# The duty of loyalty and insider trading in light of the contractual stipulations of directors and officers liability insurance (D&O insurance).

## Comments on the decision in Special Appeal no. 1.601.555 from the Superior Tribunal of Justice[1] (Third Panel, unanimous decision, Reporting Judge Ricardo Villas Bôas Cueva, judged on February 14, 2017).

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*"The corporate opportunity doctrine requires a corporate director to render to Caesar at the best possible price that which is Caesar's[2]."*

**Abstract**

This article comments on a significant decision from the Brazilian Superior Court of Justice (Special Appeal no. 1.601.555/SP) from Judge Ricardo Villas Bôas Cueva, Third Panel, which was decided on February 14, 2017. For the first time, the jurisprudence in Brazil handled a case concerning D&O insurance and insider trading and it came to an interesting conclusion, in the sense that it decided that the D&O insurance contract should not cover conduct that does not fit into the definition of a management act. The aim of this article is to look beyond the decision and comment further on some aspects not mentioned in it, such as the: (i) the need for the existence of a causal connection between the non-disclosure and the loss as a prerequisite for denying coverage and (ii) the legal classification of insider trading and its absence of coverage under D&O insurance. It focusses on the inapplicability of the business judgment rule to the case and the flexibility of the concept of intentional misconduct referred to in Art. 762 of the Brazilian Civil Code as a condition of losing cover and it also focusses on the practice of insider trading.

[1] The *Superior Tribunal de Justiça* (STJ) is Brazil's highest court for non-constitutional matters, with responsibility for harmonizing the interpretation of federal laws by the state and regional federal courts of appeal.

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[2] Robert W. HAMILTON. *The Law of Corporations in a Nutshell*. 5th ed., St. Paul, Minn.: West Group, 2000, p. 478.

## 1. Introduction

The Brazilian courts are increasingly being called upon to decide on disputes involving insurance contracts. Recently they have addressed important issues such as: (i) the right of third parties to sue the insurer directly under a facultative civil liability insurance (Special Appeal no. 962.230/RS, Reporting Judge Luis Felipe Salomão, 2nd Section, which shortly thereafter led to the issuance of *Súmula*[3] 529/STJ); (ii) time-bar on lawsuits between insurers and reinsurers (Special Appeal no. 1.170.057/MG, Reporting Judge Ricardo Villas Bôas Cueva); (iii) suicide in the ambit of life insurance (Special Appeal no. 1.334.005/GO, Reporting Judge Isabel Gallotti, modifying the previous jurisprudence of the STJ (Special Appeal no. 1.077.342/MG, Reporting Judge Massami Uyeda)); (iv) the three-year time-bar on suits by beneficiaries under collective life insurance contracts (Special Appeal no. 1.397.173/RS); and (v) adjusting health insurance premium plans due to change in age category (Special Appeal no. 1.568.244/RJ), the last two in which Judge Ricardo Villas Bôas Cueva served as the reporting judge.

This article focusses on another significant decision from Judge Ricardo Villas Bôas Cueva in a dispute involving civil liability insurance for corporate executives, known in the insurance market as D&O insurance. The case is Special Appeal no. 1.601.555/SP, Third Panel, decided on February 14, 2017.

This type of insurance, although relatively unknown to the general public, has been gaining importance and visibility in Brazil, especially following the news that claims had been filed to establish coverage for the actions of many of the executives implicated in the Lava Jato ("Car Wash") investigation into massive corruption (kickbacks and illegal political campaign financing) in contracts between Petrobras and large engineering companies[4].

From relative obscurity in the early 2000s, this type of insurance is now considered essential by companies listed on the BM&FBovespa[5]. Indeed, it is hard to imagine any sensible executive today accepting an invitation to act as an officer or sit on the board of directors of a large corporation in Brazil without the comfort of D&O insurance being part of the deal.

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[3] A *súmula* is a statement from a higher court of consolidated jurisprudence, or 'jurisprudence constante' on a particular point.

[4] With respect to the Lava Jato investigation and D&O insurance, see the following news stories: (i) "Lava-jato ajuda a divulgar e aperfeiçoar o seguro D&O", available at http://www.revistaapolice.com.br/2016/12/lava-jato-e-seguro-deo/; (ii) "D&O – Operação lava-jato e o seguro D&O", available at https://linhasfinanceiras.com/2015/03/01/do-operacao-lava-jato-e-o-seguro-do/; and (iii) "Depois da lava-jato, seguro fica mais caro para executivos", available at http://economia.estadao.com.br/noticias/governanca,com-lava-jato--seguro-para-empresas-fica-mais-caro,1702321. All consulted on March 4, 2017.

[5] A study performed by the São Paulo Securities Exchange (BM&FBovespa) revealed that of the 69 companies composing its main tracking index, the Ibovespa, at least 54 had contracted D & O insurance (78%). (data available in "A Responsabilidade Civil e o Seguro D & O". RODRIGUES, Ana Carolina. In *Revista de Direito Bancário e Mercado de Capitais*. 2012, v. 58. pp. 447-448). A more recent study indicates that of the 53 companies now comprising the Ibovespa, only one has not contracted D&O insurance for the benefit of its executives. (Source: http://www.cvm.gov.br/export/sites/cvm/decisoes/anexos/2016/20161011/0293__SEP.pdf, consulted on March 6, 2017).

