Duties"* [1990] OJLS. 265. This article focuses on directors' duties to creditors and the impact of section 124 of Insolvency Act 1986. See also Pasban, *"A Review of Directors' Liabilities of an Insolvent Company in the U.S and England"* [2000] JBL 33.
[39] Sealy LS, *Cases and Materials in Company Law*, Sixth Edition. Butterworths, p 280.
[40] This seems to be the aim of Insolvency Act 1986.

From *Walker v. Wimborne*[41] and *Nicholson Permakraft*[42] which later influence the decision in *West Mercia Safetywear Ltd v. Dodd*,[43] following the dictum in *Kinsela v. Russell Kinsela Pty Ltd*,[44] it could be suggested that the liquidation process moves the attention of directors from company's members to creditors, as the creditors are entitled to be satisfied first in the event of insolvency.[45] In *Winkworth v. Edward Baron Development Co Ltd*[46] it was held that directors of a family company were required to act with care for the benefit of the company's creditors. Here a divorce situation arose between the two directors of a company and they wanted to split between them the assets of the company. In the meantime the company's affairs were unattended, adversely affecting the interests of creditors. The creditors brought an action against the directors, seeking an order that they should take due care of the company. As a result, it has become apparent that creditor's interest has been acknowledged by the courts albeit there still are discrepancies.[47] More recently the decision in *Colin Gwyer & Associates v. London Wharf (Limehouse) Ltd*[48] it was emphasised that when adopting resolutions directors must not only consider the interest of the company but also that of creditors if insolvency is imminent. It does not matter whether the company is technically insolvent; in fact a mere possibility of insolvency may activate the additional duty to consider creditor's interest.
That said and if it is accepted that there is certain commitment on the part of directors to creditors, it is no less important to emphasise that such duties may be owed to all the creditors as a group, or a sector of them.[49]

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[41] (1976) 50 A.L.J.R 446
[42] [1985] 1 N.Z.L.R 242… "the duties of directors are owed to the company. On the fact of particular cases this may require the directors to consider *inter alia* the interests of the creditors. For instance creditors are entitled to consideration, in my opinion, if the company is insolvent or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency" at 249.
[43] [1988] B.C.L.C 250.
[44] (1986) 4 N.S.W.L.R 222.
[45] Davies: *Gower and Davies', Principles of Modern Company Law*, 7th ed, Sweet & Maxwell, 2003 at 372.
[46] [1987] 1 All ER 114.
[47] The suggestions that directors owe duties to creditors have been mostly rejected see for example: *Kuwait Asia Bank EC v. National Mutual Life Nominees* [1990]BCLC 868. *Horsley & Weight* [1982] All ER 1045. *Yukon Line Ltd of Korea v. Rendsberg Investment Corporation of Liberia* [1998] All ER 82 at 99 " It is not a breach of a duty for a director to cause the company to prefer one creditor to another". *Knight v. Frost* [1999] BCLC 364. *Multinational Gas and Petrochemical Co v. Multinational Gas and Petrochemical Services* [1983] Ch 258 CA.
[48] [2002] EWHC 2748.
[49] *Re Pantone 485 Ltd* [2002] 1 B.C.L.C 266.

Nowadays the duty to consider creditor's interest has acquired the form of statutory obligation in accordance with section 214 of the Insolvency act 1986 regarding 'wrongful trading'. It is readily apparent thought that any insolvency situation, changes the landscape entirely, by even expanding directors' duties beyond the boundaries of the company.

Within an insolvency scenario liquidators are obliged to protect the interests of creditors and may bring an action against directors who have apparently acted in a manner which prejudices the company, its members and its creditors. Liquidators in practice rely upon the Insolvency Act 1986 initiating proceedings for misfeasance,[50] fraudulent trading [51] or wrongful trading,[52] on the grounds that in case of being unsuccessful, such proceedings do not impose legal costs upon the losing party, so upon them -albeit funding the action is a matter of great concern-.[53] This cause of action, in order to succeed, must ascertain the exact moment of insolvency, -a task which is far from easy-[54] and also link such an event with the acts of directors. The question arises, can there be personal liability? The answer would seem to be in the affirmative. In fact as explained earlier[55] directors could be compelled to restore, repay or account moneys or property to the company or indemnify the corporation as the court thinks fit. The first remedy is uninsurable as explained earlier but the same cannot be said of the second.

Consequently, it is undoubtedly necessary to determine if such liability rests on uninsurable fraud or insurable negligence. It is clear that Fraudulent Trading is not covered so it is necessary to focus attention on Wrongful Trading and the effects of section 214 of the Insolvency Act 1986.

By following the arguments put forward in Chapter I, the meaning of wrongful act does not necessary imply fraud or deliberate breach of duty. It is possible to argue, therefore, that negligence could be the feature of wrongful trading whenever the

[50] Insolvency Act 1986. S 212

[51] Ibid. S 213

[52] Ibid S 214.

[53] Keay, *"The Duty to Take Account of Creditor's Interests: Has It any Role to Play"*, [2002] JBL 379-410 pp 380-393.

[54] Grier, *UK Company Law*. Wiley. 1998, p 407. It is necessary for any action against directors to be successful to link the precise moment in which the insolvency situation firstly appeared and those new activities carry on for the directors shortly after .

[55] Supra Chapter V: Duties Under the Insolvency Act 1986.

director fails to meet the standard of skill and care to which section 214(4)(a)(b) refers. As a result of this the U.K insurance market very often covers this type of risk,[56] because of the fact that negligence matches insurability and it is highly probable that directors may sustain losses if they are constrained to make good company's ones by way of indemnity.

[56] Hemsworth,, "*Insurance Policies and Directors' Insolvency Act Liabilities*".[1999] Insolvency L.J 288.

CHAPTER VII

DIRECTORS' LIABILITY AT CIVIL LAW

7.1. Contractual and Extra-Contractual Liability: Origins and Requirements

The origins of what is nowadays understood as civil liability may be found in ancient Rome whose legal principles and philosophy influenced the development of the later European law in regard to both contractual liability and tort law. Those principles were exported and adopted by the vast majority, if not all Latin American countries, to say nothing of US and Commonwealth jurisdictions.
It has been a rule of law since the earliest times that the victim of a wrongdoing is entitled to claim by means of compensation an indemnity- not only in the form of a sum of money but also in kind- which might put the victim, as far as possible, in his original position, had the wrongful act never occurred. In other words anybody who had caused damage was obliged to make it good. Now, this obligation could arise from two different sources firstly, by breaking a contract ('contractual responsibility') and secondly, by failing to exercise the general duty of care not to cause damage to third parties; the latter class of liability is known as *'delictual or quasi-delictual'* which in turn gave rise to penalties or the return of an object.[1]

Where a contractual relationship existed between the parties, ascertaining the wrong or lack of commitment and measuring the damage could be achieved by considering what the parties had promised to each other or expected to obtain. This sort of liability which has been known as *Contractual* developed a number of principles as follows:

- Contracts must be executed in Good Faith.[2] This concept -albeit very abstract and thus difficult to express with clarity - imposes upon the parties the duty to act fairly and reasonable in performing their contractual obligations. However,

[1] Taylor & Rusell, *The Civil Law System*. Little, Brown and Company . Second Edition at 567.
[2] This principle has been recompiled in a number of civil law jurisdictions of which France is one. Article 1134 of French Civil Code establishes: "Les conventions legalment formess......Elles doivent etre executes de bonne foi". To the same extent, article 1160 of Venezuelan Civil Code.

it is necessary to add indeed that good faith as a duty seems to embrace all the process of contract formation and beyond it. At first sight the phrase 'contracts must be executed' implies a duty arising as a result of forming a contract. Nevertheless, this interpretation has been proved to be to some extent inaccurate. Good faith as contractual principle has influenced the pre-contractual stage by ensuring that anybody who had given consent, in doing so, has proceed with absolute freedom, willingness and knowledge in respect of contractual subject-matter. Therefore, such assent is not vitiated by *'dolus, error or violence'* which developed in the English legal system as well, giving rise to accepted contractual principles such as Misrepresentation, Mistake, Undue Influence and Duress. The duty is therefore one which takes effect from early stages and remains throughout the execution of the entire agreement.

Good Faith might have a second role to play in that there is good faith within the contractual context when due care is exercised while performing the agreement. This could be explained by observing Roman's Law classification of the standard of care attributed to diverse types of contracts; this is why concepts such *'pater familiae'* or *culpa lata*, *'good pater familiae'* or *culpa levis* and *'the best pater familiae'* or *culpa levissima* emerged. With regard to the first, the level of skill demanded was that of a normal person, increasing as to the circumstances required. This is why contracts involving administration and representation such as *'mandate'* which authorised the *mandatary* to even dispose of *mandator's* property, demanded the maximum test of that of the best *pater familiae.*

Having said that, a contract is performed in good faith when the parties in so doing proceed with due care and honesty. One could argue that this test of diligence – *pater familiae*- might not have its origins in contractual relationships since its roots belong to the law of obligations in general and these could be of extra-contractual nature as well. In support of the argument it could be said firstly that contracts were source of obligations thus allowing general principles to be applied thereupon and secondly that the aim of the comment is not other than proving the remote origin of what nowadays is known as contractual duty of care.

- The parties commit themselves not only to what they actually agree upon but also to general principles of Equity, Usage and Law.[3] This second principle is significant in relation to contract construction and implies three different rules of law in the interpretation of what the parties have agreed. Firstly, equity could be used either by the interpreter or the judge to ascertain the substance and extent of the obligations agreed upon, in the understanding that the content of a contractual term might provoke an unfair imbalance or exaggerates the detriment upon one of the parties. It is necessary to say that equity within this context differs in meaning to the role of equity in a Common Law system, since in the latter case equity is a source of law in its own right whilst in the former, is just a rule of contractual interpretation.

  Secondly, the issue of whether or not usage might influence contract interpretation requires clarification. Since early times it has been accepted that commercial practices or technical concepts, developed as forming part of general business understanding thus, helping the interpreter in contract construction. Interpretative or conventional usage - as it is known- concerns with commercial or professional practices which might help in ascertaining the will of the parties. It is not a rule of law: it just works as means of assessing what the parties wanted by the time a contract is formed.[4]

  Thirdly, as to the role of 'the Law' two issues are readily apparent. The law might impose extra burdens upon the parties by regulating certain contractual areas, ascertaining therefore, rules of conduct that ought to be followed in any case. In the modern context one example could be either implying terms by statute or enacting laws to rule specific trades.

  Conversely, the law might intervene despite the wishes of the parties, not to impose extra requirements but to prevent certain practices. The notion of public policy seems to stem from this last argument.

[3] French Civil Code art 1135 : " Les conventions obligent non seulement a ce qui y est exprime, mais encore a touts les suites que l'equite, l'usage ou la loi donnet a l'obligation d'apres sa nature". Article 1434 of the Civil Code of Quebec : " A contract validly formed binds the parties who have entered into it not only as to what they have expressed in it but also as to what is incident to it according to its nature and in conformity with usage, equity or law". Venezuelan Civil Code follows the same principle in article 1160 also the Burgerliches Gesetzbuch articles 242 and 157 in Germany.

[4] Garrigues, Curso de Derecho Mercantil, Temis, Tomo I, Bogota, Colombia . 1987 pp 117-125.

7. 1.1 Delictual and Quasi- Delictual Liability

Although it is accepted worldwide that criminal or delictual liability may not find a remedy in insurance due to principles of public policy, it is relevant to dedicate a few comments to the origin of this sort of responsibility.

Extra-contractual, quasi-delictual or tortious liability - if preferred- found its roots in unlawful human actions which were not ruled by law thus leaving the victim without a satisfactory remedy.[5]This is why the law of *delicts* was a very, if not the most, important, source of obligations in ancient Rome. Such importance is acknowledged by the way this was classified in the *'Corpus Iuris Civilis'* in Justinian's period. To that effect, the notions of *furtum*, and *rapina,*[6] gave birth to criminal acts such as theft and theft with violence, as well as lesser criminal or civil wrongs e.g. *iniuria* and *damnun iniuria datum.*[7] The first contains the foundations of what nowadays in known as libel and slander in common law. The second consists of damage caused unlawfully[8]or in other words the source of that liability which could not find its cause neither in a contractual relationship nor in a *delict strictu sensu.*
The most important set of rules in respect of extra-contractual liability are found in the *Lex Aquilia* which gathered all the principles surrounding the theory of unlawful damage in one body, therefore contributing to the development of what is today tortious liability. This piece of legislation introduced concepts such as *damnun, iniura, dolus* and *culpa* which gave rise to the general requirements for this type of responsibility to arise. Its novelty is represented by the introduction of the concept of loss or financial loss *'damnun'*- albeit in a very peculiar sense[9]- arising as a result of culpable conduct *'iniuria datum'* which could be either deliberate or negligent.[10]
Furthermore, the victim of a damage could recover additional losses or incidental to the damage *'Damnum Emergens'* and all the profits he had been prevented from

[5] Taylor, op cit at 567. It is thought than roman delictual law contained traces of earlier systems inspired in the idea of revenge or vengeance. It is clear though that revenge is a personal matter thus actions could not be brought against the heirs of the offender.
[6] For a complete explanation see Barry N, *An Introduction to Roman Law*, Oxford, 1965 at 211.
[7] Barry, op cit 215-218.
[8] Taylor, op cit
[9] Daube, *Aspects of Roman Law*, Edinburgh, 1969 at 66: one would expect the agent of a damage.." to have to pay not the full value but only the difference between that and the reduced value after interference; plus expenses for cure, repair and the like".
[10] Barry, op cit at 218.

obtaining as a result of it *'Lucrum Cesans'*.[11]

Since an early stage it has been accepted that the notion of damage has to be connected or associated with an activity which may result in being contrary to the Law and imputable to the presumed agent of the wrong. From theses precepts three basic principles arose. Firstly, there must be an activity carried out by the agent of the wrong. This principle has evolved as to include omission as well as actions. Secondly, such activity must be unlawful, giving rise to concepts such as *dolus* or wrongful act maliciously executed and culpa which is close in meaning with the notion of negligence nowadays. Thirdly, the wrongful act must have the effect of producing damage to the claimant.[12]

These logical and simple rules of law were the foundations of contemporary requirements for civil liability to arise. In achieving the aim of this research, the following paragraphs address such conditions from the directors and the officers' perspective.

7.2. Directors' and Officer's Contractual Liability: Requirements

It is well accepted that the relationship existing between the company and its directors is a complex one; as in England there is controversy in respect of whether it is organic, managerial or purely contractual, although the preferred view is that the main feature is *mandate* or agency. One theory is that the relationship is *sui generis*, flowing from the requirement of company law for a managerial organ the existence of which makes it possible for the company to achieve its objectives. A second group of theories avoids the organic notion and prefers the managerial approach nevertheless, by nature and definition both theories seem very much alike.[13] What is important to emphasise is that less developed jurisdictions continue to assess directorship as purely

[11] Taylor, op cit at 567. Additionally see Spanish Civil Code article 1106, Venezuelan Civil Code article 1196.

[12] Upon these legal precepts, Civil Law system has built up the whole structure of extra-contractual liability. To this regard see French Civil Code articles 1382 and 1383. Venezuelan Civil Code article 1185 and BGB 823-853.

[13] Perez Carillo, *La Administracion de la Sociedad Anonima*. Marcial Pons, Madrid, Spain, 1999 at 71.

contractual, deriving from the notion of mandate.[14]

It could be suggested that all of the acts carried out within the limits of the power conferred by the mandate, on behalf of the principal, produce legal effects either to the benefit or to the detriment of the latter. Hence, in exercising such activities directors do not undertake or assume personal obligations since it is the company itself which acts through this compulsory organ. Consequently, it is when directors either exceed or –negligently or fraudulently- fail to exercise their powers or duties, that contractual principles make them vulnerable.

Irrespective of the approach taken, it is a fact that there exists a contractual relationship between the director and the company; within this context, the director is compelled to follow a number of different sets of rules. Firstly, he must follow those specifically applicable to the contract of mandate and the general principles of contract law. Secondly, there are the compulsory contents of the articles of association which are binding on directors, shareholders and the company. Thirdly, there are statutory provisions contained in commercial codes and statute laws. Fourthly, the director is subject to the general duty of care known as tort, *quasi-delict* or *hecho ilicito* depending upon the jurisdiction's adopted principles and languages.

7.2.1 Acts or Omissions

There are four cumulative requirements for a director's liability to arise, these are present in one way or another in any of the sources mentioned above. These are: an act or omission, damage inflicted, a link of causation between the act and the loss, and the criterion of culpability which denotes either the level of *dolus* or *culpa* characterising director's conduct.

Civil law recognises that directors' duties are not obligations to produce a given result for the company, for although directors are required to use their best endeavour in achieving company's aims there is no liability for not achieving those objectives.[15]

[14] Few examples are: Venezuelan Commercial Code article 243 and article 157 of Mexican Ley General de Sociedades Mercantiles.
[15] To this respect French Civil Law as much as the vast majority of jurisdictions, draws a line between

This distinction is of a major relevance for the purpose of assessing the level of diligence demanding in the execution of a director's duties. In this respect *culpa* as a concept is not univocal; in fact where one's duties feature an obligation to achieve a result the test raises the standards of diligence, making the doer liable for *culpa levissima* which – as mentioned above- reflects the idea of the best *pater familiae*, or a person whose skill and care have to be compared to that of an organised and competent business man, in other words the test tends to be subjective. Conversely, if the obligation is '*de moyens*' the level of diligence decreases as to be compared with the skills of a normal person, [16]forcing the application of an objective test.
Research of the present type is not suitable for listing exactly what directors must do in order to comply with their duties; additionally, jurisdictions tend to be casuistic on this regard, impeding accuracy in outlining them all. What is clear is that in general such duties belong to one of the following groups:[17]

- Stated or enacted Duties. To this group belong the vast majority of directors' duties which are mainly concerned with the protection of company's capital. Thus civil jurisdictions are of the view that these sorts of obligations are of a mandatory compliance or *'orden publico'* preventing the parties from departing from their compulsory application. Within this group could be found all the norms governing raising and reducing capital, accuracy of payments made in cash by shareholders, the existence of actual dividends, accounting, insolvency, taxing, stock exchange regulations etc. Contravening these rules of law leads to strict liability, which is crucial to asses, the requirement of culpability and subsequent insurability.[18]
- Duties arising from the articles of association. They usually complement statutory provisions but are not to be regarded as attempts to modify the minimum legal standards permissible; for example the articles might increase the required legal quorum needed to call for a general meeting, or the director's guarantees to hold office or establish the board of director's

what they know as obligations de moyens et des obligations de resultat.
[16] Infra Culpability: *Dolus and Culpa.*
[17] Perez Carillo op cit 123-131.
[18] In France for example if the rules result in being imperative, liability arises immediately upon the infringement irrespective of any loss that has resulted. See Campbell op cit at 283.

structure and number. Failing to comply with these duties is comparable -as to their effects - to breach of statutory duties.

- The duty of care in exercising directorship. Although this issue is dealt with below, it is worthy of mention here that civil law jurisdictions seem not to apply the same test of diligence; these range from the very demanding systems mainly in continental Europe, to less severe in Latin American ones.[19] From this class of duties arise amongst others, the specific obligations of loyalty, confidentiality and absence of conflict of interest.
- Complementary duties, such as: executing shareholder's general meeting decisions. Now, whether or not directors are under any duty to accomplish general meeting decisions is a matter for debate. What could be said is that it is generally accepted that a director might discharge himself from liability in executing an unlawful general meeting decision by recording in the corresponding minutes his non-conformity and giving subsequent notice to the company or auditor (if any).[20]

It is easy enough to appreciate that liability might arise either by acting in contravention to the law or by being at fault in not doing what it demanded.[21]Unlawful acts or omissions are thus the triggers of the right of indemnity; the key point – and that which is of concern to D&O insurance – is the nature of such act or omission which could be malicious, innocent or negligent, the first of these being unsuitable for insurance.[22] Yet, liability might arise – in the terms expressed above- irrespective of director's state of mind where mandatory provisions are not observed.

7.2.2 Culpability: *Dolus* and *Culpa.*

As well as an act or omission on the part of directors, it is necessary to demonstrate that such action has been the result of an unlawful conduct; hence, proving *dolus*,

[19] Infra Culpability: *Dolus and Culpa.*
[20] Venezuelan Commercial Code article 268; article 178 of Peruvian Law No 26.887; article 159 of Mexican ' Ley de Sociedades Mercantiles'; Brazilian Law No 6404 article 165, amongst others.
[21] Article 2391 of the newly reformed Italian Codice Civile on companies and cooperatives. " Director are liable for all damages inflicted upon the company by reason of their acts and omissions".
[22] Public Policy restrictions impede the likelihood of recovering upon director's own misconducts.

culpa or contravention either of stated law or the articles of association, might be the only possibility of making them responsible.
It has been already ascertained that a director's duties in regard to the company do not impose obligations to achieve results for the company. Also the criterion of culpability either by *dolus* or *culpa* is of less significance where mandatory rules or the articles of association have been ignored, due to the fact that the test might be objective, irrespective of fault.[23] Within this last scenario breach of duty is proved just by failing to comply with the law[24] and the company does not bear the burden of proving carelessness.[25] Conversely, where the company's allegations are founded on the general duty of care -other than that of breach of law- there is no such shift of the burden of proof; it is the company who needs to prove carelessness.

Now, directors' conduct might take the form of being intentional, wilful or fraudulent giving rise to *dolus* which denotes awareness of the wrongfulness of the action. It is generally accepted that this precludes insurability on the basis of the maxim 'nobody is entitled to benefit from his own misconduct'. *Dolus* gives rise to exactly the same sort of liability as *culpa* with the only difference of exposing the wrongdoer to criminal sanctions which depend upon the extent of the wrong.

7.2.2.1 Culpa: Test of Diligence

The issue of diligence is of major importance; in fact it is not because the applicable test is drastically different from that in England but due to the consideration that up to three different tests may be found in the Civil Law. The following paragraphs analyse the Italian, German and Latin American approaches respectively.

In Italy article 2392 of Codice Civile –as amended- provides that directors must comply with the law and articles of association and that in so doing they should

[23] This sort of liability is known as 'Objective responsibility' in civil law jurisdictions.
[24] Bolas Alfonso, *La Responsabilidad de los Administradores de las Sociedades de Capital*, Consejo General del Poder Judicial, Madrid, Spain 2000 at 48.
[25] Few exists to liability are 'force majeur' or 'hecho fortuito'; equivalent to frustration in common law and of course proving due diligence whether the company opts to allege breach of statutory provisions by carelessness.

observe the required diligence, proper nature of their functions and that of their personal skills and competence. This leads to the apparent conclusion that in order to become liable in this jurisdiction it is necessary to take into account the nature of director's functions which in the present author's view involves the structure, size and complexity of company's business; the form adopted[26] and whether it offers its shares in the public market. Hence, there cannot be a standard test since the bigger the company the higher or more demanding the test.

In Germany[27] the situation is slightly different. The 'Geschaftsleiter' imposes upon each director the duty to act as an organised and orderly businessman[28] having the obligation to use his best endeavours to promote the purpose of the company.[29] The Spanish system follows this approach and goes on to add 'loyalty in so doing'.[30] The Argentinean Ley de Sociedades Comerciales article 59 similarly provides that: "Directors and company's officers must perform their functions with loyalty and that diligence proper of a good business man. Those at fault in so performing incur unlimited joint and several liability in respect of the damage caused for their acts or omissions."[31]

The meaning of an orderly businessman could be subject to more than one interpretation; the most obvious is to be organised by keeping all company's records up to date, including accountings, tax deductions, human resources and most important investments. However, it is to some extent unclear whether being organised has something to do with efficiency in fulfilling company's expectations. It is sufficient to comment here that it could be inferred that a director might discharge liability by proving his fulfilment of that test of an orderly businessman while being

[26] Italy recognises amongst other forms of association the existence of two types of companies, la societa per azioni and di responsabilita limitata. It being in turn comparable with limited companies and a kind of closely held company in UK, respectively.

[27] It is important to say that this legal system establishes a two-tier board controlling mechanism, mandatory in those companies regulated by the Stock Corporation Act (AktG). The establishment of a two- tier board system brings out the idea of different test of diligence upon its members who are not subject to the same sort of responsibilities. In fact the supervisory board 'Aufsichtrat' is susceptible of incurring *culpa in commitendo, eligendo* and in *vigilando* by not exercising its supervisory functions or by failing to appoint a reasonable competent director. The same principles might apply in France where a company can optionally adopt a two-tier system : directoire and conseil du surveillance.