With or without a crisis and irrespective of the increase in the loss ratio due to the accusations emerging from the Lava Jato probe[6], there is no doubt that this insurance will continue gaining importance in Brazil[7].

From a legal standpoint, this contract is at the confluence of three disciplines: (i) civil law, specifically the rules on insurance contracts; (ii) corporate law, regarding the liability of directors and officers, including a wide range of related questions (disclosure of material facts, mergers and acquisitions, initial public offerings, etc.); and (iii) criminal law, as it interacts with corporate law and civil law on matters related to the criminal liability of executives. Besides these three disciplines, consideration must be given to the direct and immediate influence of the rules emanating from the Federal Constitution[8], among them the dignity of the human person (Art. 1, III), solidarity (Art. 3, I) and presumption of innocence (Art. 5, LVII).

The decision discussed in this article shows a happy coordination of these disciplines, demonstrating the care of the reporting judge, Ricardo Villas Bôas Cueva, in researching the scant doctrine on the matter, and more than this, in expressing the grounds forming his decision. My modest comments thus aim to focus on certain aspects that were not addressed by him, in an attempt to bring more substance to the conclusions already set out in his judgment. This is the intention of the lines that follow.

## 2. **The decision**

To better understand of the background to my commentary and conclusions, I reproduce the headnote of the decision and some passages from the reporting judge's leading judgment:

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[6] As of the date of writing this article, more than 50 plea bargains to give evidence to the State have been reached with executives implicated in the corruption scheme.

[7] Although still relatively new in Brazil, D&O insurance is well established in mature insurance markets such as the United Kingdom and United States. As observed by María Jesús Guerrero Lebrón: "This insurance arose in the 1930s when Lloyd's of London first formulated coverage for civil liability of the officers and directors of commercial companies. (…) Although that insurance finds greatest acceptance and success in the United States, it was born in the United Kingdom." (LEBRÓN, María Jesús Guerrero. *El seguro de responsabilidad civil de administradores y directivos*. Madrid: La Ley, 2004., pp. 17-18).

[8] The debate among scholars regarding the direct/immediate versus indirect/mediate efficacy of constitutional rules to private relations is long and complex. Although it is not the central subject of this study, I believe the efficacy is direct/immediate, precisely because the force and density that compose the constitutional axiology cannot be restricted to the filling in of occasional gaps left by ordinary laws. This would, in my humble opinion, be a huge waste. In this respect, I refer to the writings, among others, of J.J. Gomes Canotilho (CANOTILHO, José Joaquim Gomes. "Civilização do direito constitucional ou constitucionalização do direito civil. A eficácia dos direitos fundamentais na ordem jurídico-civil no contexto do direito pós-moderno." In *Direito constitucional. Estudos em homenagem a Paulo Bonavides*. Org. Eros Roberto Grau and Willis Santiago Guerra Filho. São Paulo: Malheiros, 2001. p. 113) and Pietro Perlingieri (PERLINGIERI, Pietro. *O Direito Civil na Legalidade Constitucional*. Translated by Maria Cristina de Cicco. Rio de Janeiro: Renovar, 2008., pp. 576-577).

Headnote:

**Special appeal. Civil law. Civil liability insurance for directors and officers of companies (D&O insurance). Renewal of the policy. Risk assessment questionnaire. Untrue information from the insured and the policyholder. Bad faith. Configuration. Loss of the right to theinsurance. Investigations of the CVM [Brazilian Securities Commission]. Practice of insider trading. Malicious act. Personal favoritism. Management act. Absence of coverage**.

1. The dispute hinges on (i) whether there was intentional non-disclosure when filling out the risk assessment questionnaire for renewal of the civil liability insurance for directors and officers of the company (D&O insurance) and (ii) whether the insurance indemnity is due when insider trading has occurred.

2. The penalty imposed on the insured for acting in bad faith, by making inexact declarations or omitting circumstances that can influence the acceptance of the proposal by the insurer or the rate of the premium, is loss of the insurance (Arts. 765 and 766 of the Civil Code). However, the non-disclosure or misrepresentation must have some causal connection with the loss, i.e. it must be linked to a real aggravation of the risk (Enunciation 585 from the Seventh Civil Law Meeting).

3. In this case, the information provided by the policyholder and by the insured in the proposal did not reflect the true position of the company at renewal, which induced the insurer to err in its contractual risk assessment. The malicious omission of the events under investigation by the CVM justifies the loss of the right to the insurance indemnity.

4. The omitted facts were material and should have been reported even before renewal of the contract, because of the duty of good faith on the insured, to *"communicate to the insurer, as soon as becoming aware of it, any incident that can substantially increase the risk covered, under pain of loss of the right to the insurance, if it is proven that the decision to remain silent was in bad faith"* (Art. 769 do Civil Code).

5. D&O insurance (directors and officers insurance) has the objective of protecting against the risk of potential loss caused by the management acts of officers, administrators and directors who, in their professional activity, act with culpability[9] (SUSEP Circular 541/2016). The aim is to preserve not only the individual net worth of those who hold management positions (insureds), to encourage innovative corporate practices, but also to preserve the net worth of the company (policyholder) and its shareholders, since they will be reimbursed for any damages.

6. The D&O insurance policy cannot cover malicious acts, principally those committed to favour the administrators themselves, so as to prevent managers from

[9] *Culpa*, defined as negligence, imprudence or malpractice.

> seriously reducing of the degree of diligence they exercise or assuming excessive risks, thus compromising both compliance by the company and good corporate governance practices. Application of Arts. 757 and 762 of the Civil Code.
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> 7. Insider trading is defined as any transaction carried out by insiders (officers, administrators, directors and people equated as such) with securities issued by the company, for their own benefit or that of a third party, based on relevant information not yet disclosed to the public. It is a practice that is damaging to the capital market, investors, and the corporation itself, so there must be effective deterrence of the improper use of privileged information (Arts. 155, § 1, and 157, § 4, of Law 6,404/1976 and Art. 27-D of Law 6,385/1976).
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> 8. D&O insurance only covers (i) culpable acts of officers, administrators and directors (ii) committed in the exercise of their functions (management acts). In other words, fraudulent and dishonest acts of personal favoritism and malicious acts injurious to the company and capital market, such as insider trading, are not covered by the insurance policy.
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> 9. Special appeal denied.

Essentially, the reporting judge's decision was based on two issues: first, omission of information prior to contracting the insurance and loss of cover; and second, the legal classification of insider trading and its absence of coverage under the scope of D&O insurance.

The first aspect – omission of information and loss of the insurance – is not novel, so it is not worthy of any great digression. Only one point in particular warrants attention and will be analyzed here, namely the need for the existence of a causal connection between the non-disclosure and the loss of the insurance indemnity[10].

The second aspect – the legal classification of insider trading and the absence of D&O insurance coverage – will be analyzed more thoroughly to clarify, initially, its application in corporate practice, and then to scrutinize it through the tenets of insurance contracts.

## 3. The first aspect: the need for a causal connection between the non-disclosure and the loss for coverage to be lost (sanction set forth in Art. 766, main section, of the Civil Code)

It will be instructive to start with the most pertinent passages of the Judge's leading judgment, whose first part alludes to the need for the non-disclosure to be relevant and then addresses the question of a causal connection:

> "It should be noted that according to the above-mentioned rule, except in the case of bad faith of the insured, there is nothing in the misrepresentation or omission in declarations that causes loss of the insurance. Rather, these can only influence the

[10] This is in conformity with Enunciation 585 from the Seventh Civil Law Meeting

> acceptance of the insurance or the premium. Besides this, in line with Enunciation 585 from the Seventh Civil Law Meeting, the non-disclosure or misrepresentation must bear a causal relation with the loss claimed, i.e. it must be linked to a real increase of the risk. (p. 5. Emphasis added)"

In the case giving rise to the appeal, the insured (the executive) and policyholder (the company) had failed to disclose information relevant to the insurer's risk assessment, thus justifying application of the sanction set forth in Art. 766, main section, of the Civil Code, which provides as follows:

> Art. 766. If the insured, himself or through his representative, makes misrepresentations or fails to disclose circumstances that can influence acceptance of the proposal or the rate of premium, he shall lose the right to the insurance, whilst remaining liable to pay the past due premium.
>
> If the misrepresentation or non-disclosure in the declarations results from bad faith of the insured, the insurer shall have the right to cancel the contract or adjust the premium, even after the occurrence of the loss.

The policyholder and the insured, when filling out the questionnaire given to them by the insurer, answered the question concerning the existence of any judicial or extrajudicial investigations, actions or proceedings negatively, and they repeated the non-disclosure when answering the question whether they expected judicial or extrajudicial investigations, actions or inquiries.

The specific point that deserves consideration is the need for the existence of a causal connection between the non-disclosure and the loss for the sanction, established in the final part of the main section of Art. 766 of Civil Code, to apply. This is set out in Enunciation 585 from the Seventh Civil Law Meeting:

> Enunciation 585 – Payment of the insurance indemnity is required even in the presence of ambiguous conduct, omissions or declarations of the insured when these do not have any connection with the loss.

With respect to the loss of insurance coverage due to the existence of a causal connection, as decided in the case in question, further analysis will be helpful on the timing of the non-disclosure or misrepresentation, before or after the conclusion of the insurance contract.

Let's consider the hypothetical situation of someone who, in filling out a questionnaire to contract life insurance, deliberately fails to reveal that he is suffering from cancer of the intestine. The insurer, relying on the information provided, accepts the proposal and issues the policy. It is worth repeating here the legal rule applicable to the situation (Art. 766, Civil Code):

> "If the insured, himself or through his representative, makes a misrepresentation or a non-disclosure that can influence the acceptance of the proposal or the rate of the premium, he shall lose the right to the insurance whilst being obliged to pay the past premium that is due."