[28] Fernandez del Moral, *El Seguro de Responsabilidad Civil de Administradores y Altos Dierectivos de la Sociedad Anonima (Poliza D&O).* Comares, Spain, 1998 at 82.

[29] Campbell, *International Liability of Company Directors,* LLP 1993, at 300.

[30] Spanish Ley de Sociedades Anonimas art 127.1 "directors will execute their duties as diligent business men and loyal agents".

[31] In Uruguay, article 80 of Law 16.060 in the same terms adds "the judge will decide how directors might contribute to indemnify the victim, had it been more then one responsible".

deficient in holding office.

Less developed jurisdictions base the diligence test upon the grounds of 'mandate' in the terms expressed above. In Venezuela[32] for example the relationship between directors and the company is ascertained by the wording of article 243 of the Commercial code, which provides:

"Directors do not respond but for the execution of the mandate and all the obligations imposed thereupon; they do not undertake by reason of directorship personal obligations. They cannot do any other operations than those expressly established in the articles of association, in case of transgression become personally liable not only to third parties but also to the company".

By defining the relationship as one based on 'mandate',[33] the law has the effect of applying to directors the general principles governing contracts and the specific rules applicable only to agency agreements.[34] Technically speaking the diligence test is that of a reasonable person *'bon pere de famille'* not required to do more than is expected for an average person. How does this affect a director's potential liability? The answer is that the law does not rely on company's structure, organisation, size or form to demand higher skills or competence. This is why it is commonplace to find in articles of association a good deal of detail as to the level and features of a director's duties. What is important at this stage is that basing a claim on these grounds shifts the burden of proof upon directors – in the terms expressed above- who will have to demonstrate due care and skill to avoid responsibility.

From the above analysis the notion of *Culpa* could be defined as: the omission or inobservance of that due care and skill demanded - in accordance with the nature of the obligation- which result in being unlawful and/or injurious to a third party.[35]

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[32] See also Mexican Ley de Sociedades Mercantiles article 157. Colombian Commercial Code article 200. Brazilian Ley 6404 /1976 article 165 and Peruvian Ley 26.887/ December 1997.

[33] It is a well established principle of company law that even though the contract of mandate seems to be the remote source of this sort of relationship, this is now out of date. Many factors intervene to defeat mandate doctrine for example the fact that this contract, being gratuitous in nature lost this feature by becoming onerous, additionally once appointed directors are autonomous in taking decision in which the company by its own is unable to intervene.

[34] Article 157 of Mexican "Ley General de Sociedades Mercantiles" follows this approach by expressly establishing "Directors will bear of the responsibilities arising out of their mandate, the Law and articles of association".

[35] Galan Corona and Garcia-Cruces, *La Responsabilidad de los Administradores de las Sociedades de Capital.* Tecnos.Madrid. Spain.1999. p 96-97

Consequently, directors as 'mandataries' are responsible for *culpa* in the execution of the mandate[36] and such liability could take the form of *"culpa in contraendo, in eligendo or in vigilando"*.[37] *Culpa in contraendo* means carelessness in the performance of the duty, so that whenever directors do not exercise the level of care and skill demanded in the performance of their obligations there is a breach of duty whereby personal liability arises. It does not mean that directors do not have certain freedom in taking decisions and acting thereupon, the business judgement rule or *scelte di gestione* as understood in Italy, [38]allows directors to avoid liability just by mere undesirable errors resulting in losses to the company. Thus wrongful appreciations of certain activities or market fluctuations do not lead to negligence in terms of culpa. Furthermore, there is a possibility of delegating functions, and on some occasions delegation is compulsory. Roman law liability principles – *"culpa in eligendo"* – refer to the liability a director might incur by wrongfully choosing either an incompetent or inexperienced person to perform the delegated activities. Moreover, directors are not excused from vigilance once an appointment has been made: this is referred to as *"culpa in vigilando"* whereby directors are at fault by failing to inspect and scrutinise those in whom certain functions have been vested.

2.2.2 Sharing Blameworthiness

It is a well-known feature of civil law jurisdictions that the directors' joint liability is presumed unless one or more of the directors refrain from participating in the wrongdoing and record their disagreement in the general meeting minute. This issue is very important for the effectiveness of an insurance cover and subsequent allocation.

A number of civil law jurisdictions adopt this approach, for example Argentinean article 59 Ley de Sociedades Comerciales 19.550 which provides that: "...those *directors* at fault in carrying out their obligations are unlimited and jointly liable for all the damages resulting due to their acts or omissions" (emphasis added). [39] In the

[36] See Venezuelan Civil Code article 1963 for example.
[37] Galan Corona, op cit at 111.
[38] Fernandez del Moral op cit at 89.
[39] Article 83 of Uruguayan Ley 16.060 follows the same approach, as well as article 266 of the

same context Italian Codice Civile article 2392 – as amended- goes on to add that such presumption is not applicable in those cases where the execution of a duty has been delegated to one or more directors who in turn are the only ones to blame. Presuming unlimited and joint liability might affect the board as a whole unless the following steps are taken:

- The director who successfully prove his lack of participation in either the decision-making process or its execution.[40]
- Those who are aware of the wrong used their best endeavours to prevent the damage or at least to contest the wrongful act.[41]
- Had the director been present in the general meeting in which the unlawful decision – leading to subsequent damage- was taken, he is liable unless his disagreement is recorded in the respective minute.[42]

7.2.3 Damage: Pecuniary Loss

It has been emphasised that financial loss – *damnun* suitable for compensation - by the *Lex Aquilia*; has to be shown, failing which civil liability cannot arise; such damage can take a variety of forms, including bodily injury, death, personal property damage and third party patrimonial loss. If the loss is to be recoverable under a D&O policy, it must be financial[43] and suffered by a person other than the director himself. As far as contractual liability is concerned, that person must be the company who can recover either *'damnum emergens'* and *'lucrum cesans'*, since there is no contractual relationship between directors and either shareholders, creditors or third parties by means of directorship. There is no possibility of a director incurring contractual liability other than to the company; other persons can claim only on the basis of extra-contractual liability.[44]Consequently, the *locus standi* rests upon the company, who exercises – through a decision of the general meeting[45] - the action,

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Venezuelan Commercial Code.
[40] Bolas Alfonso, op cit at 52.
[41] Italian Codice Civile article 2392.
[42] Venezuelan Commercial Code article 268;
[43] Bolas Alfonso, op cit at 45: it is suggested that damages might be suitable of measuring in money without excluding damages to morality, privacy, secrecy.
[44] Infra: Director's Extra-Contractual Liability.
[45] Spanish op cit article 133.1

usually known as 'social', by means of new or unaffected directors, a required quorum of minority shareholders[46] or creditors in case of company's insolvency.[47]

7.2.4 Causation

It is a *sine qua non* requirement for contractual liability to arise that there is a causal link between the director's conduct – wrongful or negligent act or omission- and the inflicted damage. This is not a principle applicable only to directorship and extends to civil liability generally and is based on the assumption that the immediate cause of the damage has to be the agent's act or omission. Hence, this principle might exclude remote, non-related or indirect financial loss.

7.3. Director's Extra-Contractual Liability

Civil Law jurisdictions – contrary to English legislation- do not hesitate in recognising the possibility of directors incurring personal liability to shareholders or third parties. On the contrary, the vast majority are clear as to that possibility. For example, the Italian Codice Civile, article 2395, establishes individual actions either for shareholders or third parties enabling them to seek indemnity for loss suffered as a result of the director's wilful or negligent conduct; in the same way, article 266 of the Venezuelan Commercial Code states that: "Directors are jointly liable to shareholders and third parties…." and Argentinean Ley 19.550 article 274 states that" directors are liable to the company, shareholders and third parties by wrongfully exercising their duties…".[48]

Obviously, the law would be incomplete if directors were able to escape responsibility by the fact that a contractual relation does not operate between the agent and the

[46] This quorum may vary according to different jurisdictions for example in Spain is 5% of share capital; in the same way Venezuelan Commercial Code article 291.
[47] French jurisdiction describes this sort of action as 'oblique' in the sense that it is not exercised directly against the wrongdoer –director- but on behalf of the insolvent company, aiming to recover from the director and put the company in better financial position as to cover creditor's interest. In Italy article 2394 of Codice Civile is even more specific by establishing that directors might respond to creditors where they are at fault in complying with any of the rules purporting to protect company's capital. They –creditors- have the *locus standi* to action when the company is insolvent.
[48] See also article 391 Uruguayan Ley 16.060 and Peruvian Ley 26.887/1997.

victim of the wrong. Certainly, shareholders and third parties are at risk in the event of directors' mismanagement; and assuming that there is not a contractual duty to either shareholders or third parties, the path to take is extra-contractual, with an action for compensation aimed at restoring – so far as is possible – the victim of a wrongful act to his original position, had such an event never happened. Therefore, in the hope of simplifying the issue, directors by means of individual actions are liable in accordance with the general or common law rule 'whoever has intentionally, recklessly or negligently caused damage to anybody is obliged to make it good'[49] which means, generally speaking directors do not escape from incurring extra-contractual or *Aquilian* liability in the terms expressed above.

It is important at this stage to say that this sort of liability requires proof of the same requirements expressed supra: act or omissions, culpability, damage and link of causation. As far as D&O cover is concerned, the director must have acted in his capacity as such and not in some private capacity.

The claimant in any case might have the choice of pursuing an action against either the company or its directors and this might lead to issues of insurance coverage. The further question is whether it is possible to allege that by exceeding their powers directors can assume personally, liability which replaces that of the company? If the answer to this question is yes, D&O insurance has no role to play at all; directors' liability will have been incurred not in any capacity as directors but rather as a primary personal liability. By contrast, if the company due to vicarious liability principles become liable to a third party, it automatically follows that the director was acting in his capacity as such since liability can only arise by reason of the acts of company's representatives whereby it is proved the wrongdoers' capacity of being a director.

7. 4. Officers Liability

It is a common practice in the English market to insure both directors and officers

[49] Venezuelan Civil Code article 1185; Spanish Civil Code article 1902; BGB 823 and 826; French Civil Code article 1383.

under the same policy, on the assumption that the source of their liability is identical; to this extent US practice follows the same idea. This tradition is now accepted worldwide, although it remains a matter of debate and it has been an erroneous or careless translation of foreign insurance policies.[50]

In Civil law jurisdictions directors and officers might not be exposed to the same types of personal liability. Whilst directors by reason of a contractual -mandate- relationship with the company face liability in contract as well as tort, to say nothing of the criminal law, a company's officers without representative functions or powers enter into a different sort of agreement usually governed by employment law which might trigger principles surrounding vicarious liability.[51] This sort of relationship is characterised by the subjection or subordination to the authority of the company, exercised by the board of directors;[52] instead of being at board level, officers are lower in the corporate hierarchy.[53]

Generally speaking, officers are those to whom company's directors delegate certain managerial functions and usually they are in charge of the practical execution of the board of directors' decisions. This, however, does not mean that they could not play a role in the decision-making process; for example the opinion of a sales manager could be crucial as to expansion or new undertakings. It is commonplace to find directors exercising a dual function: on one hand forming part of the board; and on the other executing its decisions. Executive directors clearly operate in this way. Thus far no problem arises in assessing a director's liability either in contract or tort since being a member of the board qualifies the nature of their relationship as contractual, more specifically by reason of a 'contract of mandate'.
Conversely, directors[54] might delegate, in its entirety, the day to day managerial activities to non-board members who belong to one of the following groups:

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[50] Roncero Sanchez, Antonio, *El Seguro de Responsabilidad Civil de Administradores de una Socieadad Anonima. (Sujetos, Interes y Riesgo)*. Aranzadi, Spain 2002 at 166.
[51] This is the approach in almost all civil law jurisdictions see for example, article 1903 of Spanish Civil Code, article 1983 of French Civil Code, Venezuelan Civil Code article 1191 and BGB 831.
[52] Campbell, op cit at 445. The author emphasises the Italian approach on this regard.
[53] Mairal, *D&O Insurance Under Argentine Law*. [1997] Int I.R.L 170: This is the approach of Law 20,744 of 1974 as amended in Argentina.
[54] Directors who are not involved in the execution of board's decisions form a part of those known as non-management or non-executive directors.

- Officers with representation powers and/or effective participation in the decision-making process such as executive managers or companies' *factors*.[55]
- Officers without such representation or participation such as sales, personnel or branch managers.

Now, belonging to one or other category ascertains the nature of the duty owed to the company and therefore that of potential liability to the company. The first group might not represent any problem since in nature they could be compared to what English law classifies as officers, thereby imposing on them the same sort of contractual liability in the form of mandate. To this extent, officers with representation powers could face liability to the company either by failing to exercise due care or for wilful or fraudulent misconduct; and to third parties by exceeding the limits of the power conferred or by performing an unlawful act, whereby a damage is caused to the latter.

However, the same argument does not cover the second group, in fact acting without representation powers places this type of director into a pure labour relationship, preventing the application of general mandate contractual duties to the company and reducing the likelihood of incurring personal liability to third parties.[56] It may be that liability insurance is largely pointless here and that this group of employees does not match the English concept of officers.

Consequently, despite the insurable subject –matter still being the same –directors' and officers' liability- the wrongful act triggering such responsibility finds its roots in different sorts of law, thus impeding the application of equivalent tests of liability. As far as insurance is concerned, the primary obligation to indemnify different assureds might not arise on the same basis since the nature of liability is distinct. It will thus be necessary to individually assess director's and officer's liability with the result that some of the officers might not match the definition of who is the assured under a standard D&O policy wording. This issue has led most of Latin American countries to adopt very wide definitions of 'directors' with the sole objective of finding suitable insurance coverage; to this extent certain managers and board deputies are deemed

[55] Legal expression used in civil law system to describe a person who by means of a specific mandate manages any enterprise on behalf of the principal. Within this context the company would be the principal. See for example article 94 of Venezuelan Commercial Code.
[56] Roncero Sanchez, op cit 166-181.

as directors.[57] However, it might be suggested that the position of being a director must be ascertained by a functional test and not by mere title and within this context reinsurers for example could successfully challenge the assured's capacity as not matching that of the person covered.

The purpose of the present discussion is justified by obvious issues of law concerning, *inter alia*, types of cover, the right to indemnity and reinsurance.[58] It is clearly the case that under civil law principles some officers owe to the company duties governed by labour law and as a result the company is potentially vicariously liable. It is less certain that a standard 'Side A Cover' offering protection for directors and officers will apply to all persons stated to be directors and officers by the company itself. This leads to the question, , to whom does a 'Side A' policy offer protection?
The author's view is that 'Side A' cover, even 'Side B' or company' reimbursement cover could be ineffective in regard to wrongful acts committed by company's officers acting without representation. This is so because, firstly, director's cover –as defined above - does not embrace such officers; secondly, while 'Side B' cover offers reimbursement to the company for all the moneys paid to its directors and officers resulting from the latter liability, it will not cover moneys paid by the company to third parties as a result of vicarious liability.

Hence, a company might find itself unprotected by taking out a standard D&O policy for wrongful acts of part of its managerial staff. This problem is seemingly solved by offering to the company 'Side C' cover which -as analysed above - provides financial protection to the company in regard to its own liability; to this extent all the sums payable to third parties as a result of being vicariously liable form part of the subject-matter covered. However, it is a well established principle of civil law that a principal or employer is entitled to claim back from employees or factors all indemnities paid to third parties resulting from their conduct. This is a risk which by its nature cannot be covered by a third party insurance since its features are those of a first party loss. Would it be necessary to take out a further EPL cover? Or possibly a Fidelity Policy?

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[57] www.risktransfermagazine.com/xp/asp/sid.0/articleid.
[58] As the issue mainly concerns with clause interpretation for the purpose of reinsurance, it is covered in Part III under the heading 'Insuring clause interpretation and Definitions'.

On the insolvency of employees or factors they will be incapable of meeting the cost of reimbursing the company, leaving the company without financial protection. The market has – as explained above- developed Employees Professional Liability[59] cover, a blend of first party and a third party insurance, to protect against this form of loss. Now, if it is the case that wrongful acts on the part of officer without representation may lead to first party loss, the obvious cover is a Fidelity Policy which by nature is a first party insurance. One could argue that a company is in any case protected by a Side A cover if it is successfully proved that its directors were at fault in exercising due care and diligence in delegating and supervising company's employees; hence incurring culpa *in eligendo* and *in vigilando,* making them responsible. Yet the issue here arises when such fault cannot be proven as link of causation, resulting in the company finding itself without insurance protection, for the above reasons.

7.5. Conclusions

The aim of this chapter has been to address the question of how directors and officer's civil liability in civil law jurisdictions may arise, in order to ascertain the effectiveness of D&O policies and their reinsurance. It has been argued that mere translations of what is meant by Directors and Officers into civil law jurisdictions and their liability, might result in difficulties ; as to the variety of rules and differing tests of diligence and as to the possibility that direct liability can be incurred to third parties in a manner not recognised by English law.

A number of conclusions are readily apparent:
In regard to the circumstances in which a director or officer could face liability under Civil Law:

- Civil law jurisdictions recognise the possibility of incurring both contractual and extra-contractual liability. The first possibility arises only in relation to the company; the second is the source of liability to third parties including shareholders. This position - as noted earlier- contrasts to some extent with English company law under which a director's personal liability to third

[59] Supra Chapter IV: Directors' and Employees' Dismissals

parties - apart from very specific circumstances such as assumption of responsibility and fraudulent misrepresentation - is uncommon.

- Civil Law Jurisdictions impose contractual liability on directors in respect of deliberate, wilful or negligent breach of duty on the basis that directorship is a contract of mandate between the company and its directors. This point dramatically contrasts with UK legislation where that relationship is by nature mainly fiduciary and not based upon a contractual agreement, albeit there could be a contract of employment between the company and its directors.

The nature of Liability:

- As aforementioned, director's liability – contractual or extra-contractual- could be *dolosa*- deliberate or fraudulent- and *culposa* - negligent or even reckless- and if such wrongful act inflicts damage, a remedy is available. More or less, the same approach is followed in England or at least the rationale behind these concepts appears to be the same. In this context issues of public policy and insurability might prevent insurance irrespective of the jurisdiction at issue.
- Liability could arise irrespective of fault by breaching the law or articles of association, leading to the situation of having to prove director's state of mind if insurers want to avoid liability.
- *Culpa* as a concept might have more than one meaning and the test of assessing it may vary. It has been shown that some jurisdictions – mainly in Europe- impose different tests, impeding to some extent harmonization in this field. English law might be moving – in accordance with section 214 of the Insolvency Act 1986- and the decision of *Re Baring Plc (No 5)*[60] towards a stricter test in harmony with its neighbours. What may lead to certain confusion is the fact that less developed jurisdictions still attribute to directorship the most basic form of negligence, which as explained, impedes standardization. This feature is of major relevance; in fact reinsurers might have to take into consideration that, what could lead to liability in some jurisdictions might result in directors not being liable in others, including

[60] [2000] 1 B.C.L.C 526

England. This makes it difficult to find a counterpart so as to interpret and enforce the contract of insurance.

Do English wordings cover these sorts of liability? and are they appropriate?

The issue here is basically to consider if a standard D&O policy might face difficulties in Civil Law jurisdictions. This problem is the subject matter of the last chapter,[61] but at this stage it might be commented that there are at a number of issues for debate:

- The notion of director for the purpose of defining the insured under the policy. It is suggested that frequently Latin American jurisdictions tend to be casuistic and write extensive articles of association with the intention not only of delimiting directors' duties but also determining who is to be deemed a director. With regard to Officers, insurers may successfully challenge their obligation to provide an indemnity by reason of not being able to find a counterpart for the expression 'officers without representation' in the English legal system. Additionally, officers' liability might not correspond to the notion of liability to third party, so that the effectiveness of a third party insurance cover in this scenario could be challenged as well. The exact construction of the Insured v. Insured exclusion could be also a matter for debate.
- Since the relationship 'company-director' is contractual –mandate - the exact construction of the exclusion 'Liability in Contract' analysed above, needs clarification. For the purpose of effectiveness in civil law jurisdictions, this clause must be interpreted as excluding contractual liability between either the company or its directors and third parties; and not the relationship between the company and its directors. Otherwise D&O policies containing this exclusion would be no more than useless sheets of paper in this legal system.
- One of the major features is the possibility of directors incurring extra-contractual liability to shareholders and third parties. This, from both insurance and reinsurance perspective, is something to be considered as an

[61] Chapter X: Reinsuring D&O Policies.

influence not only on the premium or deductible calculations but also on the assessment of the risk itself which apparently is larger.

- The presumption of unlimited and joint liability amongst members of the board might give rise to complicated insurance issues, for example, allocation when the board is not insured as a whole or where directors take different policies with different insurers.

CHAPTER VIII

D&O: DEFENCE COSTS COVER AND ALLOCATION

The relationship between liability insurance and defence costs insurance is a close one; in fact, at the beginning of the twentieth century, some German scholars were of the view that liability insurance was no more than a sub species of defence costs insurance, due to the fact that liability insurance assisted the insured in as much the way as defence costs cover did, against the costs of meeting liability to a third party. This approach motivated further research to draw a clear line between these two sorts of insurance.[1] The nature of a D&O policy and the reason for its development is such that its function is primarily to offer financial protection to directors and officers and not to the corporation itself for its liability or defence costs in contesting liability.[2] Now, some jurisdictions are of the view that liability insurance cover embraces defence costs cover unless the parties agree otherwise. This is for example the approach taken in Spain where article 74 of the Insurance Contract Act establishes: "unless otherwise agreed, the insurer will undertake the conduct of proceedings against the victim of the wrong and it is accountable for the costs arising as a result..."

This form of cover is thought to be of major importance to both the assured and the insurer, in that assureds are guaranteed that they could have access to good lawyers to contend or settle the claim where the company does not come to the rescue. On the other hand insurers benefit in the sense that this fund may help directors to successfully contest and avoid liability for which the insurer would be accountable. Defence costs cover has become, if not the most important, one of the key aspects of D&O insurance. Having regard to the narrow context within which this sort of insurance cover operates, it is possible to say that the role of D&O as to defence costs is so crucial that it has motivated some practitioners in this field to believe that this is the real financial fear of company's directors.

Some questions arise to this regard, which chapter VII purports to answer. The key issue is whether defence costs cover is offered as independent undertaking or as

[1] Becker, *Der Einfluss der Haftplichtversicherung auf die Haftung. Frankfurt* (Oder) 1996 pp 30-31 in Roncero Sanchez, *El Seguro de Responsabilidad Civil de Administradores de una Sociedad Anonima (Sujetos, Interes y Riesgo).* Aranzi. Spain 2002 at 79.

[2] Unless Entity cover in the terms expressed above is agreed.

forming part of the core insuring clause. The answer to this question is fundamental to the operation of D&O cover; if defence cost cover is offered independently, the fact that insurers are able to avoid providing an indemnity under the main insuring clause may not affect their liability for defence costs. This demands consideration of the nature of the wrong which gives rise to the third party's claim and the nature of the insuring clause and the defence costs cover.

Secondly, the issue of allocation of legal costs has proved to be of immense significance for insurers and practitioners. The questions of what portion of defence costs should be allocated between insured and uninsured directors, what portion should be allocated between insured directors and the insured company if the insurance offers entity cover and how defence costs are to be apportioned between insured and uninsured claims all arise frequently in practice.

8.1 Defence Costs Cover: One or Two Different Undertakings?

Usually D&O policies offer cover not only to meet a director's or officer's liability but also to provide financial assistance in respect of the costs of defending such liability. This is the result of being a liability policy which usually imposes upon insurers the obligation to meet the costs of defence without waving their rights to recover from the unsuccessful third party, in accordance with well established principles of subrogation.[3] Nevertheless, this sort of cover is far from being a straightforward agreement. One or more of the following issues of law might complicate the entire scenario:

- Is the assured entitled to recover under the defence costs provisions of the policy regardless of the fact that the liability claim is legally or expressly excluded e.g. fraud, dishonesty, pollution[4] etc?
- Is the assured entitled to recover in any event when the insurer decides to contest the claim against the director?
- Is the assured entitled to recover defence costs when the insurer wrongfully repudiates its liability?

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[3] Merkin, *Colinvaux's and Merkin's Insurance Contract Law*, Sweet & Maxwell at 20733

[4] Parsons, *Directors' and Officers' Liability Insurance: a Target or a Shield?* (2000) 21 Co Law 77 at 80. Albeit it is possible for claims connected with pollution and environmental damages to offer defence costs cover only.