Later, during the period of the insurance, the insured dies of a heart attack, diagnosed in the autopsy as having nothing to do with the cancer that was not disclosed. According to the interpretation expressed in

the referred enunciation from the Civil Law Meeting, the beneficiaries of this policy would not lose the right to the indemnity, thus rewarding the bad faith of the insured. But is this deliberate conduct totally irrelevant? Would this be in line with the *mens legis* that applies to insurance contracts the duty of good faith to the highest degree: utmost good faith?

With respect to timing, the duty to disclose relevant information before the conclusion of the contract is covered by Art. 766 of the Civil Code, transcribed above, while the duty of disclosure afterward is covered by Art. 769 of the Civil Code:

> Art. 769. The insured is obliged to communicate to the insurer, as soon as he becomes aware, any incident that can considerably aggravate the risk covered, under pain of loss of the right to the insurance if it is proven that he acted in bad faith.
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> § 1. The insurer may, within the fifteen days following receipt of the notice of the aggravation of the risk without culpability of the insured, notify the insured, in writing, of its decision to terminate the contract.
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> § 2. The termination shall only become effective thirty days after the notification, and the insurer must refund the difference in the premium.

In this respect, a distinction must be made between non-disclosure in the pre-contractual phase and the obligation to report circumstances that may aggravate the risk thereafter, during the performance of the contract. The themes and the timing are different, requiring different examinations of the causal connection. Pragmatically speaking, beforehand either the proponent discloses or does not disclose relevant information. What will happen during the contractual period is a separate question from what happened in the pre-contractual phase.

Going beyond insurance contracts, it is necessary to bear in mind the general rules of all bilateral contracts (containing mutual obligations[11]), where the considerations of both parties are balanced out. Although the equality of the two considerations in insurance contracts (the value of the premium paid to the insurer and the value of the coverage acquired by the insured) is not as obvious as in sale and purchase contracts[12], for example, there is no way to deny that these values can be scientifically estimated with good accuracy, in our hypothetical life insurance case by actuarial analysis based on the information supplied by the proponent.

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[11] With respect to contracts whose obligations are corresponding, some notable remedies in the Civil Code are applicable when the contractual balance is upset, namely: the unperformed contract defense – *exceptio non adimpleti contractus* (Art. 476), the tacit or express termination of the contract (Art. 475); and the so-called objection of insecurity, according to which if after making the contract, one of the parties' financial situation erodes to the point of casting doubt on its performance, the other party can demand posting of a performance guarantee before complying with its obligation (Art. 477). If the obligations were weighed, found equal and mutually accepted, the best defense to be employed if one party fails to perform is the *exceptio*, whose main purpose is to preserve the contract, by giving the party in default a chance to perform before termination.

[12] "Neither objective nor subjective equivalence is necessary. Bilateral balance will exist if one of the considerations is objectively worth more than the other and both parties were aware of the difference." (REGO, Margarida Lima. *Contrato de Seguro e Terceiros*. *Estudo de direito civil*. Coimbra: Coimbra Ed., 2010. p. 312).

Had the insurer been informed about the intestinal cancer beforehand, it would either have refused the coverage or charged a higher premium. The fact that the claim is not connected with the cancer is unrelated to the duty[13] of the insured to provide accurate and complete information to the insurer, under pain of completely subverting the solidary logic on which this contract is built.

Were the interpretation to prevail that the non-disclosure of a highly relevant fact – the intestinal cancer – is irrelevant, this would mortally wound the contractual equilibrium[14].

The rule on the need to demonstrate a causal connection is therefore dangerous. Instead of better protecting the interests of insureds, it does exactly the opposite, by making insurance more expensive for all insureds. Put bluntly, insureds cannot be allowed to lie deliberately, knowing that no penalty will apply where a causal connection is not established.

The Brazilian and foreign doctrine[15] is basically settled on the matter of the need for the proponent to act with loyalty and utmost good faith in providing information to the insurer. Making this duty conditional does not serve the interests of anyone.

## 4. The second aspect: the legal classification of insider trading and the absence of coverage by D&O insurance

In essence, the appellate decision we are focusing on adopts the position that insurance in general can never cover intentional misconduct, nor can it protect the personal interest of executives to the detriment of those of the company. It cites in this respect the recent SUSEP[16] Circular 541/2016[17], whose Art. 5

[13] With regard to the provision of information in the pre-contractual phase, the interested reader can consult two works that specifically and comprehensively cover this theme: Carlos Harten – "*El deber de declaración del riesgo en el contrato de seguro. Exposición y crítica del modelo brasileño y estudio del derecho comparado,*" Salamanca: Ratio Legis, 2007; and Luís Poças – "*O dever de declaração inicial do risco no contrato de seguro*". Lisbon: Almedina, 2013.