- Is the assured entitled to recover when the insurer forces a settlement and an admission of liability on the director?

Turning to the first point and obviously one of the most important, it is necessary to ascertain if the policy covers on the one hand directors' and officers' liability for wrongful acts and on the other defence costs incurred in contesting such liability. This may depend upon whether liability and defence costs coverage form a single undertaking which might prevent recovery in both cases, when the claim is excluded from the insuring clause; or whether the defence costs cover is independent and separately enforceable.

In *Wyeth v. Cigna*[5] the Court of Appeal was of the view that, in the absence of clear wording to the contrary, the obligation to indemnify the insured for defence costs only arises when the claim against the latter falls within the terms of the primary insuring cover. Applying this reasoning in the D&O context gives the result that insurers would be bound to indemnify for defence costs only if the claim for damages for a wrongful act is , unequivocally covered and is not tainted by fraud or any other agreed exclusion and does not fall outside the relevant period of insurance. This outcome would not always be satisfactory in the sense that directors or officers might find themselves without defence costs cover purely because the claimant has based his/her plea on uninsured grounds despite the fact that the nature of the wrong was covered in the first place. It is the author's view that the enforceability or otherwise of an insurance agreement could not simply depend upon the way in which the claimant chooses to put its claim. If insurers, following recent decisions are entitled to assess the nature of the wrong in order to repudiate liability[6] irrespective of how the claimant has framed the plea as to attach to the policy, assureds would be placed in the disadvantageous position of not having the right to establish that the claim was in fact covered and thus no right to recover defence costs.

As highlighted in *Wyeth*, the parties are free to agree that the right to recover defence costs may arise whether or not the claim unequivocally falls within the scope of the insuring clause.

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[5] [2001] Lloyd's Rep. I.R. 420
[6] *MDIS v. Swinbank* [1999] Lloyd's Rep I.R 98.

In *Thornton Springer v. NEM Insurance Co. Ltd*[7] the insurance policy provided as follows: "Underwriters shall in addition indemnify the assured in respect of all costs and expenses incurred with their written consent in the defence of the settlement of any claim made against the assured which falls to be dealt with under this Certificate..".[8] It was decided that as long as the third party claim is capable of falling within the policy and the insurer's consent is given; such a clause is activated providing its benefits to the assured. Colman J went on to say " in order to ascertain whether the claim is in substance within the scope of the insuring clauses it may be necessary to investigate what basis of the claim really amounts to, as distinct from the manner in which it is expressed in the claimant's pleadings...".[9] In *Poole Harbour Yacht Club Marina Ltd v. Excess Insurance Co*[10] Thomas J held that the claimant was entitled to an indemnity in relation to the costs and expenses in absence of express exclusions in regard to such costs and expenses. Despite the fact that the policy contained three different sorts of indemnity, its exclusions applied in relation to the entire coverage and they were not relevant to the defence costs cover. Additionally, this policy provided separate cover for sums resulting from the assured's liability to third party and defence costs incurred in contesting it with the written consent of the insurer. Thomas J was satisfied that the insurer had given consent so as to activate the defence costs cover and he went on to decide that in construing a policy in these terms, the insurer is bound to provide indemnity for defence costs where the assured's liability arises in connection with any activity as described in the policy albeit the claim is apparently not covered in the first place. If this reasoning is correct, its impact in regard to D&O policies would be very significant indeed. Directors and Officers might be entitled to indemnity under the defence costs provisions of the policy where the third party's claim arises in connection with an activity carried out in their capacity as directors or officers of the company, regardless of the fact that the claim alleges fraud or an excluded peril. This is the rationale for obtaining, as condition precedent for the provision of indemnity, the insurer's consent for costs to be incurred, where by taking control and being informed the latter can asses in advance the claim and either agree to provide indemnity or challenge it.

[7] [2000] Lloyd's Rep. I.R 590
[8] Ibid
[9] Ibid.
[10] [2001] Lloyd's Rep I.R 580

One of the leading policies in the market seems to follow the above approach, in fact Lloyds form LSW 736 under the heading definitions section (g) establishes:

" 'Costs and Expenses' shall mean all reasonable and necessary fees and expenses incurred by or on behalf of the Directors or Officers with the written consent (such consent shall not unreasonably be withheld) of Underwriters resulting solely from the investigation and/or defence and/or monitoring and/or settlement of any Claim and appeals therefrom.

(i) Underwriters shall also pay on behalf of the directors and Officers, Costs and Expenses arising out of the prosecution (criminal or otherwise) of any Director or Officer or the attendance of any Director or Officer at any official investigation, examination, inquiry or other proceedings ordered or commissioned by any official body by reason of a Wrongful Act.

(ii) Underwriters shall also pay on behalf of the Company, Costs and Expenses incurred by any shareholder of the Company in pursuing a Claim during the Period of Insurance against any Director or Officer of the Company which the Company is legally obligated to pay pursuant to an order to the court.

'Costs and Expenses' shall not mean salaries, commissions, expenses or other benefits of the Directors or Officers or employees of the Company."[11] (Emphasis added).

Once the insurer's liability to meet defence costs is ascertained, whether this contractual obligation forms part of a single undertaking or not is a matter of policy construction. The policy might provide that the insurers are to meet defence costs only after the assured's liability is established. This sort of wording could lead to the outcome that the directors have to wait until their liability is both ascertained in law and also shown to fall within the coverage provided by the policy. Furthermore, if the claim brought by the victim of the wrong fails, directors and officers might have no right to recover defence costs, on the basis that defence costs and indemnity are inextricably linked.[12]

Consequently, the question is: could defence costs cover be enforceable as a separate undertaking? The answer is very much connected with the definition of loss and whether defence costs cover has been arranged as forming part of the total aggregate

[11] Other example is contained in WWTCALL99-2002 Definitions 4. Defence Costs means that part of Loss consisting of reasonable costs, charges, fees (including but not limited to lawyers' fees and experts' fees) and expenses (other than regular or overtime wages, salaries or fees of the directors, officers or employees of the Insured Organisation) incurred in defending or investigating a Claim; Defence Costs shall also include premium paid for insurance instruments or bonds which, in certain jurisdictions, are required in order to institute an appeal".

[12] This was held in *Thornton Springer v. NEM Insurance Co Ltd* [2000] Lloyd's Rep I.R 590.

limit of indemnity which cannot be eroded or exhausted by claims based upon the core insuring clause. In *American Cas. Co. v. Rahn*[13] an American court was of the view that under the terms of the policy, defence costs were part of the defined loss rather than a separate one. In the same way, in *Helfand v. National Union Fire Ins. Co*,[14] the insured company sought indemnity under its D&O policy for proceedings commenced against its directors and officers on the grounds of securities fraud. The insurer did not contest liability with regard to the available coverage but appealed against the court's ruling that defence costs incurred did not diminish the total aggregate limit of liability. The Appeal Court, applying California law, overruled the first instance decision and held that defence costs eroded the total limit of indemnity. In *Safeway v. National Union Fire insurance Co*[15] the court concluded that defence costs paid to the claimant's attorneys as part of a settlement constituted loss and therefore were payable by the D&O carrier. It is the author's view that including the defence costs cover as part of the losses from which directors and officers could be liable and as part of the total aggregate limit of indemnity, forces the conclusion - unless the policy establishes otherwise-[16] that defence costs cover complements the core insuring clause. It does not have independent existence: on the contrary it is accessory to the main insuring clause and thus suffers the fortunes of the latter. This is the reasoning in *Thornton Springer v. NEM Insurance Co Ltd*[17] which found the defence costs clause unenforceable since the assured's liability could not be established in the first place.

This is also the approach in *Silverman v. CGU Insurance Ltd*[18] where the New South Wales Court of Appeal was of the view that a dishonesty exclusion relieved the insurer of liability for defence costs and not only for director's substantive liability.[19] In *Daniel Wilkie v. Gordian RunOff Ltd*[20]- another D&O claim- following

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[13] 854 F. Supp.492 (W.D. Mich. 1994).
[14] 13 Cal. Rptr. 2d 295 (Cal. Ct. App.1992)
[15] No. C-88-3440-DLJ (ND Cal, 30 March 1992) in Smith, *Directors' and Officers' Liability: 1992-1993 in Review*. [1993] Int. I.L.R. 371.
[16] It is possible to arrange independent cover for risk excluded by the liability insurance policy.
[17] [2000] Lloyd's Rep I.R 590.
[18] [2003] N.S.W.C.A 203 in Williams, *Triggering Indemnity for Defence Costs Under D&O Policies: Some Recent Decisions*. Becker & McKenzie. LONDOCS\2034511.02
[19] Ibid.
[20] [2003] N.S.W.S.C 1059 in Williams op cit: " If GIO elects not to take over and conduct the defence or settlement of any Claim, GIO will pay all reasonable Defence Costs associated with that claim as and when they are incurred Provided that: (i) GIO has not denied indemnity for the claim; and (ii) the

Silbermann, the New South Wales Supreme Court was of the opinion that firstly, the insurer could refuse to pay defence costs if there were grounds to believe dishonesty on the part of directors; and, secondly, defence costs formed part of a single undertaking alongside the substantive cover so that the application of any exclusion clause affected both.

8.2 Advancing Defence Costs

Having said that defence costs cover is generally regarded as accessory to the main insuring clause and that it might be enforceable only upon the establishment of directors' or officers' liability, the next question is whether the D&O carrier is contractually obliged to advance defence cost moneys to the assured despite allegations of uninsured claims.

The issue depends once more on policy wordings, of which a few examples might help. The pre-1995 National Union Policy states that: "The insurer does not assume the duty to defend: however, the insurer may and in certain circumstance must advance all or any part of such defence costs prior to the final disposition of a claim."[21] Other Insurers demand an agreement with regard to the allocation of defence costs as condition for advancement[22] and some policies may require the company to fund defence costs to its directors and officers.[23]
Now, in line with the aim of this research let us suppose there is a contractual obligation to advance defence costs to the director or officer and there is an allegation e.g. fraud which is excluded under the policy or basically the insurer is of the opinion that there are clear grounds to avoid the contract for misrepresentation or non-disclosure. Does the advance of defence costs clause bind the insurer despite liability

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written consent of GIO is obtained prior to the insured incurring such defence costs (such consent not to be unreasonably withheld)." The exclusion read: "based upon, attributable to or in consequence of (i) any dishonesty, fraudulent, criminal or malicious act or omission, or (ii) any deliberate breach of any statute, regulation or contract, where such act, omission or breach has in fact occurred".

[21] Rosenberg , Sigelko and Miller, *D&O Liability Insurance-Coverage, Liability and Advice Issues*. American Bar Association, 531-0210H. 1996 at 18

[22] Ibid at 19. Few Chubb policies are written on this basis and if agreement is not reached it is entirely discretionary for the insurer to advance defence costs until a different allocation is mediated, arbitrated or judicially established.

[23] Ibid. CNA policies work in this way and when the company does not advance defence costs e.g in case of insolvency or any lawful argument, the insurer would advance defence costs in excess of the policy retention.

needs to be established or utmost good faith issues to be addressed?[24]

In *Silbermann v. CGU Insurance Ltd*[25] the court considered this question in the context of a dishonesty exclusion. Three directors of a company in liquidation and under investigation by the financial services regulator sought a declaration that the insurer was obliged to advance defence costs in connection with such investigation.[26] The court was of the view by a 2:1 majority that the insurer could exercise its discretion not to advance defence costs if there were grounds to believe dishonesty in what directors had done. The dissenting judge was of the opinion that insurers exercising their discretion in this regard might deprive the assured of the benefit of obtaining a judgement or final adjudication. Thus, the insurer was compelled to advance defence costs and recover them after final judgement, had the directors been found dishonest. Conversely, the majority of the Court of Appeal adopted a more technical approach in construing the policy; the insurer's consent had to be obtained to trigger the defence costs cover and it appeared that such consent had not been given. This wording confirms the insurer's discretion to challenge the advancing of defence costs. However, recognising that might lead to hardship if insurers unreasonably withhold their approval thus, the majority of the Court of Appeal went on to say that they could only refuse where there were realistic grounds to believe the fraudulent nature of director's wrongful act.[27]

The Court of Appeal also decided that the insurer could seek declaratory relief that it was not required to advance defence costs on grounds of dishonesty and did not have to wait until final judgement was given. This reasoning seems to follow the decision

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[24] Williams op cit.

[25] [2003] N.S.W.C.A 203

[26] Ibid. In Williams op cit: The insurance policy provided as follows: " The insurer shall meet the Defence Costs of any Director or Officer in defending or settling any Claim made against them as they are incurred and prior to the finalisation of the Claim provided always that indemnity in respect of such Claim has been confirmed in writing by the Insurer." The exclusion was in the following terms: "This policy does not provide indemnity against any claim made against any director or officer brought about by, contributed by or which involves the dishonest, fraudulent or malicious act or omission or other act or omission committed with criminal intent to the extent that the subject conduct has been established by a judgement or other final adjudication." In regard to defence costs the policy provided: " Where the insurer elects not to take over and conduct the defence or settlement of any claim in the name of any Director or Officer, the Insurer shall meet the defence costs of any Director or Officer in defending or settling any claim made against them as they are incurred and prior to the finalisation of the claim provided always that indemnity in respect of such claim has been confirmed in writing by the Insurer. Where the insurer has not confirmed indemnity and it elects not to take over and conduct the defence or settlement of any claim, it may, in its discretion, pay defence costs as they are incurred and prior to the finalisation of ht claim, provided that it has consented in writing to such defence costs prior to their being incurred, such consent not to be unreasonably withheld."

[27] Williams op cit

in *MDIS Ltd v. Swinbank*[28] - analysed above- in that the cause of action should be assessed by its real nature and not by what the claimant chose to allege

Some decisions in the US have followed the same approach to that in *Silbermann* In *Re Kenai Corp v. National Union Fire Ins. Co*[29] a D&O policy provided for defence costs cover alongside indemnity for a director's substantive liability and the court was of the opinion that in absence of a special provision the carrier was obliged to pay defence costs only after it had been proved that the losses were covered by the policy. In *Harristown Dev. Corp v. International Ins. Co*[30] company reimbursement cover had been arranged and, under Pennsylvania Law, the court was of the opinion that the D&O insurer did not have to reimburse the company until final judgement was given.[31]

The cases are not, however, fully consistent. In *Associated Electric Gas Insurance Services Ltd v. Rigas*[32] the court held that insurers could rely upon the dishonesty exclusion only after such dishonesty had been established; it went on to decide that where the wording at issue was ambiguous it must be interpreted against insurers who purported to rely upon it to avoid the contractual duty to advance and/ or pay defence costs.[33]

More recently, the High Court of Australia in *Daniel Wilkie v. Gordian Runoff*

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[28] [1999] Lloyd's Rep I.R 98

[29] 136 B.R. 59 (S.D.N.Y. 1992)

[30] No. CIV. A. 87-1380, 1988 WL 123149 (M.D. Pa. Nov. 15, 1988).

[31] See also *American Cas. Co v. Rahn*, 854 F. Supp. 492 (W.D. Mich. 1994) and *Faulkner v. American Cas.* Co., 584 A. 2d 734 (Md. Ct. Spec. App. 1991).

[32] Civ A 02-7444, 2004 WL 540451 in Williams op cit. The dishonesty exclusion clause established: "any dishonesty, fraudulent, criminal or malicious act or omission committed or attempted with actual dishonest purpose and intent." Defence costs cover provided: "(1) The Insurer shall pay on behalf of the Directors and Officers any and all sums which they shall become legally obligated to pay as Ultimate Net Loss for which the Company has not provided reimbursement, by reason of any Wrongful Act. Ultimate Net Loss shall mean the total Indemnity and Defense Cost with respect to each Wrongful Act to which this Policy applies, provided that Ultimate Net Loss does not include any amount allocated, pursuant to Condition (T), to Claims against persons or entities other than Directors and Officers or to non-covered matters. (T) Allocation... If a Claim is made against both Directors and Officers and others, including the Company, or if a Claim against the Directors and Officers includes both covered and non-covered matters, the Directors and Officers and the Company and the Insurer shall allocate on a fair and reasonable basis any defense costs, settlement, judgement or other loss on account of such Claim between covered Ultimate Net Loss attributable to the Claim against the Directors and Officers and non-covered loss. ... If the Directors and Officers, Company, and the Insurer cannot agree on an allocation:...the Insurer shall advance on a current basis Defense Costs which the Insurer believes to be covered under this Policy until a different allocation is negotiated, mediated or arbitrated."

[33] In *Corabi v. CAN Ins.* Cos., No.C-2-87-674, 1988 WL 363612 (S.D. Ohio June 21, 1988) the court in assessing the 'option to advance' defence costs came up to the conclusion that such a wording did not impose a duty but an option to the insurer to exercise its discretion thus, it was held to be unambiguous.

Limited[34] basically removed all the possibilities for insurers to rely upon fraud exclusion clauses to deny advancement of defence costs.[35]The case concerned a typical D&O policy excluding coverage for any loss resulting as a result of any dishonest, fraudulent, criminal or malicious act or omission on the part of the assured which had in fact occurred. Exclusion 7 of the policy established the correct interpretation of the expression 'in fact' which meant a conduct admitted by the insured and/or established by judgement, tribunal or arbitrator.[36]Clause 9 also provided that the insurers should advance defence costs subject to the following two requirements: i) Insurers had denied indemnity for the claim and ii) the written consent of Insurers had been obtained prior to the insured incurring defence costs. The insured director was subject of criminal proceedings by the Australian Securities and Investments Commission and in turn, he notified the insurer and sought advancements of defence costs to assist him in defending the case.[37]
The insurers contend liability on the grounds that it was virtually proved the fraudulent nature of the insured's liability, so that exclusion 7 (referred above) applied. The High Court, in construing the aforementioned exclusion, decided that it was clear from the wording of the clause that fraud or dishonesty was only excluded if either the insured had admitted his liability or if the fraud had been established by judgement. Since none of these requirements were satisfied, the insurer could not rely upon the exclusion clause to deny the advancement of defence costs.

What can be concluded form the above paragraphs in absence of a single reported case reported in UK? Certainly, there is no real option but to suggest in line with the *dicta* in *Wyeth, Thornton* and *Poole*, alongside the Australian decisions that a result of a policy treating the substantive cover and the defence costs cover as linked each other, the obligation on the insurer to pay and/or advance defence costs to the assured relies very much –in absence of a special and unambiguous provision in the policy- upon the nature of the wrong, which as a matter of policy construction must be one to which coverage attaches. This applies irrespective of the form in which the claimant might have framed his/her claim.

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[34] [2005] HCA 17.
[35] Gregoire: United Kingdom: Can insurers rely on fraud exclusions to deny advancing defence costs? In www.mondaq.com/article.as?articleid=32469&latestnews=1&print=1.
[36] Ibid.
[37] Ibid.

8.3 Insurer's Consent to the Incurrence of Defence Costs

We have seen that as common market practice, D&O policies require the insurer's consent before the assured incurs defence costs in either defending or settling liability. The correct interpretation of this type of clause is not free from doubt. Further, it seems that whenever a policy clause requires the insurer's consent as to the incurrence of defence costs, the discretion thereby conferred should have some form of limit.

Turning first to issues of interpretation, there is plainly room for ambiguity.[38] In *Glencore International A.G v. Ryan (the Beursgracht)*[39] the defence costs clause read as follows: .... "

1) Costs incurred by the Assured shall be payable by (primary and excess) Underwriters only if leading Underwriter hereon gives written consent to the incurring of such costs in respect of any particular claim, suit or proceedings and if such costs are not covered by underlying insurance,
3) All costs incurred for claims where the total claims settlements by the Assured are in excess of the deductible, shall be for the account of the primary and excess underwriters.
4) The word "costs" shall be understood to mean investigation, adjustment and legal fees and expenses, excluding however all expenses for salaried employees and retained counsel and all office expenses of the Assured."[40]

In construing this policy wording HHJ Hallgarten QC reached a very curious conclusion, in the sense that par (1) had regard to costs incurred by the assured as claimant whilst par (3) was concerned with costs incurred by the assured acting as defendant. He went on to say "It seems to me that par. 1 seems to postulate the existence of some underlying insurance, whereas in the present case underwriters were those very insurers. In those circumstances it would be surprising were the recovery of costs arbitrarily limited by the necessity of underwriters giving written

[38] Merkin, op cit at 20737.
[39] [2001] 2 Lloyd's Rep. 608
[40] Ibid at 618.

consent".[41]

However, should such consent be required, what is its limit? In some jurisdictions the principle is that consent must not be unreasonably withheld. The meaning of what is or not reasonable encompasses not just sensible and fair behaviour but also the existence or good reasons to believe that there is no coverage under the policy.[42] Therefore, insurers might reasonably withhold their consent where there are serious, feasible and /or proved grounds to believe that the assured is not entitled to be indemnified, or that some of the conditions necessary for the recovery of defence costs have not been satisfied. Such issues might include, for example: where issues of good faith in contract formation arise; where the nature of the wrong is evidently not covered under the policy; or where issues of allocation have to be settled first.[43] However, insurer's consent could be lawfully withheld if it does not more than seeking, previously to the advancement of legal fees, expert advice as it was held in *N. Y. State Urban Dev. Corp v. VSL Corp*[44] where an American court was of the view that it was not unreasonable for an insurer to insist upon the views of counsel independent of insurance parties. However, the insurer must act reasonably in selecting the counsel who is to determined the fees to pay, as it was decided in *The Center Found v. Chicago Ins. Co.*[45]

In the UK some authorities have gone further by affirming that it is not even necessary for a policy to expressly state the unlawful withholding of insurer's consent, in fact any clause imposing upon the assured the burden to obtain consent for the incurrence of defence costs has an implied term that such consent cannot be unreasonably withheld.[46] This was so decided in *Thornton Springer v. NEM Insurance Co.*[47]That said more recent reinsurance cases have rejected the notion that

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[41] Ibid at 619.

[42] Essential English Dictionary. Collins Cobuild. 1994.

[43] Rosenberg, op cit at 19. Such as: CAN and Chubb policies respectively.

[44] 738 F.2d 61 (2d Cir. 1984) in Bordon, *Directors and Officers Liability Insurance Deskbook*. American Bar Association 1998.

[45] 278 Cal. Rptr. 13 (Cal. Ct. App. 1991) in Bordon op cit. the court was of the view that giving the fact that the insurer is to pay the fees of another, an experienced counsel is susceptible to review a standard higher than common market.

[46] *Poole Harbour Yacht Club Marina Ltd v. Excess Insurance Co* [2001] Lloyd's Rep. I. R 580 and *Glencore International A.G v. Ryan, (The Beursgracht)* [2001] 2 Lloyd's Rep. 608.

[47] [2000] Lloyd's Rep .I.R 590 "... if the assured is not permitted to incur defence costs except with the underwriter's consent and underwriters are not obliged to contest any legal proceedings unless a Queen's counsel advises that they should be contested, there is no room for the implication of a term which could oblige underwriters to consent to the assured incurring defence costs in the absence of such advice. The effect of such a term would be to force underwriters to give their consent and thereby in effect to contest the proceedings where there had been no Queen's Counsel's advice that they should

the test is one of reasonableness and have opted for an "irrationality" test akin to that applicable in judicial review cases. The point of this test is that the court is not entitled to substitute its own commercial judgment for that of the insurers, but the court does have at least the right to ensure that the insurers have reached their decision by taking into account only factors relevant to the claim and not extraneous considerations (e.g. other disputes between the parties).[48]

D&O insurer's consent to the incurrence of defence costs will unquestionably be challenged following the enactment of Companies (Audit, Investigations and Community Enterprises) Act 2004 which allows the company to advance defence costs in defending proceedings concerning director's liability; such costs must be repaid had the director been found liable of fraud, wilful misconduct, criminal fines or regulatory penalties.

The new section 337A of the Companies Act 1985 provides as follows:

> (1) A company is not prohibited by section 330 from doing anything to provide a director with funds to meet expenditure incurred or to be incurred by him-
>
> (a) in defending any criminal proceedings, or
>
> (b) in connection with any application under any of the provisions mentioned in subsection (2).

This new section 337A will give rise to a number of disputes between the insured company and insurers in regard to the statutory and/or contractual duty to advance defence costs and the consent of insurer for their being incurred. It is the author's view that this issue concerns mainly with Side B or company Reimbursement cover and regardless the statutory provision mentioned above, the insurer's consent has to be obtained in any event. The reason for this last argument lies in the fact that the inception of a D&O policy provides with a number of contractual provisions the execution of which puts in motion the insurance cover and could not be hampered by a statutory provision which works only between the company and its directors who happened to be insured by a D&O policy. What is not open to discussion is that

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be contested. Absent such advice, there is no implication that underwriters should nevertheless give their consent and so assume a further indemnity obligation. The term expressly legislates for what is to happen if underwriters do not wish to contest the claim. The implication of such a term is therefore not necessary to give business efficacy to the policy or enable the policy to operate in accordance with its express terms. Indeed, such a term would in some respects be inconsistent with the express terms."