[14] "Of the three new principles developed by contemporary contractual theory, there is a deficit in the treatment by lawmakers, legal scholars and the courts of the balance between the considerations in relation to the related tenets of objective good faith and the social function of contracts. (...) The Constitution of 1988, because of the need for compromises to ease the tension between antagonistic ideas, established on one side the principle of free initiative and on the other that of social solidarity, from which one can extract the need for economic equilibrium of contracts. Without overlooking the autonomy of the parties, the constitutional axiology suggests the presence of balance between the agreed considerations, since solidarity rejects dysfunctional imbalance. (...) Therefore, among the consequences of rereading the principle is that equilibrium, from a dynamic perspective, should not be ascertained in isolation, based on singular aspects of the contract. Instead, attention should be paid to the complexity of the relationship in its entirety, a path that can be called functional equilibrium." (Carlos Edison do Rêgo Monteiro Filho and Fernanda Paes Leme Peyneau Rito, in '*O Direito Civil entre o sujeito e a pessoa: estudos em homenagem ao professor Stefano Rodotà'*. Gustavo Tepedino, Ana Carolina Brochado Teixeira, Vitor Almeida (Coords.) – Belo Horizonte: Fórum, 2016, pp. 425-426).

[15] CAVALIERI FILHO, Sérgio. *Programa de Responsabilidade Civil*. 5th ed. São Paulo: Malheiros, 2004, p. 428; ALVIM, Pedro. *O Contrato de Seguro*. 3rd ed. Rio de Janeiro: Forense, 2001, p. 131; STIGLITZ, Rubén S., *Derecho de Seguros*. 4th ed. Buenos Aires: La Ley, 2004. tome I, p. 355, among many others.

[16] SUSEP is the Superintendency of Private Insurance, the insurance market regulator.

refers to coverage of "damage caused to third parties as a consequence of culpable illicit acts committed in the exercise of the functions to which they [directors or officers] were appointed." (p. 11).

It continues by explaining the concept of insider trading, calling on the definition given by Norma Parente[18]:

> "Insider trading is considered to be any transaction carried out by an insider (officer, administrator, director or person holding an equivalent position) with securities issued by the company, for their own benefit or that of a third party, based on relevant information not yet revealed to the public.
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> In turn, relevant information is that which can *"measurably influence the quotation of the securities issued by the company, affecting the decision of investors to buy, sell or retain these securities."* (p. 12)."

Toward the end, the reporting judge mentions the duty of loyalty, stating that:

> "(...) executives must observe duties of care and loyalty, always seeking the best interest of the corporation, within the limits of their powers. Therefore, they must "keep secret any information not yet disclosed to the market, obtained by reason of their positions and able to measurably influence the quotation of securities, their being forbidden to use such information to obtain advantage for themselves or third parties through buying or selling securities (duty of secrecy - Art. 155, § 1, da Law 6,404/1976). (...) The conclusion is hence that the D&O insurance can only cover (i) culpable acts of officers, administrators and directors (ii) committed in the exercise of their functions (management acts). In other words, fraudulent and dishonest acts of personal favoritism and malicious acts injurious to the company and capital market, such as insider trading, are not covered by the insurance. (...) However, the trading of the shares of TPI, in the situation analyzed, although classified as an intentional act of the insured, forbidden by civil law, did not come from a management act, i.e., an act under the prerogative of the position as administrator, but rather was a personal act, in the capacity of shareholder, to generate personal financial gains, to the detriment of the interests of the company.
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> Since he detained privileged information that could not, at that moment, be revealed to the public, it was wrongful to trade shares in the market, pursuant to the rule of Art. 155, § 1, of Law 6,404/1976. (p. 16)"

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[17] At the time of writing this article, the start of effectiveness of SUSEP Circular 541/2016 is suspended for 90 days, as per SUSEP Circular 546/2017. After several discussions and controversy, SUSEP issued Circular nº. 553/2017, that stands as the regulatory framework for D&O insurance contract.

[18] PARENTE, Norma Jonssen. "Aspectos Jurídicos do "Insider Trading". Comissão de Valores Mobiliários, Superintendência Jurídica, June 1978. Available at: <http://www.cvm.gov.br/export/sites/cvm/menu/acesso_informacao/serieshist/estudos/anexos/Aspectos-Juridicos-do-insider-trading-NJP.pdf>. Consulted on: December 5, 2016.

In summary, the judgment upheld the rejection of the insured's pleadings by the lower appellate court based on two grounds: (i) the insured's conduct, insider trading, is not classified as a management act; and (ii) intentional misconduct cannot be covered by insurance according to the Civil Code.

### *4.1. The duty of loyalty (similarities with, and distinctions from, the duty of care)*

Assumption of an executive position (officer, director or similar title) requires a certain level of expertise[19] and brings many duties, as defined in Articles 153 and following of Law 6,404/1976 (Law of Corporations). Of these, the relevant ones are the duty of care and the duty of loyalty.

The duty of care is specified in Art. 153 and essentially requires the executive to take certain reasonable steps when making decisions to prevent being held liable for unsuccessful business initiatives later on.

These steps involve other duties, namely: (i) the duty to obtain adequate information; (ii) the duty to act lawfully; (iii) the duty to be vigilant or provide adequate supervision; and (iv) the duty to abide by the company's internal rules of governance.

Unlike the duty of loyalty, the duty of care is flexible, as it[20] depends on the particular situation at stake, taking into consideration the parameters mentioned above.

In turn, the duty of loyalty is more rigid, with little margin for variation according to the parameters of the situation. It is not flexible, and pragmatically speaking, it means assuming that the conduct is or is not loyal and honest. There is no middle ground.