[48] See the reasoning of Mance LJ in *Gan Insurance v Tai Ping Insurance (Nos 2 and 3)* [2001] Lloyd's Rep IR 667, rejecting Longmore J's reasonableness approach adopted at first instance. This has been rationalised as either an implied term or an aspect of the insurer's continuing duty of utmost good faith. Cf *Eagle Star Insurance v Cresswell* [2005] Lloyd's Rep IR (forthcoming).

companies are entitled to provide such relief for its directors and in absence of an express declaration in the policy; insurers could not deny reimbursement if the company has provided the fund in good faith. This operates irrespective of any defence concerning Side A cover, giving the composite nature of D&O policies.

8.4 D&O Assured's Right to Defence Costs in any Event

A failure to notify, to obtain the insurer's consent, for the incurring of defence costs where such consent is required by the policy, discharges the insurers. This was so held in *Antico v. Fielding Australia Pty Ltd*[49] where the High Court of Australia was of the opinion that failure to notify the insurer- under a D&O policy- and to obtain its consent prior to the incurring of legal expenses was a breach of contract but nevertheless fell within section 54 of the Insurance Contract Act:[50] accordingly, the insurer's liability would be reduced by the amount that fairly represented the extent to which its interests had been affected by an act or omission on the part of the assured.[51] However, insurers who choose to defend the assured without consultation are liable for defence costs: this was so decided in *Allen v. London Guarantee.*[52] It should be noted that by, conducting proceedings on behalf of the assured, insurers may be directly targeted by the third party for costs awarded in their favour in proceedings brought against a director, as the Supreme Court Act 1981 s 51 allows the court to award costs against a non-party to the proceedings. The point, therefore, is that insurers could be compelled to pay defence costs to the claimant despite the fact that they are not party to the civil proceedings, although it should be said that the circumstances in which this discretion will be exercised against an insurer are extremely restricted and in essence require the insurer to have been the proximate

[49] (1997) 146 A.L.R 385

[50] S 54 (1) "...where the effect of a contract of insurance would, but for this reason, be that the insurer may refuse to pay a claim, either in whole or in part, by reason of some act of the insured...being an act which occurred after the contract was enter into...the insurer may not refuse to pay the claim by reason only of that act but his liability in respect of the claim is reduced by the amount that fairly represents the extent to which the insurer's interest were prejudiced as a result of that act. (6) A reference... to an act includes: (a) an omission; and (b) an act or omission that has the effect of altering the state or condition of the subject-matter of the contract or of allowing the state or condition of that subject-matter to alter."

[51] Wong J, *Some Aspects of Insurance Relating to Australian Corporations Law.* [1998] IJIL 122.

[52] (1912) 28 T.L.R 254.

cause of the claimant incurring those costs.[53]

The second possibility for the recovery of defence costs in any event is, by way of damages, when the insurer wrongfully repudiates liability under the policy, regardless of the fact that the costs incurred by the assured in defending liability were not expressly covered nor expressly excluded. This was so decided in *Pictorial Machinery Ltd v. Nicolls*[54] where it was held that the assured was entitled to recover defence costs reasonably incurred by way of damages if these flowed from the breach of contract by the underwriters in repudiating liability. There is nothing to suggest that D&O assureds might not be awarded damages in the same scenario.

The third possibility arises when the insurer forces the assured to admit liability under the policy. In this regard the assured is once more entitled to defence costs incurred as a result, as it was decided in *Capel-Cure Myers Capital Management Co Ltd v. McCarthy*.[55]

8.5 D&O: Allocation

Before embarking on one of the most controversial issues surrounding D&O policies, it is necessary to clearly understand from the outset the meaning of "allocation". This has been defined as: "The process by which an Insurer evaluates which portion of a loss is covered.... An Allocation process occurs both at the beginning of the claims process to evaluate how much of the defence costs are advanced and again at the end of the claims process to evaluate how much of a settlement or judgement is covered".[56]Unlike conventional liability policies such as general liability or motor insurance which require the insurer to defend the assured, D&O insurance does not afford this benefit to the directors and officers. As seen above, unless the wording provides otherwise, the assured is required to choose its representation, pay the fees

[53] Merkin, op cit at 20738, for the full citation of the authorities on this point. See, for the origins of the jurisdiction, *Aiden Shipping Co Ltd v. Interbulk Ltd The Vimeira* [1986] A.C. 965 and *TGA Chapman Ltd v. Christopher* [1998] 2 All E.R 873.
[54] (1940) Ll.L.Rep.524.
[55] [1995] L.R.L.R 498.
[56] Glossary of D&O Industry Terminology- Chubb- in www.pianic.com/daoglossary.htm

(unless advanced costs have been agreed) and then to seek reimbursement from the D&O insurers who remain free to dispute liability. [57] Assuming that the insurers do face and accept liability, allocation issues may at that point arise.
There are four different scenarios leading to allocation problems Firstly, when both the company and its directors and officers are found liable and there is a dispute as to what proportion is to be met by the D&O insurer and what proportion is to be met by the Company's insurer (if there is one). Secondly, there is also room for controversy in allocating defence costs when the assured incurs liability for insured and uninsured perils. Thirdly, when both the company and its directors and officers are found to be jointly and severally liable to the claimant and it transpires that not all of the defendants are insured or they are covered by different insurers. Fourthly, when the assured director may have acted in more than one capacity e.g. as director and shareholder or as a member of a law firm, who advises the company and sits on the board.[58]

From these perspectives one might conclude that separate allocation issues arise in regard to settlement of the third party claim and in regard to defence costs incurred in defending that claim.
Apparently, foreign courts seem to treat these matters differently[59] in that they apply a single "reasonably related" test to defence costs allocation but apply four different techniques to the settlement costs allocation, namely pro-rata, relative exposure, relative benefit[60] and the larger settlement rule. In the absence of a clear authority in England, each of these methods of allocation is individually analysed in the hope of suggesting the way forward in this jurisdiction

[57] Montelone, Bailey and McCarrick, *Allocation of Defence Costs And Settlements Under D&O Policies* in www.duanemorris.com/publications/printer/ppub857.html.
[58] Ibid at 4.
[59] *Aerojet-General Corp. v. Transport Indem. Co*, Cal. Rptr. 2d, No S054501, 1998 WL 104692, at 1(Cal. 11 March 1998), modifying, 948 P.2d 909 (Cal. 1997). " Indemnification costs and defense costs are mutually exclusive: the latter are expenses to avoid or at least minimize liability that arise before the insured's liability is established and apart therefrom; the former are expenses to resolve liability that arises after the insured's liability is established and as a result thereof. Hence, at least as a general matter, the same costs cannot be characterized as both." In Bolduan L, *Allocation and the problem of the "self-insured" insured.* [1998] IJIL 236 at 244.
[60] Smith F, *Directors' and Officers' Liability*: 1992-1993 in Review. [1993] Int. I.L.R 371.

8.5.1 Allocation of Defence Costs: The Reasonably Related Test

From a logical perspective and in favour of market effectiveness the parties to a D&O policy should use their best endeavours to agree an allocation before resorting to arbitration, seeking the advice of a Queen's Counsel or commencing legal proceedings. This is the rationale behind policy wording of one of the leading D&O insurance carriers in UK. In fact, Lloyd's form LSW 736 establishes in its section (6)(g):

"With respect to Costs and Expenses and any joint settlement...... the Company and the Directors and Officers and Underwriters agree to use their best efforts to determine a fair and proper allocation of the amount as between the Company and the Directors and Officers and Underwriters."

This is of course an aspiration rather than a legally binding agreement[61] although there is no case decided in England, in practice, insurers may agree that they will pay the substantive claim but very often contest the amount to be paid for defence costs, regardless the clearest of policy wordings. The rationale for this lies in a number of factors amongst which are the facts that other persons[62] apart from the assured may benefit from these payments and insurers are determined in not providing assistance – for obvious reasons- to persons from whom they have not received a premium.
In *Structural Polymer Systems Ltd and another v Brown*[63] Moore-Brick J was of the view that cover with respect to costs only extends to costs incurred in connection with claims which fall within the scope of the policy. Furthermore, it was assumed by the parties that losses were to be allocated between insured and uninsured claims. Accordingly, the assured could only recover the costs incurred in defending those claims in respect of which they were entitled to be indemnified.[64]It is clear from this decision that insurers are liable for that part of the costs stemming from an insured risk and for this to happen the loss must accrue as a result of a wrongful act committed by an assured acting in his capacity as such. Nevertheless, how can defence costs be apportioned when the proceeding involves uninsured co-defendants and their liability is inseparable from that of insured co-defendants?

[61] *Safeway Stores. Inc v. National Union Fire Ins Co.* 64 F. 3d 1282 (9th Cir. 1995)
[62] Such as directors and officers insured with different insurers or simply uninsured at all.
[63] [2000] Lloyd's Rep. I.R 64
[64] Ibid

The solution appears to be the development of what is known as Reasonably Related Defence Costs Test under which defence costs are regarded as "reasonably related" to the defence of covered claims if those costs would have been incurred had it been the case that only insured claims against the officers and directors had been alleged in the relevant proceeding. If this is the case, then Insurers are liable to pay 100% of defence costs even if these result in benefiting both insured and uninsured claims.[65] This method of allocation obviously benefits not only uninsured parties but also the company itself if it is proved that defence costs have accrued to the benefit of the insured directors and/or officers as well. If insurers are to avoid this possibility, they bear the burden of proving that some or all of the incurred costs were completely unrelated to any insured claim against the assured directors or officers:[66] in practice this would be difficult, bearing in mind that the company and its directors are usually co-defendants and assisted by the same lawyers.
This method of allocation has been defined in *Continental Casualty Co. v. Board of Education of Charles County*[67] as follows: " Legal services and expenses are reasonably related to a covered count if they would have been rendered and incurred by reasonably competent counsel engaged to defend a suit against the Board and Assureds arising out of the same factual background as did the [underlying] suit but which alleged only the matters complained of in [the covered] counts..."[68]

The reasonably related test was applied in *New Zealand Insurance Company Limited v. New Zealand Forest Products Limited and Another.*[69] The issue before the New Zealand High Court and the Privy Council was whether a D&O reimbursement policy covered not only the assured director for amounts that he was legally liable to pay but also for sums paid in relation to a settlement in which uninsured co defendants were also party. All defendants were represented by the same US attorneys and the claim was settled for US$3.3m with additional US$8m spent on defence costs. Two sides of

[65] www.acelimited.com/MediaCenter/DAndOReport/html/daor_16.html. "This method appears to permit the corporate defendant to obtain a "free" defense by "riding the coattails" of the D&Os and the D&O insurance policy.
[66] *Fox, M: Allocation under D&O policies- what every director should know.* [1999] IJIL 316 at 319. See *Calvert Insurance Company v. Bionaire Inc.* [1998] Province of Quebec, District of Montreal N:500-09-000474-940, 2 june 1998 (Que. C.A.).
[67] 489 A.2d 536 (MD 1985) in Friedman and Meyers, *Allocation Under Directors' and Officers' Liability Insurance.* [1995] Int.I.L.R. 199.
[68] Ibid at 544.
[69] (1995) 8 A.N.Z Insurance Cases 75, 769.

cover had been provided, on the one hand D&O insurance and on the other company reimbursement insurance for all the sums the latter had lawfully paid to the directors by way of indemnity. After a settlement was reached, the company agreed to indemnify its directors and in turn sought payments under the relevant section of the policy from the insurer.[70] The policy was limited to NZ$10m but the assured company claimed it was entitled to the total amount of cover possible because in defending all the parties defence costs reached the sum of NZ$14m. The Privy Council held that the policy did not contemplate severability and went on to decide that the policy was to be construed as to covering all of the costs accrued in the defence of the claim if these costs were reasonably related to the insured's director's own liability, regardless of the benefits accruing to other defendants from those payments.[71]

In the US, where the reasonably related test first developed, the test has been the centre of a number of cases and decisions. *In Safeway Stores Inc. v. National Union Fire Insurance Corp,*[72] the court was of the view that there is no room for allocation where the action giving rise to potential liability is sustained by company's directors and officers, since there is no prospect that the company would be independently liable. *Safeway* was potentially liable as a result of supporting or assisting its directors and officers, thus its liability should be concurrent with the wrongdoers. The court went on to say that defence costs are covered under a D&O policy if they are reasonably related to the insured directors and officers even though the uninsured corporation takes advantage of these payments.[73]

In *Perini Corp v. National Union Fire Ins Co.*[74] four useful guidelines were

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[70]The clause provided as follows: "1.1 Insuring Clause: In consideration of payment of the required premium...the Company agrees to pay on behalf of the Insured Organisation all Loss for which the Insured Organisation grants indemnification to any Officer...as permitted or required by law, which such Officer has become legally obligated to pay on account of any claim(s) made against him/her, individually or otherwise. 9.1when used in this policy Defence Costs means that part of Loss consisting of costs, charges and expenses (other than regular or overtime wages, salaries or fees of the directors, officers or employees of the Insured Organisation) incurred in the defence of legal actions (whether criminal or civil), claims, or proceedings and appeals therefrom and the cost of appeal , attachment or similar bonds. ..Loss means the total amount of Defence Costs which the insured Organisation is permitted or required to indemnify any Officer for Wrongful Acts with respect to which coverage applies hereunder. Loss does not include fines or penalties imposed by law." In Nicoll, *Recovery for Legal Costs and Settlement Sums Under D&O Policies From a New Zealand Perspective.* [1996] IJIL 235.

[71] For a concise analysis of the decision *in New Zealand Company Limited v. New Zealand Forest Products limited & Another* (1995) 8 A.N.Z. Insurance cases 75, 769, in accordance with the New Zealand law approach see Nicoll, *op cit.*

[72] 64 F. 3d 1282 (9th Cir. 1995) in Rosenberg, Sigelko and Miller op cit at 7.

[73] Ibid

[74] Civ. A. 86-3522-S 1988 WL 192453 (D Mass. June 2. 1988).

developed to achieve proper allocation where the uninsured company and its insured directors are found to be jointly liable: whether the claim is brought against the company or against the director or officer as primary wrongdoer; the number of claims asserted against each defendant; the percentage of the total number of defendants who are directors and officers; and which part will derive primary benefit from the resolution of the action.[75]

It has been held in Canada that the D&O insurer is required to pay the entire amount of the defence costs regardless of allocation issues where the liability of insured directors or officers and that of the uninsured company are concurrent.[76]This was the ruling in *Company v. Clearly Canadian Beverage Corporation.*[77] The facts of the case were straightforward. The company and nine of its directors and officers were sued on grounds of alleged violation of American securities legislation. D&O insurance had been issued for the director's protection but the company was uninsured. Both the company and its directors were represented by the counsel with the approval of the insurer. A settlement was reached resulting in both the company and its directors being found liable to pay damages. Lowry J was of the view that when directors and officers' liability is concurrent to that of the company, there should not be allocation as between them. However, there was a major issue in that the policy wording dealt with defence costs allocation but it was silent in regard to the allocation of settlement. In this regard the judge held that allocation of the amount of the settlement rested not upon the contract but because it was essential for the ascertainment of the insurer's limit of liability and what the policy provided.[78]

In England the principle adopted in *New Zealand Forest Products* was applied by the Court of Appeal in *John Wyeth & Brothers Ltd v. Cigna Insurance Co. of Europe SA/NV*,[79] where Waller LJ held that the costs which reasonably related to the defence of claims and which fell within the policy period should be paid to the claimant. This case concerned a product liability insurance policy where loss accrued for a number

[75] Rosenberg, op cit at 15. See also *Caterpillar. Inc v. Great American Inc Co* Nos. 94-3707, 94-3708. 1995 U.S. App. Lexis 21607 (7th Cir. Aug. 10. 1995) were the court held that allocation was a matter of contract construction and the policy at issue implies a complete indemnity for claims [attributable to insured's directors and officers] regardless of who else might be at fault for similar actions. At 8
[76] Fox, op cit.
[77] [1999] B.C.J No 43, 14 January 1999 (B.C.C.A)
[78] Rutherford , *Canada: Insurance- Directors and Officers Liability*. [1997] Int.I.L.R. 103.
[79] [2001] Lloyd's Rep. I.R 420

or years not all of which were within the insurance period. The Court of Appeal, by applying the *New Zealand Forest Products* case ruled that there was no room for saying that simply because the total costs might also relate to an increase in the injury during a period outside the cover, the insurers' liability to meet defence costs was not to be reduced in any way.[80]
The reasonably related test was also applied in *Thornton Springer v. NEM Insurance Ltd.*[81] It is the author's view that Colman's J decision, in regard to the apportionment of defence costs, amounts to the adoption in England of this method of allocation and for the most part resolving the intricate issue of allocating costs between insured and uninsured defendants where it is impossible to demonstrate which actions were those of the assured in his capacity as such and which work was carried out by the assured in some other capacity not covered by the policy. The judge went on to decide that when the work has a dual purpose and is concerned with the defence of two defendants one of whom is uninsured, the indemnity embraces the dual purpose work and not only the work of the insured defendant.

In *Continental Copper & Steel Industries, Inc v. Johnson*[82] an American court decided that where a director is acting in two different capacities but at least one of them is on behalf of the assured company or in his insured capacity the cover attaches. However, it is crucial for the attachment of the insurance that proceedings are commenced against the assured in his capacity as such and not as shareholder or advisor.[83] In other words, insurers could successfully repudiate liability and allocate defence costs if the claim is pursued against the company alone or only against the assured but in his capacity as shareholder or advisor, as was the case in *Olson v. Federal Ins. Co.*[84]

8.5.2 Allocation of Settlement Costs

It has been common practice -at least abroad- to use different methods of allocation in regard to settlement costs. This seems to be convenient if the issue before the court is

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[80] Ibid.
[81] [2000] Lloyd's Rep. I.R 590.
[82] 491 F. Supp. 360 (S.D.N.Y. 1980). In Montelone op cit at 4
[83] *Management Science America, Inc v. Hartford Fire Ins.Co* No C84-2299 (N.D.Ga.Feb. 26,1986). In Montelone op cit 4
[84] 219 Cal. App. 3d 252, 268 Cal. Rptr. 90 (1990).

only a dispute concerning the quantum of substantive indemnity and there is no issue as to defence costs. However, it is the author's view that applying two different sets of principles in deciding defence costs and settlement costs allocation leads to inconsistency. Therefore, whatever test is used, it should be so used in both sides of the dispute.

One of the apportionment methods used in indemnifying settlement costs is Pro Rata Allocation in accordance with which the loss is equally divided among the defendants or group of defendants. It does not represent a major intellectual challenge but merely the application of very well known principles of mathematics. What could produce difficulty is the application of a group pro rata method in the sense that the court firstly has to classify the defendants into groups and then effect the apportionment in groups rather than on an individual basis. For example a claim for £1m awarded against three directors and the company would be apportioned evenly in two groups, the three directors in one and the company in the other. It is suggested that the pro rata allocation system does not always achieve equitable results in that very often the degree of participation of some of the defendants in committing the wrongdoing is not the same and they may obtain disproportionate benefit from the defence and settlement of the claim. For these reasons, the majority of foreign courts appear to be not keen on this mechanism of apportionment.[85]

8.5.3 The Relative Exposure/Benefit Approach

This allocation is based upon a twofold criterion in that it seeks to identify the relative liability exposure from the subject claim and the relative benefits obtained by defending it.[86] Few leading insurers in the D&O market are attracted by the relative exposure test. The CNA wording has been drafted as follows:

"The insureds agree that there must be an allocation between insured and uninsured loss if a Claim made against the Insureds includes both covered and uncovered matters, or if Claim is made against Insured Persons who are extended coverage therefor and others (including the Company and Subsidiaries) who are not extended

[85] www.acelimited.com/MediaCenter/DAndOReport/html/daor_16.html

[86] Ibid. "Among other things, this method takes into consideration the allegations in the claim, the factual and legal support for the claims and the defenses of the defendants, the collectibility from each defendant, the benefits realized by the defendants in settling the case, the intent of the parties behind the settlement, and similar factors. This method results in a more equitable allocation of loss, but is extremely fact specific and somewhat subjective in its application."

coverage therefor. The Insureds and the Insurer shall exert their best efforts to agree upon a fair and proper allocation between insured and uninsured loss based upon the relative and financial exposures of the parties to such matters, and the relative benefits obtained by the parties to any settlement of such matters."[87]

Following the same approach is Chubb:

"If an Insured Person incurs both Loss covered by this policy .....and loss not covered by this policy, either because a Claims includes both covered and uncovered matters or because a Claim is made against both an Insured Person and the Insured Organisation, the Insurer shall pay: (a) 100% of Defence Costs as incurred; and (b) 100% of other Loss arising out of a Securities Transaction.
Allocation of other Loss
16. The Insured and the Insurer shall allocate Loss not predetermined under Section 15 above, based upon the relative legal exposures of the parties. If the Insured and the Insurer cannot agree on an allocation: (a) the Insurer, if requested by a Insured, shall submit the dispute to binding arbitration before panel, which shall consist of one arbitrator selected by the Insured, one arbitrator selected by the Insurer, and a third independent arbitrator selected by the first two arbitrators; and (b) no presumption as to allocation shall exist in any arbitration or other proceeding.
Any allocation or payment of Defence Costs shall not create any presumption as to allocation of other Loss."[88]

There is not a single report in England at least in D&O matters suggesting the application of this form of allocation, although guidance is to be found in foreign decisions. In *Nodaway Valley Bank v. Continental Casualty Co* [89] the court was of the view that an allocation of 90% to the D&O insurer and 10% to the company was an equitable one since the company had no prospect of incurring significant liability in respect of the claims in question. Consequently, the D&O carrier had to indemnify the majority of the loss since it was the assured directors who potentially might have been exposed to the higher amount of responsibility, had they not been favoured in the decision.[90]

There are at least two factors against the use of the relative exposure method in England. Firstly it is extremely subjective in the sense that it is up to the court to decide the level of exposure of or benefit to the sued director or officer. From this perspective it is inappropriate to support its application.

Secondly, reality shows that it is the company which is the first target when a

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[87] In www.cnaeurope.com

[88] Chubb WWTCALL99-2002. Section D-Directors & Officers Liability.

[89] 715 F Supp 14588 (WD Mo, 1989).

[90] *Pepsico Inc v. Continental Casualty Co* 640 F Supp. 656 (SDNY 1986)

wrongful act is committed, not only because it has deeper pockets but also because the directors represent the legal entity which is financially accountable to third parties for the directors' wrongdoings. Consequently, it cannot be said that the company is more or less exposed to liability if very often it is sued and held jointly liable with its directors.

8.5.4 Larger Settlement Rule

The larger settlement rule is based upon the principle that the insurer is allowed to allocate part of the costs to uninsured either companies or directors only to the extent that wrongful acts of uninsured parties increase the amount of the settlement.[91] In other words if the participation of uninsured parties in the proceedings and the subsequent settlement does not affect – or at least not that much – the quantum of indemnity, allocation between insured and uninsured claims or persons is impossible.

This principle was considered in *Nordstrom Inc v. Chubb & Son Inc*[92] where a D&O carrier proposed to allocate both settlement and defence costs fifty-fifty between the defendant company and its directors. The court applying Washington law and assessing that company's liability was derived from the wrongful actions of the directors, held the insurer liable for the entire settlement. In reaching its decision the court developed two situations in which allocation between insured and uninsured claims is possible; where the company is proved to be liable for matters of which its directors were not responsible; and when the ascertainment of company's liability enlarges the amount of losses. Should the insurer fail in proving individual liability or enlargement, it becomes liable for all defence costs since 'there is no reasonable means of prorating the costs'.[93]In *Harbour Ins. Co v. Continental Bank Corp*[94] upon which the decision in *Nordstrom* was based, the court stated that allowing the insurer to apportion between directors' liability and company's derivative liability could deprive the insured directors of the protection sought when purchasing insurance.

[91] www.acelimited.com
[92] 54 F.3d 1424 (9th Cir.1995) in Bordon op cit at 164-165.
[93] Ibid.
[94] 922 F.2d 357 (7th Cir. 1990). See also in Bordon op cit at 166.

It follows that the larger settlement rule, albeit slightly more accurate than relative exposure rule, could be criticised in exactly the same way , specifically in that in the majority of cases the company and its directors are found to be jointly liable.

PART THREE

CHAPTER IX

THE REINSURANCE OF D&O POLICIES

Much of the reinsurance businesses placed in the London market come from abroad. This is not mere coincidence, but on the contrary, market stability, expertise and capacity have made the London market an advantageous place to carry out this sort of commercial activity. D&O insurance is typical here, and it is a long standing practice for these types of policies to be reinsured in 'The City'. The reinsurance of 'foreign direct risks' in the London market has given rise to a series of complex legal problems, which are analysed in this chapter.

Usually local insurers will act as fronts for London market reinsurers and the business is conducted by way of reinsurance or retrocession. There is often a local law requirement that direct business is placed with a local insurer[1], hence the need for fronting[2] if the business is to find its way to London. This is how much D&O cover – particularly emanating from the South American market – reaches the English forum by way of facultative or, less commonly, treaty reinsurance.

The use of fronting in other jurisdictions gives rise to a number of important legal issues, which surge from the consideration that the direct policy and the reinsurance are entirely separate contracts[3] even though as a matter of practice any loss will be handled directly by the reinsurers with the local insurers playing at best an information-gathering role.

From the outset D&O reinsuring parties could face and sustain one or more of the following issues of law: first, and perhaps most significantly, the insurance will be governed by local law, whereas the reinsurance will almost certainly be governed by

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[1] This seems to be a common feature in the Latin American Market.

[2] Prescott and Lambert: *What's Up Front: a Guide to Fronting Arrangements*. In www.captive.com/newstand/jlcovt/fronting.html. " Fronting is a term that describes a specialised form of reinsurance frequently employed in the captive insurance marketplace. In its most common form, a commercial insurance company ("fronting company"), licensed in the state where a risk to be insured is located, issues its policy to the insured. That risk is then fully transferred from the fronting company to a captive insurance company through a reinsurance agreement, known as a fronting agreement".

[3] There is no privity of contract between the reinsurer and the assured. See *Norwich Equitable Fire* (1887) 57 LT 241. Also *McMahon v. AGF Holdings (UK) Ltd* [1997] LRLR 159.

English law. Secondly, it may be that certain of the liabilities recognised by the law applicable to the direct policy have no counterpart in English law. Thirdly, there may also be an issue as to the meaning of the policy terms themselves: it is the usual practice as regards facultative reinsurance to incorporate the terms of the direct policy into the reinsurance. Yet incorporation has proved to be highly problematic[4] in that there may be a resulting conflict between the agreed reinsurance terms and the incorporated terms, to say nothing of the different interpretations to policy wording which may be given by local courts and by the English courts. Fourthly, it is also necessary to consider the effects of follow settlements/fortunes clauses and the impact of such clauses on claims co-operation and claims control provisions.

In order to cope with these problematic areas it is necessary to determine the types of reinsurance which may be used to cover D&O risks. There are two main classes of reinsurance contract, facultative and treaty. Fronting is only an issue in the former case.

9.1 Facultative Reinsurance: Nature and Terminology

A facultative reinsurance contract is simply a reinsurance of a single direct risk accepted by the insurer. The essence of facultative reinsurance is that it is optional: the insurer is not bound to offer, and the reinsurer is not bound to accept, any such offer. Facultative reinsurance was the earliest form of reinsurance known to English law,[5] and in legal terms consists simply of an individual -one off- contract between reinsurer and reinsured; to this extent it differs little from an ordinary contract of original insurance. Facultative reinsurances have generally been referred to by the courts as policies, and in the case of fire reinsurance, perhaps more often in the past than at the present, as 'guarantee policies' or 'guarantees'.

Facultative reinsurances are for the most part proportional, i.e., the insurer retains for himself an agreed proportion of the risk, the remainder being reinsured at the original

[4] Merkin, *Incorporation of Terms into Reinsurance Agreements*, in The Modern Law of Marine Insurance. Thomas D. Rhidiam. 2002 at 57 ss.
[5] Golding, *The History of Reinsurance*, 1927.

premium paid minus the insurer's commission. As the costs of the reinsurer are greater under the facultative method, the commission allowed to the reinsured will normally merely reflect the latter's own costs and will not allow for profit. Facultative reinsurance is thus less attractive to an insurer than the use of a treaty for cover of the equivalent sum. It might be noted that increasing use is being made of excess of loss facultative reinsurance for certain types of business: under this kind of arrangement the reinsurer does not contract for a given proportion of the risk but merely agrees to indemnify the reinsured against liability incurred on an original policy above a stipulated sum. In such instances reinsurance will usually be arranged in layers, with reinsurers accepting liability in excess of different monetary limits; and of course making the agreement vulnerable to reinsurance aggregation disputes.

The fact that the reinsurer does not contract for a given proportion of the risk but for the reinsured's liability under the original policy ascertains the nature of a facultative reinsurance as liability insurance on its own[6], contrary to the early opinion of the English Courts.[7] Accepting otherwise may result in the inconvenience as to understand why the reinsurer is obliged to indemnify the reinsured upon the establishment of the former's liability to the insured under the direct policy; or upon a reasonable and fair businesslike agreement, had the reinsurer been obliged to follow the settlements as contractual term. This attribute is the distinguishing characteristic of liability insurance thus defeating early thoughts which compared facultative reinsurance with co-insurance or partnership contracts or in other words as sharing both reinsurer and reinsured the same insurable interest in the risk.[8]

With the development of treaties the use of facultative reinsurance has declined steadily. The reason for this is readily understandable. Once the terms of a treaty have been agreed upon between the parties, reinsurance is either automatic or a matter of relative simplicity, so that the insurer can underwrite any relevant business within the scope of the treaty without both the delay and cost of seeking *ad hoc* reinsurance for it. These advantages of the treaty method may be demonstrated by brief consideration of the processes commonly involved in arranging facultative reinsurance. This is

[6] Merkin op cit at 64.
[7] *British Dominions General Insurance v. Duder* [1915] 2 KB 394 and *Nelson v. Express Assurance Corporation* [1925] 2 KB 281.
[8] Merkin op cit at 66.

normally done by means of a slip which details the business to be reinsured and the size of the insurer's retention. The slip is passed round potential reinsurers by the insurer or by a broker acting on the latter's behalf. Reinsurers will then initial the slip, indicating the proportion of the placement they are willing to accept, a process which continues until the slip is fully subscribed to. If, as so often happens where a placement is made by a broker, the slip is oversubscribed, the liability of each reinsurer has to be reduced proportionately, a process which is known as 'signing down'. The expense of this system is obvious and delays arise from the danger that it will not be certain from the outset that adequate reinsurance will be obtainable. The legal issues that arise from these procedures- with special emphasis in D&O insurance- will be considered fully later in this work. However, facultative reinsurance does remain of significance, particularly in the underwriting of large liabilities which fall outside treaty limits, or in cases in which the insurer does not carry on enough business of any given class to justify the use of a treaty. Further, in many jurisdictions it is a requirement of local law that insurance is placed with a local carrier and in practice that insurer will reinsure some or all of its liability under a single contract in the form of a facultative reinsurance arrangement.

9.2 Treaty Reinsurance

A reinsurance treaty or contract may be regarded as a master agreement[9] –for insurance and not of insurance[10]- regulating a continuing relationship between insurer and reinsurer and under which a number of separate direct policies may be reinsured. In considering the nature of treaty reinsurance, two broad distinctions have to be drawn: between proportional (surplus and quota share) and non-proportional (excess of loss and stop loss) treaties and between obligatory, non-obligatory and facultative-obligatory treaties. In essence, a proportional treaty is one under which the reinsured and the reinsurer effectively share the risk between them in agreed proportions, whereas a non-proportional treaty is based on financial limits and the interests of the

[9]Legh-Jones, *MacGillivray on Insurance Law*, Sweet & Maxwell, 10th ed, 2003 at 955: " A treaty may represent no more than a standing offer to reinsure if and when business is ceded, and it seems more accurate to classify such an agreement as a contract for insurance rather than of insurance".
[10] *HIH Casualty and General Insurance v. Chase Manhattan* [2001] Lloyd's Rep IR 191.

reinsurer and reinsured are less obviously linked. This point was made by Lord Mustill in *Axa Reinsurance v Field*[11], where the issue was whether the meaning of an excess of loss reinsurance should be construed in a manner consistent with that of the underlying direct policy even though the wording was different: Lord Mustill expressed the view that there was no presumption of back-to-back cover in a non-proportional treaty and that the words were to be construed according with their ordinary meanings even if the result was that the cover did not match. Lord Mustill noted that proportional contracts in some respects resembled co-adventures between the reinsurer and the reinsured so that there was greater justification in giving them a common meaning.

Treaties may be obligatory, non-obligatory or facultative-obligatory. An obligatory treaty is one under which the reinsured is obliged to cede all risks of a given description and the reinsurer is obliged to accept them: in most cases the process is automatic on both sides.[12] There are various terms implied into obligatory treaties, as laid down by *Baker v Black Sea*[13]: these relate to underwriting, claims handling and inspection. A non-obligatory treaty is one which provides a framework whereby individual risks accepted by the reinsured may be declared to the reinsurer and the reinsurer can then decide whether or not to accept that risk. A facultative-obligatory contract is one under which the reinsured has the right to decide whether or not to declare an individual risk but, if he does, the reinsurer is obliged to accept it.

Whether a treaty is obligatory, facultative or facultative-obligatory is a matter of its proper construction. The point is not always easy, although it might be thought that there is some form of presumption in favour of a purely obligatory arrangement as these are the most common and easiest to administer. In *SA d'Intermèdiaires Luxembourgeois* v. *Farex Gie*[14] the open cover was non-obligatory and facultative in form, in that the reinsured was not required to make declarations to the open cover and the reinsurer was not obliged to accept any declarations which were made. The open cover contained two different 'held covered' clauses. Under the first, the

[11] [1966] 2 Lloyd's Rep 233.
[12] See *Baker v. Black Sea and Baltic General Insurance Co Ltd* [1995] LRLR 261; *Glencore International AG v. Ryan, The Beursgracht* [2002] Lloyd's Rep IR 335.
[13] Ibid.
[14] [1995] LRLR 116.

reinsured was entitled to treat new declarations as covered for seven days and under the second; the reinsured was entitled to treat renewals as covered for thirty days, in each case pending a final decision by the reinsurer. The reinsured argued that the 'held covered' provisions converted the open cover into an obligatory agreement, in that the reinsured was entitled to the benefit of cover until it was refused. Gatehouse J held that the inclusion of open cover provisions — which were not, in practice, used to any great extent — could not affect the facultative non-obligatory nature of the agreement. It did not, therefore, amount to a contract of reinsurance as such, but rather to a mechanism under which contracts of reinsurance could be arranged. In *Glencore International AG v Ryan, the Beursgracht*[15] the assured was insured under a marine liability policy described as an "open cover". The period clause in the policy stated that it related to "all vessels chartered by" the assured in the relevant period and there was a further optional clause which allowed the assured to include in the cover cargo insured by a third party. At first instance HHJ Hallgarten QC held that the insurance provided by the period clause was obligatory on both sides. While the phrase "open cover" could not be regarded as conclusive one way or the other, the use of the word "all" in the period clause indicated that neither party was to have any discretion and the additional optional clause under which the assured could declare risks insured elsewhere was to be contrasted with the period clause where no such discretion was referred to. In the Court of Appeal the correctness of Judge Hallgarten's reasoning was not questioned.

More recently in *Glencore International AG v. Alpina Insurance Co*[16] Moore-Bick J was of the view that the purpose of an open cover in a facultative/obligatory form, is to guarantee that cover is available on a permanent basis in regard to goods in the course of trading and that such cover remains at insured's disposal for as long as it may be required.[17]

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[15] [2002] Lloyd's Rep IR 335.

[16] [2004] 1 Lloyd's Rep 567

[17] Ibid at 569. He went on to say: " The nature of commodity trading is such that it will often be difficult to tell how long goods placed in store are likely to remain there, so it is likely to be of advantage to the insured to be able to obtain cover for an indefinite rather than a fixed period and no doubt insurers are aware of that".

9.3 Content of a Facultative Reinsurance Agreement

The traditional method in which a facultative reinsurance agreement is placed in the London market is by means of a single cover sheet – generally described as a Slip Policy – which is appended to the direct insurance policy to which it relates and in respect of which reinsurance is being given. The fact that the slip is referred to as a Slip Policy means that no further documentation is to be issued and that the direct policy taken with the cover sheet constitute the entire agreement between the parties.

The terms of the reinsurance cover are generally described as the same as those in the direct policy. This is achieved by words similar to "as original", which has superseded earlier formulations including "warranted subject to the same terms and conditions as original". The assumption to date has been that the phrase "as original" operates to incorporate the terms of the direct policy into the reinsurance agreement following the decisions in *Forsikrings Vesta v Butcher*[18] and *Toomey v Banco Vitalico de Espana SA de Seguros y Reaseguros*[19], where the suggestion that the phrase "as original" was a warranty that the terms disclosed to the reinsurers were those of the direct policy – the phrase had an incorporating function.[20] It may be noted, however, that in the appeal in *Toomey*, Thomas LJ expressly refused to decide whether the phrase "as original" does have an incorporating effect, echoing the doubts expressed by Lord Griffiths in *Vesta v Butcher*.

The Slip Policy will generally contain a small number of terms of its own. The reinsurer usually agrees to "follow the settlements" or "follow the fortunes" of the reinsured: there is no English authority on the latter formulation, but the former has been held to oblige the reinsurer to indemnify the reinsured where there has been a judgment or arbitration award against the reinsured or where the reinsured has entered into a *bona fide* and businesslike compromise with the assured relating to the assured's claim under the direct policy.[21] Where the terms of the original have been incorporated and there is a follow settlements obligation, the reinsurers are not

[18] [1989] 1 All ER 402
[19] [2003] EWHC 1102 (Comm)
[20] Supra : Incorporation from Direct Policy
[21] *Insurance Co of Africa v. Scor (UK) Reinsurance* [1985] 1 Lloyd's Rep 312

entitled to rely upon the reinsuring provisions of the facultative contract to defeat a settlement by the reinsured which has been reached on the basis that the direct policy provides cover: this was decided in *Assicurazioni Generali SpA v CGU International Insurance Plc.*[22]

It is also frequently the case that the obligation to follow settlements is tempered by a claims control or claims co-operation provision, under which the reinsurer is not to face liability unless the reinsured has either handed over to the reinsurer all responsibility for negotiating with the assured (claims control) or has at least kept the reinsurer informed of the progress of negotiations and has secured the reinsurer's consent to any settlement (claims co-operation).[23] Albeit it still common practice to include both follow the settlements and claims control provisions within the same slip cover– as noted later in this work- this tradition has proved to be meaningless in the sense that whenever reinsurers take control of the claim, any arrangement reached is binding on them not for following the settlements of the reinsured but due to the fact that they -by taking control- are parties to the agreement itself.[24]Hence, it is the author's view that the rationale behind the inclusion of these two provisions is none other than a very polite way of saying 'I trust you, but just a little'.
There may be other express terms relating, e.g. to defence costs, but for the most part the reinsuring terms are extremely short.

9.3.1. Incorporation from Direct Policy

English law allows a term to be incorporated into a contract by way of reference as long as it is shown that the parties intended to incorporate such term into the new agreement.[25] Now, as mentioned early the path taken by the majority of D&O policies to the London market is by way of reinsurance, it being necessary in a vast number of cases –due to local restrictions- to use fronting to achieve this purpose. Quite why the London market has so readily embraced the notion of incorporation of terms from the

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[22] [2003] EWHC 1073 (Comm)
[23] *Gan Insurance Co v. Tai Ping Insurance Co* (No 3) [2002] Lloyd's Rep IR 612.
[24] Although they do not face direct liability to the assured: *Grecoair v. Tilling* [2005] Lloyd's Rep IR (forthcoming).
[25] Monnick & Turner: *Incorporation by Reference of Arbitration Clauses*, [1995] Int. I.L.R. 360.

direct policy to the reinsurance, when it has been shown that the process is one fraught with legal difficulty, can only be guessed at: laziness and conservatism are probably the key factors here. The outcome is that reinsurers provide their services by doing no more than subscribing to a slip of paper containing a very simple phrase that might incorporate – if the term is appropriate - all the wordings contained in the direct policy. The courts have ruled that terms in the direct policy which are inconsistent with the reinsurance cannot be incorporated and equally those which are repugnant to the very nature of a reinsurance agreement will not be incorporated. In *Home Insurance of New York v Victoria-Montreal Fire*[26] a fire insurance policy was reinsured incorporating all the terms of the direct policy. There was a clause which prohibited an action to be taken unless commenced within twelve months immediately after the fire.[27] The issue before the court was thus to ascertain whether this clause, which by its nature is inappropriate to reinsurance matters, could be incorporated. The Privy Council found against incorporation. The Court held that time bar clauses were perfectly reasonable in policies insuring direct loss to specific property, since the insured was in control of the situation by being able to commence proceedings immediately after the occurrence. However, in cases of reinsurance against liability the situation differed, because the reinsured could not take action until the direct loss "is ascertained between parties over whom he has no control and in proceedings in which he cannot intervene".[28]

In *Municipal Mutual Insurance Ltd* v. *Sea Insurance Co Ltd*[29] a series of third party liability policies incepted and were reinsured from 1983. The policies protected the Port of Sunderland Authority against losses suffered by a third party to which it provided its services. The underlying policy was renewed for successive periods of insurance and amended by endorsements. For the years 1986/87 and 1987/88 reinsurance was placed; all the terms of the underlying policy were incorporated into the reinsurance. The insured Port Authority incurred liability to a third party and was found liable to pay a sum for which the insurer was itself required to provide an indemnity. Such liability arose from a number of losses occurring over a three-year time span covering more than one period of insurance and the reassured sought to

[26] [1907] AC 59
[27] Ibid.
[28] Ibid at 64
[29] [1996] LRLR 265

recover for the reinsurer. The reinsurers successfully contended that they were only liable to indemnify losses referable to the relevant policy year since the reinsurance policy happened to be a one year policy irrespective of being renewed on a yearly basis. Additionally, had the reinsured been successful in establishing reinsurance cover, the events which had occurred between 1987 and 1989 were subject to a deductible under the wording of both the underlying and reinsurance policy. The key aspect of the case was that the court refused to allow the incorporation of the duration provisions of the underlying insurance cover into a reinsurance which was specifically stated to be for a more limited period.[30]

The issue of inconsistency was also dealt with in *CNA International Reinsurance v Companhia de Seguros Tranquilidade.*[31] In this case the risk of cancellation of a concert was insured by the defendant insurer and reinsured as to 90% by the claimant reinsurers. The concert was cancelled due to the illness of the performer's mother. A claim was made against the insurer for both loss of profits and costs incurred and this was settled by the defendants who sought recovery from the reinsurers.
The insurance incorporated the Lloyd's contingency policy NMA 2540 with the Lloyd's standard non appearance wording NMA 2396, it being intended that the terms should be the same for both insurance and reinsurance agreements.[32] Furthermore, a wording contained in defendants' standard 'General Civil Liability Policy' was annexed as forming part of the agreement, giving rise to 'a curious mix of local and London terms'.[33]This mixture led to a very complicated issue of law, since the court had to determine which – if any of the clauses in the underlying policy had been incorporated into the reinsurance despite the fact that the former had been written on reinsurers' form. The learned judge reached two interesting conclusions. First, given that it was the intention of the parties to create a back-to-back contract, it did not matter that the reinsured had used a standard civil liability form to give effect to a risk characterized by being a first party loss. Secondly, in this regard it was held that the terms of the direct policy were to be incorporated and, in order to give effect to them; they had to be adapted so as to fit the purposes of the reinsurance. This issue was

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[30] Ibid.
[31] [1999] Lloyd's Rep IR 289.
[32] Ibid.
[33] Merkin, op cit at 88.

clearly addressed by Lord Griffiths in *Vesta v. Butcher*[34] where – as explained below - a fish farmer insured his stock under a direct policy which had been prepared from a standard form of Lloyds which expressly stated that the underwriters reserved the right to replace the stock lost (trout and salmon) with a similar stock of a like species. The policy was reinsured by means of a slip stated to be "as original" and thus to be on the same terms and conditions as the direct policy. Lord Griffiths commented: "do we have to suppose that it was the intention of the parties that the reinsurers could have discharged their liability by delivering a load of live trout and salmons to the reinsured?"[35]

Although there are a number of cases illustrating the point,[36] special consideration is merited by the decision in *Casualty and General Insurance v. New Hampshire insurance*[37] where David Steel attempted to classify the principles governing incorporation, by formulating four statements:

- Incorporation may be achieved if the term is germane to reinsurance.
- The term must make sense, subject to permissible manipulation, in the context of the reinsurance.
- The term must be consistent with the express terms of the reinsurance.
- The term must be apposite for inclusion in the reinsurance.

However, the leading authority is the decision of the Court of Appeal in *HIH v. New Hampshire* [38] where Rix LJ, for the first time, clearly articulated the distinction between the 'fact of incorporation' and 'the effect of a term once incorporated.' This case concerned a pecuniary loss indemnity insurance – increasingly commonplace in the film industry - to indemnify the insured investors in the event of a shortfall between the amount of finance provided and the revenue collected in the making of two separate groups of films. One group was to be co-produced by 7.23 Productions LLC and Flashpoint Ltd and the other by Rojak Films Inc and also Flashpoint Ltd.

[34] [1989] 1 All ER 402
[35] Ibid.
[36] See for example: *Excess Insurance v. Mander* [1995] LRLR 358; *Tryg-Hansa v. Equitas* [1998] 2 Lloyd's Rep 439; *Municipal Mutual Insurance Ltd v. Sea Insurance Co Ltd* [1996] LRLR 265; *AIG Europe (UK) Ltd The Ethniki* [1999] Lloyd's Rep IR 421; *Gan Insurance Co Ltd Tai Ping Insurance Co Ltd* [1999] Lloyd's Rep IR 229.
[37] [2001] Lloyd's Rep IR 191
[38] [2001] Lloyd's Rep IR 702.

Two insurance policies were issued accordingly. These underlying policies contained a series of terms of which Clause 8 gave rise to the most contentious issues. This Clause was a Disclosure and/or Waiver of Rights provision[39] by which the insurer agreed not to seek relief on the grounds of invalidity or unenforceability of any of its arrangements with the assured.