This duty, as stated, is based on the principle of objective good faith and it acts as a main pillar, from which all other actions expected of executives are derived. It does not require having "pure-hearted sentiments" – love, compassion or charity, but from a practical standpoint, this duty translates into conduct that once transgressed can lead to various abuses.

The obligation to act loyally can be divided into positive and negative behaviours. It is not sufficient, for example, to exercise the right to vote in conformity with the perceived interest of the company (positive behavior); it is also necessary not to abstain from voting when necessary to protect the corporate interest

[19] Deep knowledge, acquired at a good business schools, economics, production engineering or related areas, allied to wide practical experience, is an essential ingredient, without which this task becomes difficult to achieve. Instead of the outmoded *bonus pater familiae*, it is necessary to make space for the businessman. There is plenty of corporate law doctrine endorsing this: EIZIRIK, Nelson. Deveres dos Administradores de S.A. Conflito de Interesses. Diretor de S.A. indicado para conselho de companhia concorrente. In *Temas de Direito Societário*. Rio de Janeiro: Renovar, 2005, p. 68; CARVALHOSA, *Modesto. Comentários à lei de sociedades anônimas: Lei nº. 6.404, de 15 de dezembro de 1976*. São Paulo: Saraiva, 1998, p. 228); and MARTINS, Fran. *Comentários à lei das sociedades anônimas*. v 2. t. 1. Rio de Janeiro: Forense, 1978. pp. 361-362.

[20] "In this respect, the fundamental difference is that while the duty of care is malleable to fit the circumstances of each case and is modulated in function of distinct competing characteristics, the duty of loyalty is not subject to any modulation. (…) Loyalty, in business, does not allow any modulation regarding the limits of this concept, since fidelity and loyalty to the company and its interests are not a concept that can be graduated depending on the circumstances, as stated." (TREVIJANO, Cristina Guerrero. El deber de diligencia de los administradores en el gobierno de las sociedades de capital. La incorporación de los principios de la *business judgment rule* al ordenamiento español. Cizur Menor (Navarra): Thomson Reuters/Aranzadi, 2014, p. 236).

(absenteeism[21]). So, the duty of loyalty guides executives in all aspects, acting as a backbone of other obligations to be observed in corporate life.

As studies of corporate law deepen, this duty is increasingly present, ranging from trivial to complex questions. Be it the act of establishing a corporation, increasing its capital, floating shares, providing information to the market, exercising the right to vote or abstaining from voting, taking part in a takeover or merger, among many other possibilities, the duty of loyalty is present, reflected in various aspects of corporate law.

Having covered the connections and limits inherent to the duties of loyalty and care, I now analyze these concepts through the spectrum of the D&O insurance contract.

### *4.2. Analyzing the decision through the spectrum of the D&O insurance and the business judgment rule*

Assuming that D&O insurance protects executives from the consequences of their management acts, with the condition that these should not be malicious, it appears clear that no insurance coverage can apply, because of the violation of the duty of loyalty. Since this insurance is intended to protect well-intentioned management acts, disloyal behavior by the executive cannot be protected.

Recalling what has been said about the rigidity of the duty of loyalty (no middle ground exists between loyalty and disloyalty), disloyal conduct can have no synergy with the duty of care, which is covered by the insurance contract, if the respective prerequisites are satisfied (as mentioned above).

The first aspect to be considered regarding alleged breaches of the duty of care is the so-called business judgment rule. Although still relatively recent in Brazil, the business judgment rule[22] has been applied in the United States for nearly 200 years[23]. Essentially, the rule is a mechanism that protects diligent

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[21] "(...) However, dispersed shareholding among a wide ownership base, which is characteristic of listed corporations, leads to absentee ownership, which is marked by indifference of most owners of shares in participating at general meetings and trying to influence the company's management. This absenteeism renders the rights afforded to minority shareholders inoperable, since they cannot reach the minimum percentage required by law to have their desires considered. One of the causes of absenteeism, according to Joaquín Díaz-Cañabate, is the fact that shares are purchased for different motives (see Garrigues and Díaz-Cañabate, 1982, p. 24). Shareholders can be classified according to the interests that prompted them to acquire the shares into entrepreneurs, speculators and income-seekers (see Requião, 1988, p. 107). Furthermore, the greater the dispersion, the larger will be the number of people who buy shares only as a source of earnings, be it in the form of dividends or appreciation (income-seekers and speculators, respectively).

[22] "The 'business judgment' sustains corporate transactions and immunizes management from liability where the transactions are within the powers of the corporation (intra vires) and the authority of management, and involves the exercise of due care and compliance with applicable fiduciary duties." (HENN, Harry G.; ALEXANDER, John R. Law of Corporations. 3rd ed. St. Paul: West, 1991, v.1., p. 44, cited in SILVA, Alexandre Couto. *Responsabilidade dos administradores de S/A: business judgment rule*. Rio de Janeiro: Elsevier, 2007, p. 107).