The insurer (HIH) reinsured both policies with Axa Reassurance S.A and New Hampshire Insurance Co Ltd in respect of the two policies; Independent Insurance Co Ltd was also reinsurer but only in respect of the 7.23 policy. The reinsurance slip contained the following wording: "Cancellation Clause as Original Policy". The film producers did not make the requisite number of films and the assured investors obtained indemnity from the insurer up to US$31 million. In turn the reassured sought to recover under the reinsurance policy. The reinsurers refused an indemnity, relying in particular on breaches of warranty and breaches of the duty of good faith. The underlying policy contained a warranty that the assured had to make a slate of six or ten films respectively and the Court of Appeal was satisfied that the warranty had been incorporated into the reinsurance agreement. Additionally, the reinsurer's consent was required for any amendment to the underlying policy. The reinsurers asserted that they were not obliged to make payment because the insurer had known, but not informed them, that the requisite number of films had not been made and that in any event the failure to make the full number of films was a breach of the reinsurance warranty. For its part the reassured alleged that clause 8 had been incorporated from the direct policy into the reinsurance and precluded the reinsurers from relying upon breaches of warranty or breach of any duty of good faith unless fraud had been involved. Although the Court had to deal with a number of issues, two are of interest in the present context. The first was whether Clause 8 had been incorporated into the reinsurance. The second was, if it had been incorporated, what its effect was in the reinsurance context. With regard to the first point the Court of Appeal was of the opinion that incorporation was achieved when there were

[39] Ibid. The aforementioned wording was on the following terms: " 8.1 To the fullest extent permissible by applicable law, the insurer hereby agrees that it will not seek to or be entitled to avoid or rescind this Policy or reject any claim hereunder or be entitled to seek any remedy or redress on the grounds of invalidity or unenforceability of any of its arrangements with Flashpoint Ltd or any other person (or of any arrangements between Flashpoint Ltd or the Purchaser) or non-disclosure or misrepresentation by any person or any other similar grounds. The insurer irrevocably agrees not to assert and waives any and all defences and rights of set-off and/or counterclaim (including without limitation any such rights acquired by assignment or otherwise) which it may have against the Assured or which may be available so as to deny payment of any amount due hereunder in accordance with the express terms hereof."

appropriate words of incorporation sufficient to accomplish this and also when the term, so incorporated, made sense in the contractual context of reinsurance. Secondly, and given that there had been incorporation, the further issue was the effect of the clause. David Steel J at first instance assumed that clause 8 was to be incorporated in a form which meant that it bore the same meaning at the reinsurance level as it had at the direct level, namely that the reinsurers had agreed to waive any utmost good faith defences that would have been open to them. To achieve this result it was necessary to "manipulate" the wording of clause 8 so that it referred to the reinsurance context rather than to the insurance context. The Court of Appeal departed from David Steel J on this matter. Rix LJ noted that if the clause had been incorporated, it could take effect in the reinsurance in either a manipulated or unmanipulated form. In its manipulated form the incorporated clause operated as a waiver of disclosure rights by the reinsurers. In an unmanipulated form clause 8 merely amounted to a statement to the reinsurers that the reinsured had waived its right to avoid the direct policies and accordingly that an indemnity could be sought from the reinsurers even though the reinsured would – but for clause 8 – have had a good defence against the investors. The Court of Appeal preferred the latter interpretation, and ruled that clause 8 had been incorporated in an unmanipulated form and was no more than an "follow the settlements" clause, i.e. a promise by the reinsurers that they would provide an indemnity in the event that clause 8 precluded avoidance of the direct cover.[40]

9.3.2 The Presumption of Back to Back Cover

The presumption of back to back cover is the result of a simple interpretation of the nature of a reinsurance contract which is written on a proportional basis. The reinsurers and the reinsured share a common goal since the purpose of the reinsurance is to transfer some or (in the case of fronting) all of the risk to the reinsurers, by means of the reinsurance in return for an agreed proportion of the premium.[41] From this perspective it is logical that the two policies are to be construed as back to back. Were it otherwise, the reinsured might face loss for which no indemnity was

[40] Ibid at 201

[41] Merkin op cit at 67.

available. Such presumption works upon three well established premises: first, the risk at both levels (insurance-reinsurance) is alike; second, the duration of the two contracts is interpreted as matching and third, the warranties contained in the reinsurance contract should be given the same effect as to not contradict those contained in the direct policy.[42]

In *Forsikringsaktieselskapet Vesta v. J.N.E Butcher, Bain Dawes Ltd*[43], it was held that, by reason of the "full reinsurance clause" under which the terms of the direct policy were to be incorporated into the reinsurance, it was plainly intended that the reinsurance was meant to be back to back with the underlying policy. This case concerned a fish farmer in Norway who sought insurance amongst other risks of that of loss of living fish. The insurer –Vesta, a local Norwegian company - arranged reinsurance with the defendant up to 90% through a subsidiary of Lloyd's brokers. Reinsurance was obtained by means of a standard form London market slip which provided that property covered was that described in the original policy. As noted above, the slip included the full reinsurance clause under which the reinsurance is stated to be on the same terms and conditions as the direct policy and that the reinsurers would follow the settlements of the reinsured. The problem in this case was that the reinsured broke a warranty in the direct policy (failure to maintain a 24-hour watch on the fish farm), but that under Norwegian law – which governed the direct policy – that breach did not discharge the insurers because it had not been causative of the loss. However, under English law, which applied to the reinsurance agreement, a breach of warranty had an automatic discharging effect on the reinsurers' liability. The majority view was that the full reinsurance clause operated to incorporate the terms of the direct policy into the reinsurance, but that in order to ensure that the cover was back to back it was necessary to construe the English policy in the same way as the direct policy, i.e. in accordance with Norwegian rules of construction. Their Lordships were thus prepared to distort the principle that the applicable law governs all matters of construction in order to achieve back to back cover. Lord Griffiths agreed that the reinsurers could not rely upon the reinsurance warranty, but was able to reach that conclusion purely on the basis of the presumption of back to

[42] Merkin op cit at 68. See also *Ace Insurance SA-NA v. Zurich Insurance Co* [2000] 2 Lloyd's Rep 425 affirmed [2001] Lloyd's Rep IR 504.
[43] [1989] 1 Lloyd's Rep. 331

back cover and felt that there was no need to resort to any principle of incorporation[44]; this point was referred to earlier.

The presumption of back to back cover was taken even further than the decision in *Vesta v. Butcher*. In *Groupama Navigation et transports v. Catatumbo C.A Seguros*[45] the Court of Appeal declined – in the interests of finding back to back cover - to give effect to an express clause in the reinsurance contract governed by English law regarding a warranty as to the obligation to maintain two vessels in class.

In this case a Venezuelan insurance company provided hull and machinery cover to a local company in respect of two vessels. The underlying policy contained a clause in the following terms: 'Guarantee of maintenance of class according to the ABS (American Bureau of Shipping) Standards and Rules.' The insurer sought facultative reinsurance in respect of liability under the insurance contract; the policy which was in the form of a slip providing "All terms clauses conditions warranties...as original and to follow all decisions settlements agreements of the same in every respect...Warranted existing class maintained."[46]

The two vessels were badly damaged in a storm and it turned out that by the time of the casualty they were not actually classed and in fact they never had been. Nevertheless, the insurer agreed to indemnify the costs of repair since in accordance with Venezuelan law – which governed the underlying policy- a breach of warranty does not discharge the other party to a contract unless it is causative of the loss. In turn the insurer sought to recover under the reinsurance policy. The reinsurers sought a declaration that a failure on the part of the assured to maintain the vessels in class constituted a breach of warranty contained in the reinsurance slip; and in accordance with English law – which governed the reinsurance- the reinsurer had been discharged from the obligation to provide an indemnity.

The Court of Appeal held the two policies were, in absence of clear words to the contrary, intended to be back to back, thus producing the same effect at both levels. Consequently, the warranty in the direct policy was to be regarded as having been incorporated into the reinsurance and was to be construed in accordance with Venezuelan law so that a breach which did not cause any loss was to be disregarded. This case extends the *Vesta* principle, in that in order to reach its conclusion the Court

[44] Ibid
[45] [2000] 2 Lloyd's Rep. 350
[46] Ibid

of Appeal had to ignore the express warranty in the reinsurance. The Court of Appeal was able to do this by noting that the insurance and reinsurance warranties were similarly worded and that in any event the reinsurance warranty had presumably been inserted as a precautionary measure to cover the possibility that the direct policy did not contain an equivalent provision: once the direct policy was found to contain a classification warranty, the reinsurance warranty could be presumed to have been ousted. This decision would seem to take the notion of back to back cover to its outer limits.

The boundaries of the presumption of back to back cover have been tested recently in two more cases. In *GE Reinsurance Corporation v. New Hampshire Insurance Co*[47] the reinsurance slip was issued 'as original' but contained a series of conditions which were not in the underlying policy. The issue before the court was to ascertain whether or not the presumption of back to back cover worked to eliminate reinsurance provisions which had no equivalent in the reinsurance cover. The court was of the view that a condition in the reinsurance slip requiring the continuing employment of two of the insured's employees was a warranty, the breach of which discharged the reinsurers from their obligation to indemnify the reassured for the resulting loss. The court distinguished *Groupama* on the basis that in the earlier case the direct policy and the reinsurance had contained equivalent provisions and it was appropriate to construe them in the same way: this was not possible where the reinsurance agreement contained its own provisions which had no direct equivalent, as it was necessarily the case that the reinsurance was intended not to be back to back to that extent.

Goshawk Syndicate Management Ltd and others v. XL Speciality Insurance Co,[48] was one of a number of insurance claims arising out of the atrocity of September 11 in this case relating to the loss of retail stock by a company with outlets in the World Trade Center. The underlying policy was subject to an annual aggregate limit deductible of US $5 million, so that cover did not attach until that figure had been reached. There was also a variety of per claim deductibles. The key provision for the purposes of the case was a further clause which provided that individual claims in excess of US $1 million would be covered even though the annual aggregate deductible figure had not been reached. Reinsurance was sought and arranged 'as

[47] [2003] All ER 392
[48] [2004] EWHC 1086

original' 100% for two-thirds of the premium for a maximum of US $20 million, also including an annual aggregate limit of US $5 million. The reinsurance was written on the basis that it was subject to the original deductibles. The tragedy happened and the insured sought indemnity. The claim was in excess of US $1 million, although the annual aggregate deductible figure had not been reached. The insurers, having paid the claim, sought indemnification from the reinsurers, but this was refused on the basis that the reinsurance contained an aggregate deductible of US $5 million, a sum which had not been reached. The issue before the court was to determine whether the terms of the direct policy were to be regarded as having been incorporated into the reinsurance. The court ruled that the clause, providing for payment of losses in excess of US $1 million, was a "deductible" clause and accordingly the reinsurers were bound to make payment. This decision illustrates the strength of the notion of back to back cover, because the insurers themselves had expressly refused to argue that the US$1 million clause was a deducible. Morison J's view was nevertheless that the policies had been written on a back to back basis and that the only way to give effect to the parties' intentions was to adopt this generous interpretation of the word "deductible". The case is presently under appeal and indeed Morison J gave permission to appeal without any request to do so. If the learned judge's reasoning is correct, the back to back presumption can override the actual words of the reinsurance in a manner not even contemplated by *Groupama v Catatumbo*.

After analysing both edges of the spectrum, the notion of incorporation and the presumption of back to back cover, it is possible to conclude that the first concept does more harm than good for the successful resolution of reinsurance disputes. If it is understood that reinsurers are protected by a strong presumption of back to back cover with regard to the reinsuring clause, there is simply no need to incorporate the terms of the underlying policy in the reinsurance. The point becomes even clearer by asserting the nature of facultative reinsurance as liability insurance on its own and the fact that the underlying policy might not be one on liability(e.g. fidelity policy) thus impeding a sensible construction of two policies that by nature exclude each other.[49] In any case reinsurers are well protected without recurring to the notion of incorporation in the two possible situations: firstly, there is a variation of a term in the

[49] Merkin op cit at 99

underlying policy, such modification needs reinsurer's consent to be binding on them; and secondly, had a breach of warranty in the direct policy occurred, the notion of back to back discharges also reinsurers on the grounds that both policies bear the same construction. Upon this premises strong support has recently been given to the presumption of back to back cover by Thomas LJ in *Toomey v Banco Vitalicio de Espana SA de Seguros y Reaseguros*[50], when he reserved his position on the correctness of incorporation and hinted that Lord Griffiths' views in *Vesta* were preferable.

9.4 Meaning of Terms and Policy Interpretation. D&O Insuring Clause

Once the background against which issues of incorporation and /or back to back cover arise has been ascertained, it is necessary to address the effect of reinsuring ' as original' in respect of a D&O policies. Despite this market offers a number of different wordings, it seems that the majority of policies agree:
'to pay on behalf of the Directors or Officers of the Company Loss arising from any claim first made against them during the period of insurance and duly notify to the insurers during the same period by reason of any wrongful Act committed in the capacity of Director or Officer of the company....'[51]

One of the characterising features of a D&O policy is that it is a cover against legal liability to third parties. This characteristic is crucial for the issue of incorporation since facultative reinsurance is often regarded[52] as being akin to a liability insurance policy under which the reinsurer agrees to indemnify the reinsured once the latter's liability to make payment to the assured has been established and quantified. This means that matching the two policies, on the one hand D&O and on the other the facultative reinsurance, might not be as difficult as might otherwise be the case, given that both are by their nature liability covers. However, despite this common feature, there are individual characteristics of D&O policies which are unique and not readily reconcilable with the nature of reinsurance and it is also the case that D&O policies may be written on a variety of different terms.

[50] [2004] EWCA CIV 622
[51] Lloyd's form 736
[52] Merkin op cit 61 ss

Thus, in the US market, it is common to cover losses caused by the director's fraud,[53] although as a matter of English law such claims are excluded as a matter of public policy. Having said that D&O policies do not follow a common model, it is necessary to consider to what extent incorporation into the reinsurance policy of the terms of the underlying policy is commendable or practical.

There is always a possibility that the direct policy and the reinsurance are governed by different applicable laws and the same words may bear different meanings in the two agreements.[54] These problems have led to strong judicial criticism of the traditional method of forming facultative contracts, particularly by Lord Griffiths in *Vesta v Butcher* but the practice has not altered.

The first problem would be the meaning of 'Directors and Officers' and it has been emphasised that civil law might not match English law. As suggested earlier certain jurisdictions – mostly Latin American- tend to be casuistic in drafting extensive articles of association; and defining directors and officers is no exception to this approach. The intention is not only to supplement loopholes in domestic legislation but also to ascertain as far as possible who is to be treated as a director or officer for liability purposes. A reinsurer agreeing to reinsure on an 'as original' basis as regards what is contained in the underlying policy, bears - by reason of incorporation or back to back cover- the consequence of having to pay an indemnity when the wrongdoer falls within the local contractual construction of Director or Officer. This is the result of *Vesta v. Butcher* as explained, above.

The outcome could thus be that reinsurers would have to indemnify the reinsured for its payments for wrongful acts committed by an individual who under English law would not be covered by the direct policy. Two examples might illustrate the point. It is astonishingly common to find in Latin America and even Continental Europe, 'directors of *de facto* companies' yet the notion is far from accepted in England.[55] In these jurisdictions such directors represent unregistered companies or *de facto* companies which - albeit engaged in trading – have not been issued with a certificate

[53] www.gtlaw.com/pub/alerts/2002/millerm_08.asp
[54] *Vesta v. Butcher* [1989] 1 All ER 402; *Groupama v. Catatumbo* [2000] 2 Lloyd's Rep 250 and *Ace Insurance SA-NV v. Zurich Insurance Co* [2001] Lloyd's Rep IR 504.
[55] Supra: Types of Companies.

of registration by domestic regulatory authorities. The sanction is usually[56] that of imposing joint or several liability on any persons trading on their behalf.[57]Consequently, directors who trade on behalf of an unregistered company face unlimited joint and several liability. D&O insurers might overcome this problem by offering insurance upon proof of registration and if this policy is reinsured this seems to be a term, breach of which, may discharge the reinsurer. Nevertheless, the issue could hypothetically be different where the D&O insurer offers cover without imposing such a condition and it is at this stage when issues of incorporation might arise. In this scenario the exact construction of a policy offering cover for directors or officers irrespective of the company's status would imply that the insurer bears the burden of paying indemnity without contesting liability on the grounds of lack of registration unless there has been non-disclosure or misrepresentation. It is almost certain that a reinsurance policy placed in the London market would be governed by English Law so the question to answer is whether a judge would condemn a reinsurer to providing indemnification in respect of liabilities which cannot arise under English Company Law? The author's view is that the "as original" provision would require the reinsurers to provide indemnity in these circumstances. The only real defence which reinsurers might have in the absence of any express contractual limitation is that of misrepresentation or non-disclosure of the scope of the reinsured's potential liabilities. However, even here there is a danger that an English court could find that – in the absence of any express question - reinsurers had waived disclosure by failing to inquire as to the nature of the direct liabilities.

There will also be a problem if the local policy does not define the terms "directors and officers". In this situation the definitions current in the local law applicable to the direct policy will govern the position and as a result of *Vesta v Butcher*[58] that interpretation would prevail in the reinsurance. Local courts may rely upon the articles of association of a specific company and its assured directors to give the underlying policy its exact construction. In some jurisdictions it is perfectly common to include in the articles of association wide definitions of "directors and officers". To this extent it might result that not only members of the board and persons acting

[56] In some jurisdictions e.g. Peru a *de facto* company is deemed null and void. See article 365 of Peruvian Commercial Code in www. cajpe.org.pe/rij/bases/recur2/chi/1/leyes/ley1/htm.
[57] See for example article 219 of Venezuelan Commercial Code.
[58] [1989] 1 All ER 402

as such but also any representative, adjuster, agent or employee who performs an activity –technical or administrative- similar to that of directors, are defined as such, with the resulting effect of exposing them to the same sort of liability. Now, providing Side A and C cover to a company which defines directors in the form stated above, imposes upon the insurer the burden to indemnify when the wrongdoer matches such definition. The "as original" wording, or at least the back to back cover principle, causes this meaning in the underlying policy to be transferred to the reinsurance, with the result that the reinsurers have to provide indemnification for liabilities arising from the acts of persons who would have no status under English law.

9.5 D&O: Incorporation and The Quantum of Indemnity: *Damnum Emergens* and *Lucrum Cesans*.

Once again assuming that the terms of the insurance match those of the reinsurance, by reason of the "as original" wording or by reason of the presumption of back to back cover, problems may arise in relation to the quantum of indemnity and the meaning of 'loss'. It is accepted by English law that as a matter of public policy, insurance cannot not provide cover, in respect of exemplary or punitive damages awarded against the insured. The aim of such damages – to punish the culprit- would be lost had indemnity been possible. Further, as such damages are generally awarded in respect of deliberate misconduct on the part of the assured; English law would simply not recognise any obligation on insurers to provide an indemnity. Indeed, as a matter of English law, exemplary or punitive damages are awardable in exceptional circumstances only English law's rules of remoteness and causation confine damages to the amount of the victim's actual loss. However, in other jurisdictions the concept of 'Damnum' is wide in its interpretation and can embrace additional or incidental losses as well as all the money the victim has actually lost as a result of the tortfeasor's wrongdoing. The question is: does the reinsurer- by reason of reinsuring as original- agree to provide indemnity even though the concept of loss under other laws demands a wider construction? A good example is provided by Brazilian Legislation where the word 'danos' embraces consequential loss[59] which would be too remote from an English perspective. Should the reinsurance policy be governed

[59] Leech, S Insurance and Reinsurance Claims in Latin America, The Insurance Institute of London, October 1999. See also Spanish Civil Code article 1106 and Venezuelan Civil Code article 1196.

by English Law, as is almost certainly the case, reinsurers might argue that providing indemnification for punitive or exemplary damages is contrary to English law and accordingly that the reinsured has no right to be indemnified. The problem with this approach is that the reinsured seeking indemnity has done nothing wrong and indeed has paid under a legal liability recognised by the law applicable to the direct policy. The ability of reinsurers to deny liability on public policy grounds would, therefore, seem to be remote. An alternative argument might be that the reinsurance should not, as a matter of construction, extend to indemnifying the reinsured for such payments, but the back to back principle and the full reinsurance clause may undermine this argument as well. The point can, it would seem, be resolved only by the use of an express exclusion in the direct policy or in the reinsurance in relation to punitive or exemplary damages.[60]

It is also relevant to note that not all Latin American jurisdictions follow the same pattern in regard to the currency of the loss. It is usually the rule that local currency dominates so that payments have to be made in local currency, although it is possible to contract in a foreign currency providing that payments are made in the local currency.[61] It is sadly the case that Latin American Economies have not been successful in their struggle with inflation and there have been astonishing rates in recent times. By way of example, Venezuela reached around 107% in 1996. It is customary to apply monetary corrections to the quantum of indemnity and it is not surprising for sums to nominally represent many millions. This issue is of major repercussion, albeit only from a technical and statistical perspective. Reinsurers must take into account at the time of making business that had the policy provided indemnity in local currency, the effect of having to consider inflation and possible devaluations which by one way or another, might affect the sum assured, limits of indemnity, deductibles and the like to say nothing of risk assessment and reserves. From reinsurance perspective the problem is that as a matter of law the insured cannot recover more than the agreed limit stated in the policy; it being also necessary to mention that liability policies are not valued but capped at a maximum figure of liability. Is a reinsurer required to follow the reinsured's monetary corrections? Relying on *Vesta* and *Groupama* it could be suggested that the idea of incorporation might play its role in transferring to reinsurers the obligation of having to make

[60] Supra: D&O Exclusions

[61] See for example article 118 of Venezuelan Commercial Code

monetary corrections. However, it is to be emphasised that monetary adjustments are not contractual obligations or even the result of a rule of law, but are customarily used by courts – usually after long tail trials- to award the claimant a new sum which represents as far as possible the original claim. The fact that the principle is not contractual weighs against incorporation, as it is not to be assumed that the reinsurers have agreed to be bound by a principle which simply arises from common practice. In any case, where devaluation is the cause of the correction, it is the author's view that reinsurers would be better off by having to use less pounds sterling to meet the cost of indemnity. This issue has already been raised before an English Court in *Trygg Baltica International (UK) Ltd v. Boston Compania de Seguros SA*[62] where the claimant reinsurers sought declaration that a 'Pesification' pursuant to decrees 214 and 320 of 2002 promulgated by the Government of Argentina, forcing the currency of account to be paid in Argentinean pesos, should be deemed not to be binding upon reinsurers irrespective of its application to the underlying policy. The proceedings were principally concerned with jurisdiction and whether England was the appropriate forum for the hearing of the action. Accordingly, no substantive decision was necessary.

In absence of decisions in this regard, it is the author's view that reinsurers could successfully contest liability by reason of the fact that a modification to the direct policy, either voluntary or mandatory (as on the facts in *Trygg Baltica*) could not affect the reinsurers. Were it otherwise, the suggestion would be that the full reinsurance clause or the back to back principle would bind the reinsurers to accept liabilities which the parties could not have contemplated at the time the agreement was entered into.

9.6 D&O: Incorporation and the Nature of Liability

By looking at a D&O policy and considering what sort of problems incorporation might produce, the nature of director's liability is a crucial issue. Wrongful or criminal acts in English law may be very different from wrongful or criminal acts in other jurisdictions. A clear example is represented by the decision in *Canelhas*

[62] [2004] EWHC 1186.

Comercio Importacao e Exportacao Ltd v. Woolridge[63] where the English court was of the approach that the foreign risk did not match the English one. The facts of the case regarded a Jeweller's Block Policy providing cover to a jewellery shop. The policy contained an exclusion for loss or damage to property by robbery when premises were open for business or when staffs were in attendance. While returning from Sao Paulo airport in Brazil the managing director and a shareholder of the jewellery together with his wife, mother and son were kidnapped by six men wearing police uniforms. The director was told to follow the kidnappers instructions if he wanted to save his family otherwise he would never see them alive. He was asked to go to the office and get all the emeralds in stock along with other orders. He went to the office about 1.30 pm and told the staff what was going on so two bags were filled with emeralds and later surrendered to the criminals. The policy contained the following special condition:

III. Holdup or Robbery Limit
"Underwriter's liability....in respect of loss of or damage to property by Robbery when premises are open for business or when the Assured or any or their employees (other than security Personnel) are present, at or in attendance at, the premises shall not exceed: nil".

The underwriters contended that the aforementioned clause attached since the robbery was committed in working hours when employees were present at the premises. The Court of Appeal upheld the decision in the first instance and held that the clause did not exclude the claim. Mance LJ addressed the exact construction of the 'holdup or robbery' clause in that it was directed at the extra risk when premises were open for business or when the respondent or its employees (other than security personnel) were on the premises. Now, the relevance of this decision for this research lies in the fact that the judge had to construe the exact meaning of the word 'robbery' for the enforcement of the exclusion clause. This policy concerns an English Law policy covering a Brazilian insured against contingencies in Brazil thus, concepts contained within it, such as 'robbery' have to be understood not in any English legal sense, but in the sense that "ordinary commercial men"[64] would understand them. In this sense

[63] [2004] EWCA Civ 984.
[64] Ibid. "Interpretation is the ascertainment of the meaning which a document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract".

the judge was satisfied that the concept of 'robbery' differed in meaning to that of kidnapping in which the victim is put under some form of duress (violent or not) to fulfil somebody else's expectations. From this perspective the relevant exclusion did not attach. If this decision is analysed from a broader perspective, one could imply that an English Court may have to deal with liabilities recognised in other jurisdictions but not in England e.g. director's statutory liability in other jurisdictions, discrepancies in regard to directors negligent breach of duty or basically a liability unrecognised in England but enforceable where the facts took place.

In regard to D&O insurance the point has to be analysed from a dual perspective: the fraudulent or negligent nature of the wrong; and the tortious or contractual nature of liability. As far as fraud is concerned, there are jurisdictions which apparently allow cover in this regard.[65] It might nevertheless be thought that the clearest wording of incorporation would not convince an English Court to allow indemnity if liability is tainted by fraud. As regards negligence, as already explained[66] civil law jurisdictions do not follow the same pattern as English law to ascertain directors' and officer's liabilities and indeed the development of the law as such between jurisdictions varies considerably.