[23] "The first decision involving the principle of the business judgment rule dates from 1829 and refers to the case of *Percy v. Millaudon*, judged in Louisiana. On that occasion, the state court held that the mere generation of a loss did not make the manager liable. For this purpose, it would be necessary to prove he committed an act inadmissible according to the standard of the common man under similar conditions. The precedent entered the case law before any mention of standards of behaviour. Due to the influence of

executives, i.e., those that abide to the duty of care, when carrying out routine management acts (Art. 158, main section, Law of Corporations). Without a modicum of protection, it would be very hard to find serious and competent professionals who would be willing to assume leadership positions in corporations, and this would hamper their financial health.

The business judgment rule is closely connected to the duty of care, which as explained requires, above all, that the executives thoroughly know what they are doing and obtain accurate information. Indeed, they do not have to be (nor could they be!) experts in all areas of human knowledge applicable to corporate operations. On the other hand, there is no doubt that middling, merely ordinary, knowledge, is not sufficient to manage a large company.

All the comments made regarding the level of care expected of executives should be reiterated, considering that they, applying their general and technical knowledge, will be called on to make important decisions in the corporate interest.

The rule, as said, protects management acts, i.e., acts carried out in administering the company. To reiterate, disloyal conduct is deemed to fall outside the scope of legitimate management, so it is not protected by the business judgment rule[24]. Obviously, the rule does not serve to protect disloyal acts, which at worst involve fraud[25].

Turning now to the second aspect, which is the D&O insurance contract, I believe the STJ's decision left something to be desired, by indicating that the conduct of the executive in question did not qualify as management act, i.e., something that could, under other circumstances, have fallen under the duty of care, and hence been eligible for protection under the business judgment rule. Instead, the conduct clearly violated the duty of loyalty, because the executive, due to his inside position, took advantage of privileged information to enrich himself, relegating the company's interests to the sidelines.

The fact of the matter is that the business judgment rule can never be invoked to shelter disloyal acts. As stated, this rule applies to business management decisions, where the risk can be transferred via D&O insurance.

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American case law, it was incorporated in Art. 72, no. 2, of the Code of Companies of Portugal, determining the exclusion of liability of managers if they demonstrably act "in an informed manner, free of any personal interest and according to the criteria of business rationality." (HENTZ, Luiz Antônio Soares. "Ação social de responsabilidade e business judgment rule". *Revista de Direito Bancário e do Mercado de Capitais*, v. 68/2015, pp. 99-112, April-June 2015).

[24] With regard to Spanish law, Cristina Guerrero Trevijano explains, with good support, the reason the business judgment rule does not serve to protect conduct considered disloyal by executives: "In the first place, decisions related to the obligations derived from the duty of loyalty are under no circumstance protected by the rule, since it does not apply to decisions in which executives have no margin of discretion that allows them to choose between possible solutions. The expression has the same sense in American doctrine, which does not allow the rule to apply in alleged conflicts of interest or lack of independence." (TREVIJANO, Cristina Guerrero. op. cit., p. 256).

[25] The business judgment rule does not protect decisions by directors that constitute fraud, illegality or *ultra vires* conduct. (BLOCK, Dennis J.; BARTON, Nancy E; RADIN, Stephen A. *The Business Judgment Rule: Fiduciary duties of corporate directors*, 5th ed. New York: Aspen Law and Business, 1998, p. 90. Cited in SILVA, Alexandre Couto e. op. cit., p. 126, footnote 338).

### *4.3. The legal classification of insider trading*

In simple language, insiders have access to information that can be harmful to the company if disclosed to the market prematurely but useful to them because of advance knowledge of matters that can cause stock price movements. All these matters will be debated by the board of directors, executive board and (if established) the oversight board[26], before being debated at a general meeting and/or revealed to the general public.

Therefore, insiders must safeguard the secrecy of the information they receive, always acting in the best interests of the company. Their engagement in acts that seek personal benefit to the detriment of that of the company must be strongly penalised, and this includes the possibility of criminal prosecution[27].

Modesto Carvalhosa and Fernando Kruyven[28], specifically referring to members of the oversight board, explain how privileged the position occupied by them is, thus requiring them not to use the information received for their own benefit:

> "The members of the oversight board are classified as primary insiders, since they have direct access to the confidential information of the company in the exercise of their functions. Therefore, if they buy or sell shares immediately before the disclosure of a material fact about a matter under their purview, the presumption is that they acted with privileged information. This is a relative presumption, placing the burden on the accused member to prove the trading was not based on that information, or that he had been regularly buying or selling those shares beforehand, or because the information did not reach the board, or because it was in the public domain."

In the case under review, the insured was a member of the board of directors of the company (policyholder). Because of his position, he had access to certain internal information of the company, and took advantage of that knowledge to obtain a personal advantage by buying shares issued by the company, in a textbook case of insider trading.

The directors or other executives are permitted, under normal circumstances, to acquire shares of their company, of course if this is not restricted by the respective bylaws. So, if they do so under normal circumstances there is no way to speak of a management act, but instead a private act in their capacity as shareholder.

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[26] The oversight board is called *conselho fiscal* in Portuguese, where *fiscal* comes from the verb *fiscalizar,* to oversee/examine/supervise. It is acts purely as a watchdog that can be established at the behest of the shareholders (with greater weight given to minority shareholders), to perform an independent and supplementary supervisory role to that of the board of directors.