The key question, however, is whether the reinsurers would be bound if the assured incurred liability in a manner not recognised by English Law but nevertheless within the scope of the direct cover? The notions of incorporation and back to back cover would appear to apply in full here and it is therefore suggested that where reinsurers use the full reinsurance wording 'as original' they are bound to accept –with the exception of fraud- liability to the reinsured, irrespective of the test taken to ascertain the insured's liability. It is irrelevant that local law imposes stricter or higher levels of diligence since, as long as the reinsured settles its liability in good faith and in a businesslike fashion (in order to comply with the requirements of the follow the settlements provisions of the full reinsurance clause) and in accordance with the provisions of the local law, the reinsurers will have no option other than to pay.
This seems to be a matter for concern where 'a follow the settlements clause' has been agreed and there is a dispute as to whether or not the reinsurer was entitled to have been disclosed as to how local law operates. The point is discussed below and it

[65] www.gtlaw.com/pub/alerts/2002/millerm_08.asp
[66] Supra Chapter VII: Culpa: test of diligence

is suggested that reinsureds, acting mainly as fronts for reinsurers, are not obliged to disclose to the latter local law, for reinsurers by using fronting agreements, are presumed to be aware that their liability to indemnify will be tested by local law.

Civil Law jurisdictions recognise the possibility of directors incurring both contractual and extra-contractual liability. Contractual liability arises only in regard to the company and extra-contractual is the source of liability in respect of third parties including shareholders.[67] English company law does recognise a director's liability to third parties but only in the clearest of circumstances when there has been an assumption of personal responsibility on the part of the director. Now, a contract of reinsurance for the reasons already covered above, is presumed to match the terms of the insuring clause in the underlying policy and as a result, this is once more one of the situations where in construing the reinsurance agreement, the reinsurers might have agreed to cover and pay indemnity when the reinsured's liability arises as a result of covering directors contractual and extra-contractual liability. The fact that there may be no liability in the English system which matches the potential liability in a civil law jurisdiction is not enough to discharge the reinsurers from their obligation to indemnify the reinsured. This all means that the reinsurance risk in these jurisdictions is for the most part more extensive than the direct insurance risk in England where the possibility of a director's liability to third parties is a remote one. In conclusion there might be no defence to liability simply because English law does not recognise the risks reinsured: the effect of reinsuring 'as original' removes any defence in this regard.

However, the same cannot be said in regard to officer's liability to third parties since this is only possible in the civil law when officers act as company's representatives and not merely as employees. An officer acting without representation is just an employee and cannot incur personal liability to third parties by reason of his/her contract of employment. There still is a possibility that companies may try to use their 'Side C' cover to recuperate all the moneys paid on the grounds of vicarious liability. For the same reasons expressed above, reinsurers could successfully discharge their liability by proving the first party nature of the claim and therefore its inconsistency[68] with the nature of a D&O policy.

[67] Supra chapter VII: Directors' and Officers' Liability in Civil Law Jurisdictions: Requirements.
[68] *HIH Casualty v. New Hampshire Insurance* [2001] Lloyd's Rep IR 191

9.7 D&O: Incorporating Terms and Conditions

The real effect of the decision in *Vesta v. Butcher* is to remove, in the context of the scope of the reinsuring clause, the significance of the fact that the reinsurance is governed by English law. By reason of incorporation or because of the principle of back to back cover, an English law reinsurance agreement is to be construed in accordance with the law applicable to the terms of the underlying policy. It is almost inevitable that the direct policy will be governed by local law and the application of the decision in Vesta means that it is local law which has to be used to interpret the reinsurance contract.

The *Vesta* principle is not confined to the insuring clause, it extends also to other policy terms, including conditions and warranties. This is perhaps not the place to explain in detail the common law principles which govern these terms, but it is nevertheless appropriate to emphasise that warranties are probably the most important types of contract terms. As understood in England, warranties are promises made by the insured which, once breached, discharge[69] the insurer as from the date of breach, regardless of whether the breach is or is not causative of the loss.[70]

It has been emphasised that in virtually all jurisdictions other than England, a breach of warranty does not discharge the insurers unless the breach is causally linked to the loss which has occurred.[71] In England a warranty can be relied upon even if it has no immediate connection with the risk run by the insurers. This is precisely the principle which gave rise to the difficulties facing the courts in *Vesta* and in *Groupama*. Thus, D&O reinsurers ought to be aware that reinsuring "as original" might have the effect of rendering illusory the protection conferred by the House of Lords in *The Good Luck*[72], interpreting the statutory provision in section 33(3) of the Marine Insurance Act 1906 to mean that breach of warranty automatically discharges the risk.

There are a number of issues arising here, ranging from allegations of misrepresentation to breaches of specific warranties in a D&O policy. One of the scenarios is that there could be a warranty whereby the company undertakes to

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[69] *Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd, The Good Luck.* [1991] 2 W.L.R 1279

[70] In full compliance with section 33(3) Marine Insurance Act 1906.

[71] For example in Norway as highlighted in *Vesta v. Butcher*.

[72] [1991] 2 W.L.R 1279

maintain a specific director on the board, as a condition for the policy to be issued in the agreed terms or to come into existence at all. There seems to be a limit to the principle that the breach must be causative of the loss- mainly this is the case in Civil Law jurisdictions-. In fact this is an *ad hoc* policy issued to cover specific directors and not whoever becomes a member of the board. In this situation the dismissal or removal of the insured director, gives enough grounds to repudiate liability for breach of a condition precedent in the insurance agreement, regardless of the loss which might happen later is or not linked with such dismissal or removal.

If this warranty forms part of the underlying policy and reinsurance is provided 'as original' it seems likely that reinsurers could successfully discharge liability for the dismissal or removal of any of the directors to whom such condition apply. The rationale behind this approach lies in the fact that the reinsured, had the breach taken place, is not liable in the first place. Once more the back to back cover plays its role here.

A second possibility is that, for example, insurers might demand the company to be up to date and in full compliance with both regulatory and statutory provisions. The problem here is that some jurisdictions are very flexible in regard to non-compliance with certain statutory rules. For example in Venezuela, it is common practice for a company whose financial statements have not been duly approved on a yearly basis – at the compulsory annual meeting of shareholders- to be authorised to hold an extraordinary meeting at any time to update the company and comply with the statutory requirement. Nevertheless, this does not seem to be good practice when insolvency strikes the company in this irregular situation, for the latter might have incurred 'fraudulent insolvency' making its director's criminally liable.[73] Apart from this, there is no major sanction.

Undoubtedly, reinsurers might refuse to provide cover in the awareness of company's irregularity or non-compliance with local statutory provisions albeit in any case, that the company become insolvent, director's liability would be almost certainly fraudulent giving strong arguments for reinsurers not to respond on the grounds of public policy. Now, whether or not the company was up to date at the time of contracting reinsurance; or the delay in passing and approving its financial statements

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[73] Venezuelan Commercial Code article 920. Also Spanish Commercial Code article 1007.

happened afterwards, gives rise to two different interpretations which might undermine the notion of incorporation. Firstly and assuming that reinsurance was provided 'as original' it seems that not disclosing the lack of financial statements approval is a material fact that would influence a prudent reinsurer in not taking the risk or at least not for the agreed premium. The rationale for this lies in the notion that, a company in this irregular situation is more vulnerable – as well as its directors- to claims from shareholders and creditors. Reinsurers have therefore, strong arguments to contend liability for misrepresentation or non disclosure. However, albeit the issue is dealt with later in this chapter, the situation becomes difficult to asses when a 'follow the settlements' clause is agreed between the reinsurance parties and the reinsured has indemnified the insured in good faith and/or in a businesslike manner. In this situation, by issuing reinsurance, reinsurers might have waived their rights to discharge liability on the grounds of non disclosure or misrepresentation. Secondly and supposing the abnormality takes place after the inception of the reinsurance policy, could easily lead to the conclusion that the original insured risk has been modified. Since the insured is obliged to maintain the risk status, irrespective of reinsuring 'as original' the reinsurer is not liable, not by reasons of incorporation but for the basic notion that the reinsured is not liable in the first place.[74] It could be suggested that lack of compliance is in any case a breach of director's duty either negligent or fraudulent and from this perspective it is the subject matter of a D&O policy and not a modification of the original risk. Nevertheless, there might not be room for 'negligence' where such responsibility is the result of absolute inobservance of statutory provisions and this is even a better defence to avoid indemnity.
Other examples of events or circumstance which modify or aggravate the risk usually highlighted by D&O policies are mergers, acquisitions for over 50% of the share capital with voting rights or the acquisition by any person of part of the company's assets.[75] It is customary to introduce a clause, imposing the duty to notify the insurer company within an agreed period of any change of circumstances that would modify the risk and this gives rise to another issue of incorporation, had the reinsured agreed to amend the coverage. The question to answer is whether a D&O reinsurer is bound, subject to a clause 'same terms and conditions as original', by changes to coverage agreed by the reinsured and not notified to the former?

[74] Supra Facultative Reinsurance
[75] Rayleigh\38471.1

It seems the notion of back to back cover will be of very little assistance to bring within the reinsurance any variation in the direct policy.[76] This is the conclusion reached in *Norwich Union Fire Insurance Society Ltd v. Colonial Mutual Fire Insurance Co Ltd* [77] where McCardie J held that a variation in an existing policy is comparable, as to its effects to the issuing of a new one, thus any modification discharges the reinsurers who by using general words of incorporation might have not accept a modified or larger risk. Now, when the reinsurance agreement imposes upon the reinsured the burden of notifying any amendments or changes in the direct policy, such a term, following the decision in *HIH Casualty and General Insurance Ltd v. New Hampshire Insurance Co,*[78] is rendered as warranty, the breach of which discharges the reinsurer's liability as for the date of it.[79]

9.8 Dispute Resolution-Choice of Law- Choice of Jurisdiction

As the authorities stand to date, dispute resolution provisions – arbitration agreements[80] choice of law clauses[81] and choice of jurisdiction clauses[82]– will not be regarded as incorporated from the direct policy into the reinsurance unless express words of incorporation are used. The rationale for this lies in the fact that clauses of this nature are self contained contracts which, in one way or another, remove from the claimant the right to sue in a court which would otherwise be competent to hear the dispute under its own jurisdictional rules; and the view taken by the courts is that a party should not lose that right unless he specifically agrees to it.[83] This inevitably means that the precise content of a facultative reinsurance contract is not always clear from the outset. The matter is complicated by the consideration that, even where there has been incorporation, the incorporated term will in some instances operate in the

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[76] Merkin op cit at 84
[77] [1922] 2 K.B. 461
[78] [2001] Lloyd's Rep IR 224.
[79] Birds & Hird: *Bird's Modern Insurance Law*, Sweet & Maxwell, 6th Edition, 2004 at 157.
[80] *Pine Top Insurance v. Unione Italiana* [1987] 1 Lloyd's Rep 476; *Excess Insurance v. Mander* [1995] LRLR 358; *Trygg-Hansa v. Equitas* [1998] 2 Lloyd's Rep 439; *Cigna Life Insurance Co of Europe SA-NV v. Intercaser SA de Seguros y Reaseguros* [2001] Lloyd's Rep IR 821.
[81] *Gan Insurance Co Ltd v. Tai Ping Insurance Co Ltd* [1999] Lloyd's Rep IR 229
[82] *AIG Europe (UK) Ltd v. The Ethniki* [2000] Lloyd's Rep IR 343; *AIG Europe SA v. QBE International Insurance Ltd* [2002] Lloyd's Rep IR 22
[83] Merkin, op cit at 95

same way at the reinsurance level as in the direct policy but in other cases simply amount to a statement of the circumstances in which the insurer will pay and thus operates as no more than a type of 'follow the settlements clause'.[84]

Regarding arbitration clauses the rule of law "is that the obligation to arbitrate is distinct, and will not be carried by general words of incorporation unless the wording and intention are absolutely clear".[85] This principle emphasises that the arbitration agreement is independent from the contract that contains it, in other words it might be considered the existence of two different contracts, – the main agreement- which establishes all the conditions, warranties and clauses descriptive of the risk and the collateral agreement- setting the arbitration agreement up.[86] This does not mean that the arbitration agreement is to be regarded as physically different[87] but legally independent in the sense that its enforceability does not depend upon where it is contained.[88] In fact the arbitration agreement might not have been necessarily included in the underlying policy to be effective, its inclusion is possible by reference as section 6(2) of Arbitration Act 1996 establishes.[89]
In *Pine Top Insurance Co Ltd v. Unione Italiana Anglo Saxon Reinsurance Co Ltd*[90] the insurer issued a number of travel policies covering medical expenses which contained brief arbitration clauses and procedures. Such liability was reinsured by means of a slip stating "all terms and conditions as original". This slip contained a more complete arbitration clause than the underlying policy. In turn this agreement was retroceded 'all terms and conditions as original'. The issue before the court was to determine whether or not any dispute between retrocedants and retrocessionaries was to be submitted to arbitration by reason of having incorporated the arbitration

[84] *HIH Casualty and General Insurance Co v. New Hampshire Insurance Co* [2001] Lloyd's Rep IR 596.
[85] Merkin, Arbitration Act 1996. LLP.2000.29
[86] Redfern & Hunter: *Law and Practice of International Commercial Arbitration*, Third Edition, Sweet & Maxwell, London 1999 at 154.
[87] Merkin, Arbitration Act 1996. LLP, 2000 at 31
[88] This principle is known as 'Detachment of the Arbitration Agreement' and it is established in the Arbitration Act 1996 s (7) as follows: " unless otherwise agreed by the parties, an arbitration agreement which forms or was intended to form part of another agreement(whether or not in writing) shall not be regarded as invalid, non-existent or ineffective because that other agreement is invalid, or did not come into existence or has become ineffective, and shall for that purpose be treated as a distinct agreement".
[89] Arbitration Act 1996, section 6(2) " The reference in an agreement to a written form of arbitration clause or to a document containing an arbitration clause constitutes an arbitration agreement if the reference is such as to make that clause part of the agreement".
[90] [1987] 1 Lloyd's Rep 476

agreement from the reinsurance to the retrocession agreement. Gatehouse J was the opinion that the expression 'all terms and conditions as original' in both the reinsurance and the retrocession agreements referred to the insuring provisions in the underlying policy. As a result and in absence of a clear word of incorporation, the arbitration agreement was regarded not to have been incorporated therein.
In *Excess Insurance Corporation Ltd v. Mander*[91] Colman J was of the view that a general condition in a retrocession agreement containing a clause "terms, conditions and warranties as original and to follow original settlements and/or agreements of the Reassured in all respects' did not have the incorporating effect of transferring the arbitration agreement contained in the reinsurance contract to the retrocession one, since arbitration clauses stand free of the contracts in which they are found[92] and can only be incorporated by express declaration.

In *Trygg Hansa v Equitas*[93] Judge Jack QC was of the view, that despite the reinsurance contract followed by reference the same terms as the direct policy, the arbitration clause was not expressly referred therefore, it was neither effective nor binding. In this case, the applicant reinsured the defendant Lloyd's syndicate in respect of second, third and fourth layers of excess of loss, the original insurance contract provided any dispute to be referred to arbitration in London. The judge interpreted that there was no indication that the parties wanted to incorporate the arbitration clause within the reinsurance contract so it was ineffective.
Choice of Jurisdiction represents the second limb of this discussion and as a rule of construction, jurisdiction clauses will not be carried across by general words of incorporation. Where the defendant is domiciled in the European Union so that jurisdictional rules are governed by Council Regulation 44/2001 (or the equivalent provisions of the Lugano Convention 1989 applicable to EFTA countries), art 23 of the Regulation provides that the parties are free to enter into a jurisdiction agreement and this will be given binding force by the courts. Indeed, if a court with jurisdiction under an exclusive or non-exclusive jurisdiction clause is first seized of the dispute, it has no power to stay its proceedings and must hear the case. Where the defendant is not domiciled within the EU or EFTA, but there is a jurisdiction agreement

[91] [1995] LRLR 358
[92] Monnick & Turner, *Incorporation by Reference of Arbitration Clauses*. [1995] Int.I.L.R 360.
[93] [1998] 2 Lloyd's Rep. 439

nominating the English courts, CPR 6.20 empowers the English court to assert jurisdiction and as a matter of practice it will inevitably do so whether the clause provides for exclusive or non-exclusive jurisdiction. The principles which determine whether a jurisdiction clause is valid are more or less the same under art 23 or in the common law and cases decided under both regimes have concluded that a jurisdiction clause in a direct policy will not be carried across to a reinsurance agreement whether the matter is determined by EU or common law principles.

In *Prifi v. Musini Sociedad Anonima de Seguros y Reaseguros*[94] a Spanish insurer offered cover to Real Sociedad –Spanish football team- against the risk of any player suffering accidents or sickness. The policy contained an exclusive jurisdiction clause in favour of Spanish Courts. This risk was 98% reinsured in London with *Prifi* by means of a slip stated 'as original' and contained a full reinsurance clause. A player, due to injury, was forced to an early retirement and in turn the football club sought indemnity from the insurer's Musini who contended liability on the ground of non-disclosure of player's pre-existing condition thus, the policy was voidable. The reinsurer also sought negative declaratory relief upon the same grounds, in England; the reinsured sought a stay in Spain by alleging that the reinsurance contained an exclusive jurisdiction clause indicating that the Courts of Spain would substantiate proceedings in accordance with art. 23 of Council Regulation 44/2001. The issue before the court was to assess whether such clause was incorporated by the use of general words of incorporation; and in reaching his conclusion Andrew Smith J was of the opinion that the full reinsurance clause did not generate such incorporation; it only had the effect of incorporating, from the underlying policy, the terms which were germane and consistent with those of the reinsurance. This decision is consistent with the earlier judgements in *Arig Insurance Company Ltd v. Sasa Assicurazione Riassicurazione SpA;*[95] *AIG Group (UK) Ltd v. The Ethniki*[96] and *AIG Europe SA v. QBE International Insurance Ltd.*[97]

Many cases involving D&O reinsurers emanate from the US or Latin America and in these cases the validity and enforceability of an exclusive jurisdiction clause is a matter for the common law. As commented above, an English court is not required to entertain an action under a contract which confers jurisdiction on that court where the

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[94] [2003] EWHC 2796

[95] [1998] unreported

[96] [1999] Lloyd's Rep. IR 221, affirmed [2000] Lloyd's Rep. IR 343.

[97] [2002] Lloyd's Rep. IR 22.

defendant is domiciled outside the EU and EFTA.

D&O policies would be affected by the use of either arbitration or choice of jurisdiction clauses, yet it does not seem that in assessing their effect, the interpreter would have to depart from the general rules of construction set above. However, the same cannot be said in regard to choice of law.

As far as reinsurance is concerned, choice of law is governed by the Rome Convention 1980: the provisions of choice of law rules for insurance, contained in the regulations made under the Financial Services and Markets Act 2000 do not apply to reinsurance agreements. Articles 3 and 4 of the Rome Convention are the focus of our attention. Article 3 requires a Court to enforce a choice of law clause if it is expressed with reasonable certainty. Article 4 on the other hand, fills the gap in absence of an express choice of law provision by presuming that the applicable law is that of the forum where the business of the party, whose performance features the main contractual obligation.

The effect of the decisions in *Vesta* and *Groupama* makes of little relevance the fact that a reinsurance policy -issued as original- is governed by English law.[98] If the reasoning in the aforementioned cases is the appropriate one, the effect of the presumption of back to back cover would be that of deeming both contracts as to be governed by the law applicable to the direct policy.[99] In *GAN Insurance Co. Ltd v. Tai Ping Insurance Co Ltd*[100] reinsurance was sought in the London Market by means of a facultative slip policy which did not contain any wording in regard to choice of law. A follow the settlements and claims co-operation clause were incepted in the reinsurance slip; however for the most part reinsurance was provided 'as original'. The insured sustained losses which were settled by the reinsured accepting liability. Nevertheless, the reinsurer sought a declaration that they were not liable and was entitled to avoid the policy for misrepresentation and also there had been a breach of the claims cooperation clause on the part of the reinsured. Since the underlying policy was governed by Taiwanese Law by containing a choice of law clause in this regard, the reinsured contended that by means of incorporation this should be the law

[98] Merkin op cit at 98
[99] *Ace Insurance SA-NV v. Zurich Insurance Co* [2001] Lloyd's Rep IR 504
[100] [1999] Lloyd's Rep. IR 472

applicable to the reinsurance contract. This argument was rejected by the Court of Appeal because it was inappropriate for the reinsurance to be governed by Taiwanese Law. In fact it could not be suggested that the reinsurers wanted to be governed by an isolated choice of law clause in the underlying policy.

In Ace Insurance SA-NV v. Zurich Insurance Co[101] it was correctly emphasised, following the teaching in Vesta v. Butcher, that English Law would be irrelevant as to the law applicable to the direct policy since it has to be construed – as a result of back to back cover- in accordance with the law applicable to the direct policy. It does not mean English Law is irrelevant at all, in fact when the notion of incorporation, instead of referring to the insuring wording, regards to the incorporation of terms and conditions proper of the direct policy, which may be irrelevant and even repugnant to the reinsurance policy, clear words of incorporation are mandatory. For example, incorporation of claims co-operation clauses, which form part of the reinsurance agreement and not of the underlying policy. In this context English Law is of very much assistance as to give to these special provisions their exact construction.[102]

In the absence of an express term of incorporation to the contrary and in accordance with the decision of Longmore J in *Tiernan v. Magen Insurance Co*[103] -when a reinsurance contract is placed by Lloyd's brokers on the Lloyd's market in the conventional way, the contract is on a Lloyd's form and it contains London market clauses, there is consequently an implied choice of English law as the governing law under article 3 of the Rome Convention.[104] This decision reaffirms once more that there are limits to the notion of incorporation not only when the term is inappropriate for inclusion in the reinsurance agreement but also when the parties have done nothing to specifically incorporate a choice of law clause contained in the underlying policy into the reinsurance one.

Besides, policy definitions, conditions, warranties and the like, choice of law is of major impact to D&O policies in two other scenarios namely: liability of reinsurers to insureds in fronting agreements and limitation of actions and time bar. These merit separate comments.

[101] [2001] 1 Lloyd's Rep. 618
[102] *GE Reinsurance Corporation v. New Hampshire Insurance Co* [2003] All ER 392
[103] [2000] I.L.Pr.517
[104] As established by the Contracts (Applicable Law) Act 1990.

9.9 Liability of Reinsurers to Insureds in Fronting Agreements

Undoubtedly, one of the major concerns of D&O reinsurers using fronting agreements is the possibility of them facing a direct action by the assured under local law.
A number of jurisdictions in Latin America and even the US allow the possibility of third parties to claim directly against insurers despite lack of privity. In Brazil for example the Code of Civil Procedure entitles the victim (third party) to sue the insurer in two specific circumstances, where insurance is compulsory namely: motor insurance and employer's liability.[105] The same practice is followed in Venezuela but only in road accidents, where there is an '*iuris tantum*' presumption that not only the driver but also the owner and the insurer are jointly and severally liable.[106]
Now depending on languages and jurisdiction this practice is known as 'denunciacao da lide(Portugues) , Cita en Garantia, Citacion en Garantia or Llamamiento en Garantia (Spanish). All the proceedings are featured by the possibility of joining the insurer as co-defendant and sometimes, as in Colombia, this practice known as 'Litisconsorcio Necesario' is mandatory. Now, in theory insurers could by means of 'Cita de Terceros' as it is known in these jurisdictions, join the reinsurer in the proceedings and the outcome for this practice lies very much in how keen local courts are to apply foreign law and jurisdiction clauses. It is true that in countries like Venezuela, Argentina and Uruguay, English wordings and clauses usually prevail and are enforceable conversely, the same cannot be said in Brazil, Peru and Mexico where persuading the courts to follow this practice is a remote possibility.[107]
In the US the situation is even clearer since there have been court's decisions allowing direct actions by policyholders against reinsurers despite lack of privity. However, this practice seems plausible only when there has been reinsurance for 100% of the risk and the reinsurer enters into a direct relation with policyholders by taking over reinsured's services.[108] In *O'Hare v. Pursell*[109] the court ruled:

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[105] Leech, op cit at 5
[106] Leech op cit. In Chile there is a possibility of direct action against liability insurers albeit the Commercial Code refers to marine matter its application could be extended as to cover other types of Insurance. In this regard article 1201 Provides: " only in the cases in which a liability insurer issues a guarantee to cover the liability of the insured can he be sued directly by the third party and in whose favour the said guarantee has been issued".
[107] Ibid
[108] Hall: *Fronting: Business Considerations, Regulatory Concerns, Legislative Reactions and Related Case Law* in www.robertmhall.com/articles/frontingdoc.htm
[109] 329 S.W. 2d 614 (Mo.1959) in Hall op cit.

"By taking over the risk assumed by [the cedent, the] reinsurer put itself in a position of a contractor with the insureds. The law supplies the privity necessary for insureds to maintain a direct action upon the contract of reinsurance."[110]

English Law does recognise direct actions against insurers, in two important cases: motor insurance; and where the assured has become insolvent. Secondly, the Contracts (Rights of Third Parties) Act 1999 does permit a third party to rely upon a contract term for its benefit. Thus if a reinsurance agreement contained a cut-through clause, then the assured would have the right to rely upon it.[111]
In a fronting situation the insurance and reinsurance are separate agreements and in the absence of a cut-through clause English Law would not allow the assured to sue the reinsurers. However, if the reinsurance is governed by the same law as the local agreement (usually as a result of back to back cover) and local law allows a direct action then the reinsurers could be caught. In reality what happens is that the reinsurance agreement will contain a claims control clause[112] under which the reinsurers will handle the claim by the assured and will treat themselves as the insurers for all practical purposes.

Consequently, in reinsuring D&O policies by means of fronting agreements, reinsurers should act in the awareness that their liability in full could be tested by foreign jurisdictions. It is true, English Courts may unlikely allow reinsurers' assets in England and Wales to be subject of foreign executing orders however, if keeping credibility in the captive market is the issue, non compliance with local interpretation might undermine the future of their business.

9.10 Limitation of Actions and Time Bar

Once more if both the insurance and the reinsurance are governed by the law of the insurance few problems can arise from claims conditions and time bar provisions. As

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[110] Ibid at 622. There is a number of decision in the field e.g. *Foremost Life Ins Co v. Department of Insurance* 395 N.E. 2d 418 (Ct.App.Ind.1979); *Venetsanos v. Zucker, Farcher & Zucker*, 638 A.2d 1333 (Sup.Ct.N.J.1994); *Keightley v. Republic Ins Co* 946 S.W. 2d 124 (CT.App.Tex.1997) and more recently *Edens v. United Benefit Life Ins. Co*, 2001 WL 11431140(N.D. Tex).

[111] Subject to doubts as to the compatibility of a cut-through clause with the insolvency rule that unsecured creditors must be treated *pari passu*.

[112] Infra Claims Control Clauses.

noted above[113] English courts could be reluctant to treat as incorporated a claims clause since it is inappropriate for inclusion in the reinsurance agreement. It is the author's view that the real hazard for D&O reinsurers in this state of affairs is as it has been emphasised, that some jurisdictions e.g. Peru and Mexico may tend to construe the policy in accordance with local law irrespective of a choice of law clause to the contrary. Hence if a party (insured or reinsured) challenges an English law clause and persuades the court to apply local law instead[114] the reinsurer could be liable under local interpretation. A typical example is when, in accordance with local law, the period of time for rejection or acceptance of the claim has expired.

Let us suppose the first limb is met and local courts decide to apply the law of the forum; the point is then to asses the impact of local provisions regarding notification, acceptance or rejection of the claim for the purpose of reinsurers' liability. There are two examples to illustrate the problem. In Argentina, the insured must notify its insurer within three days of the happening of the event giving rise to a claim and the insurer has thirty days to notify the insured whether or not the policy responds and/or the claim is covered. Lack of compliance on the part of the insurer leads to full acceptance of the claim and this potentially gives rise to a claim against the reinsurers, subject to considerations of whether the insurers have acted gratuitously and not bona fide and businesslike (for the purposes of a follow the settlements clause) and whether they are not in breach of any claims provision in the reinsurance agreement.[115]

Colombia represents the second example; in this jurisdiction the matter is governed by article 1080 of the Commercial Code following its amendment by law 510 of 1999. Once the insured has established its right to claim before the insurer, the latter has one month to pay the claim or give evidence as to discharge its responsibility. Failing to do so or proving within one month results in a twofold set of sanctions: firstly, the insurer and the reinsurer could be liable for punitive delay interest on the principal sum in excess of 50% pa; secondly, the insured is entitled to initiate proceeding by using a fast track route which in any case does not take long to reach a conclusion.[116]

Two matters might favour reinsurers. First, irrespective of the applicable law English law, only in exceptional circumstances, recognises awards of punitive damages. In any case there is a good defence in this regard as to not meet liability. Secondly, if

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[113] Supra: Incorporation from the Direct Policy.

[114] Leech, op cit at 3

[115] Leech, op cit at 5

[116] Leech op cit at 6

Home Insurance of New York v Victoria-Montreal Fire[117] is applied, the one month time limit for the acceptance or rejection of the claim, together with the sanction for non-compliance, could be held inappropriate for inclusion in the reinsurance agreement despite the presumption of back to back cover.

As hinted above, even where the reinsurance contains a follow the settlements clause, it is far from obvious that reinsurers would be bound in a situation in which the insurers have incurred liability by reason of their own negligence or recklessness in not observing local law provisions.

9.11 Follow the Settlements and Fortune Clauses in D&O Reinsurance Policies

Nowadays it is customary to include as part of a facultative reinsurance agreement a follow the settlements clause which may preclude the reinsurer from reinsured to indemnify the reinsured when: (a) the latter has settled any claim against it in good faith and businesslike fashion; and (b) the loss falls within the terms of the reinsurance. This twofold approach was laid down in *Insurance Co of Africa v. Scor (UK) Reinsurance Co Ltd*[118] where the reinsurance policy stated: "a Reinsurance of and warranted same…terms and conditions and to follow the settlements of the Insurance Company of Africa." Robert Goff L.J was of the opinion that the effect of a clause in these terms is that reinsurers bind themselves to follow whatever was agreed by the reinsured provided the two tests are met. In other words reinsurers could escape liability only by proving that the settlement has not been reached in good faith or businesslike manner or that it does not fall within the reinsurance. From the outset it could be suggested that reinsureds in any case bear the burden to prove that as matter of law, the loss is covered by the reinsurance.

The leading authority is the decision in *Assicurazioni Generali SpA v. CGU International Insurance Plc*[119] a Canadian company acting as front for Generali, offered cover for the risk of installation and maintenance of power cables to be laid under a river. A year later one of the cables suffered damage as a result of abrasion in the river-bed. The cable was replaced and in turn the insured claimed and settled the dispute with Generali for Can$4m. Generali reinsured 80% with the defendant and a

[117] [1907] AC 59
[118] [1985] 1 Lloyd's Rep 312.
[119] [2004] EWCA Civ 429

number of Lloyd's syndicates, the policy which was issued read: "As original: Anything herein to the contrary notwithstanding, this Reinsurance is declared and agreed to be subject to the same terms and conditions, special or otherwise, as the original policy or policies and is to pay as may be paid thereon and to follow without question the settlements of the Reassured except ex-gratia and/or without prejudice settlement". (Emphasis added).

Lloyd's syndicates paid their share nevertheless, the defendant contested liability as to pay its share by relying on the decision in Scor on the following grounds: a) the losses did not fall within the reinsured risk; b) the reinsured payment was ex-gratia therefore it was not entitled to an indemnity. The two questions before the Court of Appeal were: firs to what extent reinsurers are precluded to contest liability in regard to back to back cover?; secondly, what was the effect of adding the statement 'without question' to the above said clause?

In reaching its conclusion, the Court of Appeal was of the opinion, following the earlier authority in Scor, that the presumption of back to back cover does not mean the reinsurer has to indisputably agree to a settlement reached by the reinsured in good faith and businesslike manner if the claim does not fall within the terms of the reinsurance as a matter of the law applicable to the reinsurance agreement. Consequently, the effect of a follow the settlements clause is not embraced by the presumption of back to back cover where the settlement so reached either contradicts or differs in nature from the risk upon which the reinsurer agreed to provide its service.

Secondly, the effect of the expression 'without question' does not affect or qualify what the defendants have agreed to follow but the manner in which they are required to follow the settlement of the reinsured.[120] In other words, the clause works as enforcing the original obligation to follow the settlements not as to impose a wider one.

Putting this decision in D&O context provides interesting results. In regard to the first limb of the *Scor* test, that a follow the settlements clause provides its benefits where the reinsured has acted honestly and in a businesslike fashion in settling the dispute with the insured, gives rise to a number of problems,. In a D&O policy, when is a reinsured deemed to have acted honestly? It is clear from the cases that the reinsured

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[120] Ibid.

must settle, other than simply, on the basis that there is cover under the reinsurance policy. This is precisely, the rationale of a follow the settlements clause from reinsurers' perspective. In fact the purpose of this clause has been stated as being: "to ensure that the integrity of the reinsurer's bargain was not eroded by an agreement over which he had no control."[121] The point here is to imagine possible scenarios in which reinsureds could act in bad faith or outside the reinsured risk for the enforcement of the clause.

One circumstance appears to be where reinsureds settle a claim without enquiring into and assessing the nature of the relationship between the insured (director) and the company, when it is in fact the case that the director's capacity is debatable as a matter of law. For example, mere employees of the company are not directors. Here, any settlement by the reinsured would be rendered both in bad faith and repugnant to the reinsured risk. Secondly, what would the reinsurers' position be if the reinsured paid in the awareness of the fraudulent nature of the claim? Let us suppose for an instance that a situation like that of the facts in *Macdonnell Information Systems Ltd v. Swinbank and others*[122] where despite the claim being framed in terms of negligence, the Court of Appeal accepted the insurer's argument that it was necessary to look at the true basis of the claim and in this case it was fraud. Yet, what is the position if the reinsured pays anyway. It is almost certain that reinsurers could successfully argue that the reinsured's liability was not incurred in a bona fide and businesslike fashion and thus not binding on reinsurers.

Thirdly, the position would be radically different where the dispute is based upon the meaning of local terms or contractual construction;[123] following the authorities in *Vesta* and *Groupama*, where the reinsured pays upon a fair interpretation of the policy in accordance with its governing law it seems that the follow the settlements clause might provide its benefits in full. This scenario could arise for example if the reinsured settled a claim on the understanding that the insured director acted in his capacity and the wrongful act was one of negligence and it subsequently became clear from further evidence that the act was ultra vires or reckless or fraudulent. In this scenario, the *Scor* case is clear that the reinsurers would nevertheless be liable as long

[121] *Assicurazioni Generali Spa v. CGU* [2004] EWCA Civ 429

[122] [1999] Lloyd' Rep IR 98. For the facts of this case see supra Chapter II 2.3.2 The Unwelcome Scenario.

[123] Recently in the decision *Canelhas Comercio Importacao e Exportacao Ltd v. Wooldridge* [2004] EWCA 984 the Court of appeal decided about the enforcement of an exclusion clause by means of interpreting the expression 'robbery'

as at the time of the settlement the reinsured had acted in a bona fide and businesslike fashion. The reinsurers will of course have subrogation rights against the indemnified party in such a case.

Finally, what is the effect where there is no follow the settlements clause in the reinsurance agreement? In *Commercial Union Assurance Co v. NRG Victory Reinsurance Ltd*[124] it was decided that in absence of a follow the settlement clause the reinsured has to establish his liability to the assured as a matter of the law applicable to the direct policy

Hence, it is not enough that any settlement is made in good faith or businesslike manner; the Court of Appeal went on to decide that it is necessary for the reinsured to prove on the balance of probabilities that the reinsured faced liability to the assured. It is not enough for the reinsured to show that the rationale behind the settlement of the dispute was merely to avoid larger costs or fears as to the outcome of the case.[125]

9.12 The Impact on Claims Co-operation and Claims Control Provisions.

D&O reinsurance policies, in the same way as other reinsurance agreements, contain claims control or claims co-operation clauses, particularly where there is fronting. D&O gives room to specific controversies in this field. Furthermore, these sorts of clauses are closely connected with the 'claims made' nature of D&O policies; issues sufficiently covered as part of this research[126] and it is suggested that those should be read in conjunction with this discussion. Reason being the fact that what triggers insurer's liability could activate, by means of claims control/co-operation clauses, the contractual duty impose upon reinsureds to notify, co-operate and/or passing the claim over to reinsurers in order to deal with it. Consequently, the following paragraphs address the law as it stands nowadays as a useful instrument for D&O reinsuring parties.

[124] [1998] 1 Lloyd's Rep 80 reversed [1998] Lloyd's Rep IR 421

[125] See also *King v. Brandywine Reinsurance Co (UK) Ltd* [2004] EWCA 1033.

[126] Supra Chapter II 2.4.1 Substantive Trigger of Liability and 2.4.2 The Procedural Trigger of Liability: When Notice Must Be Given.

As suggested earlier on, 'claims control[127] and co-operation clauses' put before reinsurers basic tools to prevent reinsureds for settling claims which as a matter of law could have been successfully contested or avoided. However, the inclusion of both claims control and follow the settlement provisions leads to some extent to confusion. The key aspect of claims control clauses is that the wording used in drafting may render such clauses as *condition precedent* the breach of which, discharges reinsurers. In *Eagle Star Insurance Co Ltd v. Cresswell*[128] a reinsurance agreement provided a follow the settlements clause subdue to a *condition precedent* to any liability under the policy that the company would: "(a) notify all claims or occurrences likely to involve the Underwriters within 7 days from the time that such claims or occurrences become known to them; (b) The Underwriters hereon shall control the negotiations and settlements of any claims under this Policy. In this event the Underwriters hereon will not be liable to pay any claim not controlled as set out above."[129] After deciding that limb (a) was not a condition precedent, the court turned its attention to limb (b) by individually assessing each of the sentences of the statement. The first one 'the underwriter hereon shall control the negotiations and settlements of any claims under the policy' was understood as not imposing an obligation upon reinsurer but giving them the right to exercise control of the negotiations at their will. At this point it was necessary to ascertain when reinsurers could exercise their right to take control of the settlement and the Court of Appeal was the of view that reinsurers were entitled to be informed by the time the negotiations began and it was at this stage that reinsurers may decide to take control.

In regard to the second part of clause (b) 'In this event the Underwriters hereon will not be liable to pay any claim not controlled as set out above' the court held that the

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[127] Form LM4 NMA 2738 contains a model of claims control clauses in the following terms: Claims Control Clause (approved by Lloyd's underwriters' non-marine association): "Notwithstanding anything to the contrary contained in this Reinsurance it is a condition precedent to Reinsure(s) liability under this Reinsurance (a) The Reinsured shall give to the Reinsure(s) written notice as soon as reasonably practicable and in any event within 5 days of any claim made against the Reinsured in respect of the business reinsured hereby or of its being notified of any circumstance which could give rise to such a claim.(b) The Reinsured shall furnish the Reinsurer(s) with all information known to the Reinsured in respect of claims or possible claims notified in accordance with a) above and shall thereafter keep the Reinsurer(s) fully informed as regards all developments relating thereto as soon as reasonably practicable.(c) The Reinsurer(s) shall have the right at any time to appoint adjusters and/or representatives to act on their behalf to control all investigations, adjustments and settlements in connection with any claim notified to the Reinsurer(s) as aforesaid.
The Reinsured shall co-operate with the Reinsurer(s) an any other person or persons designated by the Reinsure(s) in the investigation, adjustment and settlement of such claim".
[128] [2004] EWCA Civ 602
[129] Ibid.

word 'in this event' meant no in case reinsurer opted to take control but in the event there were negotiations following a claim at insurance level. For this reason, such a clause was a condition precedent for the mere fact that "underwriters will not be liable to pay any claim not controlled".[130]

Now if reinsurers refuse to control the negotiation, the reinsured could be in a helpless position, in other words incapable of settling the claim since in any case the reinsurer will not follow the settlement. Rix LJ suggested two possible solutions: a) waiver on the part of reinsurer to take control which activates the contractual duty to follow reinsured's settlements; and (b) following the decision by the Court of Appeal in *Gan Insurance Co Ltd v. Tai Ping Insurance Co Ltd (Nos 2 and 3)*[131] that reinsurers should not exercise their discretion as to the enforcement of a clause of this nature in bad faith to the detriment of the reassured. In either case it seems that reinsurer's discretion is not unlimited: it being the real issue that a court of justice would not award damages for bad faith in rejecting a claim or delaying payments.[132]

In *Gan v. Tai Ping*[133] the Court of Appeal set out fundamental rules of construction namely: firstly, this type of clause is a condition precedent for the right to recover under the reinsurance policy, it is irrelevant if the reinsured could prove his loss; secondly, in case of breach the burden of proof is upon reinsurers; thirdly, the claims co-operation clause does not impose an obligation upon reinsurers to undertake the investigation, it gives the right to participate in the negotiation process; fourthly, lack of reinsurer's approval in either settling or admitting on the part of reinsureds discharges the latter as to his duty to indemnify.

More recently in *Royal and Sun Alliance Insurance Plc v. Dornoch Limited*[134] it was decided that in construing claims control clauses, omission as to who has proposed the clause is demanded, to give this sort of interpretation consistency. In so achieving 'condition precedent' has not to be subject to narrow interpretation: a fair construction

[130] Ibid.

[131] [2002] Lloyd's Rep IR 667.

[132] See the decision in *Normhurst Ltd Dornoch Ltd* [2004] EWCA 567 (Comm).

[133] [2002] Lloyd's Rep IR 667. The claims control clause was in the following terms: " Notwithstanding anything contained in the reinsurance agreement and/or policy wording to the contrary, it is a condition precedent to any liability under this policy that (a) the reinsured shall, upon knowledge of any circumstances which may give rise to a claim against them, advise the reinsurers immediately, and in any event not later than 30 days; (b) the reinsured shall co-operate with reinsurers and/or their appointed representatives subscribing to this policy in the investigation and assessment of any loss and/or circumstances giving rise to a loss; (c) No settlement and/or compromise shall be made and liability admitted without prior approval of reinsurers."

[134] [2004] EWHC 803. For the facts of the case see supra Chapter II: The Procedural Trigger of Liability: When Notice Must Be Given.

is required to give the policy holder protection as to the onerous consequences of failing to comply with clauses of this nature.

CONCLUSIONS

The task of conducting a research in this, for the most part, unexplored area of judicial debate has provided a number of interesting ideas which – the author hopes - might contribute in one way or another to ease D&O disputes. The most important conclusions from this work are the following:

Firstly, it is a fact that D&O policies have developed from professional indemnity insurance with the idea of providing Directors and Officers with the same sort of protection, namely against liability to the company and to third parties. However, directorship is not a profession in its own right. This leads to the conclusion that – albeit there is not to date a single case decided in the United Kingdom- when the time comes, a court might have no option but to consider that whenever D&O cover is provided, the insured is acting as a director but does not obtain protection under the professional indemnity provisions of the policy, had umbrella cover been agreed. This argument does not prevent D&O cover working as an ancillary protection for professionals but the point remains that the covers cannot overlap since the nature of D&O insurance excludes that possibility.

Secondly, facing the issue of whether or not D&O policies have performed as designed in the UK, the surprising fact is that there is no single decision regarding at least the substantive cover offered by this sort of insurance. The reason lies in the fact that almost all disputes have arisen with regard to issues relating affecting cover and their allocation between insured and uninsured claims, and between insured and uninsured defendants. It would not necessarily be right to believe that this is the result of a deliberate decision by underwriters not to contest the scope of D&O primary cover in order to prevent binding precedents being handed down by the courts. However, given the restricted environment in which D&O insurance might offer benefit, one may have no option but to believe that some element of this may be involved.
Directors and Officers are subject to a significant number of duties leading to criminal and civil liability which by nature are uninsurable. It is accepted that public policy impedes the likelihood of insurance in scenarios tainted by fraud, wilful misconduct,

bad faith, fines, punitive and/or exemplary damages; but this is the feature of most of their liabilities. Likewise, a number of civil liabilities do not result in insurable loss to the victim: within this context, account of profits, injunctions, declaratory relief, restoration of property – amongst others – simply do not give rise to the sort of liability covered by D&O insurance. Other liabilities which may be imposed are not incurred in the insured capacity, but simply affect directors as members of the company which also undermines D&O effectiveness. Further, insurers exclude a number of claims – usually in the form Insured v. Insured claims – to restrict even more its efficacy.
Additionally and of huge importance is the issue of directors' tortious liability which courts are unwilling to recognise other than in the clearest of circumstances. The application of the assumption of responsibility principle as precondition to tortious liability is still a possibility in private companies, where there could be proximity between third parties and directors. Nevertheless, such a possibility is remote in the extreme as regards public companies. However, recent amendments to the Companies Act 1985 show that the legislature has recognised a kind of statutory liability of directors to third parties by introducing 'third party indemnity provisions' which by the way open the door as to the possibility of companies indemnifying their directors. While the nature of these provisions is still to be tested by the courts, it is obvious that third parties might be entitled to claim by way of indemnity against both the company and its directors, had such provisions been agreed. D&O insurance is concerned with this scenario in the sense that having agreed to these sorts of provisions implies not only full disclosure to insurers but the real possibility of directors incurring liability to a nominated third party, which obviously, increases insurers' risk perception to say nothing of side B or companies' reimbursement cover whenever they lawfully fund and indemnify directors.

Thirdly, and given that the disputes reaching the courts concern defence costs and allocation, it is necessary to adopt an efficient and for the most part reliable method of ascertaining the scope of coverage and apportioning the costs. It has been said that the Relative Exposure Test might successfully work in this regard, in the sense that the party more vulnerable to liability should not only take the lead in resisting the outcome but also benefit the most by the time apportionment of legal cost become at issue. There is evidence that these methods of allocation are becoming popular in this

forum. Comments in regard to defence costs would be incomplete if the recent impact of the Companies (Audit, Investigations and Communities Enterprises) Act 2005 is ignored. In fact, companies are, quite properly, allowed to advance defence costs incurred by directors in defending legal proceedings concerning their liability. Whether the director is found liable of fraud or wilful misconduct, he/she is bound to repay the costs; otherwise companies might recur to Side B cover to claim from D&O insurers by means of reimbursement the costs of defending their directors. The importance of this comment lies in the fact that, given the composite nature of D&O policies, the company might be entitled to reimbursement from its insurer whilst the director's claim is successfully refused. Additionally and most important is the fact that, sooner rather that later, disputes will arise as between companies and insurers as to the statutory and/or contractual duty to advance defence costs to directors. We will have to wait and see how the courts will interpret a case concerning a dispute as to who has to advance these moneys and if insurers have to give consent for their being incurred , given the fact that now companies are statutorily allowed to do so and Insurers could be contractually liable as well.

Fourthly, reinsurance does not escape controversy in this field. Without doubt the issue of fronting gives rise to a number of issues which affect the correct interpretation and functioning of D&O policies. It has been ascertained in chapter VII that Civil Law jurisdictions do recognise directors' liabilities which are to some extent alien to those recognised by English law. This means that whenever D&O reinsurers provide facultative reinsurance by using fronting agreements, the presumption of Back to Back cover matches the two polices as to having the same construction and even, following the decision in Vesta, the same applicable law. The last point results in reinsurers having to indemnify insurers' directors in a number of situations which under an English perspective would have not given rise to liability in the first place. It does not mean that reinsurers face liability when rules of public policy are ignored, but rather that on a strict contractual interpretation, reinsurers cannot escape liability by alleging that the nature of directors' liability recognised in the captive market is unknown, more or less demanding in this legal forum. The problem remains in that the notion of Back to Back cover and that of incorporation are still unresolved. Some examples have illustrated how judges have gone a long way in using incorporation so as to match both covers. It is believed that quite innocently and for the most

understandably, some decisions tend to protect the London reinsurance market by providing reasoning that may - if appropriate to say so - alleviate indemnities following terrorism, financial and natural disasters.

Finally and having said all of this, what is left for D&O policies? Undoubtedly, one might think that this research challenges the usefulness of this kind of liability insurance by observing that the majority of liabilities that directors could incur are by nature and /or on grounds of public policy uninsurable. However, D&O polices are very effective in a number of situations which go from covering negligent breach of duties, innocent misunderstandings of directors' disabilities, alongside liabilities arising from innocent or non-deliberate interpretations of companies' constitution, giving rise to recoverable insurable losses to the company and whether possible to third parties.
D&O insurance seems to provide its benefits in full when insolvency strikes the company and wrongful trading is carried out by its directors in the sense – despite the doubts expressed above – that this sort of insurance would work as a fund to guarantee the legitimate rights of third parties including shareholders. Also, its efficacy is unquestionable in regard to defence costs cover and allocation by providing, once more a fund which might permit a good defence or reimbursement in successfully contesting liability. This last scenario is for the most passionate due to its complexity and technicality.

The true aim of all that has been said above is simply to give guidance to whoever sees himself in need of liability cover, as to what that cover should be and what exclusions should be accepted. By doing this D&O market perception could be assessed by its real significance and not merely by good marketing.

It is of less importance whether the author's ideas are right or wrong. What really matters is if these ideas help others to develop good or better ones.

Adolfo Paolini

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