[27] Brazil's Law of Corporations. "Art. 27-D. To make use of relevant information not yet disclosed to the market, of which they [administrators] are aware and that should be kept secret, which is able to provide, for themselves or others, undue advantage through trading securities, in their own name or that of others. Penalty – reclusion, from 1 (one) to 5 (five) years, and a fine of up to 3 (three) times the value of the illicit advantage obtained as a result of the crime."

[28] CARVALHOSA, Modesto e KRUYVEN, Luiz F. Martins. *Sociedades Anônimas. Tratado de Direito Empresarial*. São Paulo: Revista dos Tribunais, 2016. v. 3, p. 950.

Along the same line, the mention in the decision of SUSEP Circular 541/2016[29] was fortunate, as was the transcription of the passage from the insurance contract clearly stipulating coverage for management acts.

The question that calls for analysis here is a subtle one, namely: was this act from an insider merely culpable, thus eligible for coverage by the insurance policy, or was it intentional – malicious – not covered by the policy?

### *4.4. The flexibility of the concept of intentional misconduct (referred to in Art. 762 of the Civil Code) as a prerequisite of losing cover and the practice of insider trading*

Intentional misconduct, as is obvious, is not embraced by the insurance contract. This is because under Brazilian law insurance requires the existence of a pure risk that can come to pass. If the pure risk turns into a speculative/provoked risk, insurance cannot cover it[30].

From the moment the risk ceases to be uncertain, unpredictable (pure, as stated), and enters the land of certainty, or in other words, becomes a preordained loss due to the insured's own conduct, the equilibrium of the insurance contract is totally upset.

Article 762 of the Civil Code is clear in stating that "a contract insuring a risk arising from a malicious act of the insured, the beneficiary or the representative of one or the other is null."

Hence, if the insured intentionally drives his car into a river, he will lose the cover under his car insurance. The same goes for the businessman who sets fire to his warehouse (fire insurance) and the beneficiary who kills the insured (life insurance). In these common examples, the loss of coverage is a logical, rational, consequence, leading to the transmutation of the originally lawful contractual subject matter into an unlawful objective (Art. 104, III, Civil Code), eliminating one of the essential prerequisites for the validity of contractual transactions in general.

However, it will be helpful to examine the flexibility of the rule contained in Art. 762, whilst focusing on the conduct of the insider. To reiterate, in the case in question a corporate director acted on privileged information to trade the company's shares. This conduct was unquestionably intentional.

Even though the director did not behave this way just to receive the insurance indemnity (assuming that the insured did not engage in insider trading because he knew that if any problems arose he would be protected by the insurance policy), meaning his conduct was different from the *modus operandi* depicted in the examples given above, is it suitable to apply Art. 762 of the Civil Code to his behaviour?

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[29] See paragraph 4.

[30] In a comment on Article 2 of the Argentine law on insurance (Law 17,148/1967), Domingo Lopez Saavedra stresses the importance of the risk being unprovoked, because the risk would be replaced by certainty: "According to the best national doctrine, it can be stated that the risk is the probability or the possibility of producing an event or an act of man that can cause damage to the interest covered by an insurance policy or that gives rise to the obligation of the insurer to perform the agreed return consideration. The concept clearly excludes damage provoked by an act of intentional omission or gross negligence of the insured, since in this case, instead of a risk, there will be certainty, which will release the insurer from liability, as will be seen in the continuation of the comments on article 70 of the law." (SAAVEDRA, Domingo Lopez. *Ley de seguros 17.148. Comentada y anotada*. Buenos Aires: La Ley, 2009, p. 45).

The doctrine[31] regarding Art. 762 of the Civil Code usually takes a restricted view, focusing on acts that intentionally violate the insurance contract. But is this the only circumstance subject to the rule? Is intentional misconduct sufficient per se to void the insurance coverage, or is there a need to intentionally violate the insurance contract, i.e., to act deliberately to receive the indemnity?

What can be gathered from the rule of Art. 762 of the Civil Code is that for coverage to be avoided, there must be intention on the part of the insured, the beneficiary or the representative of one or the other. Analyzing the matter further, it is enlightening to reflect on the conditions for contractual transactions in general to be null and void, set forth in Art. 166 of the Civil Code, especially those specified in its numerals II (illicit subject matter), VI (fraud) and VII (comprehensively declared null by the law):

> Art. 166. A contractual transaction is null when:
>
> I – one of the parties has no capacity;
>
> II – its subject matter is illicit, impossible or uncertain;
>
> III – the motive, common to both parties, is illicit;
>
> IV – it does not have the form prescribed by law;
>
> V – a formality that the law considers essential for its validity was overlooked;
>
> VI – its objective is to defraud mandatory law;
>
> VII – it is null in its entirety, or its practice prohibited, under applicable law, regardless of any sanction. (emphasis added)

The director of the company (policyholder) received valuable and relevant information, and could not use it for his personal benefit (Art. 155, Law of Corporations). His buying or selling of shares before public disclosure of the information was doubtlessly deliberate. The objective he pursued, which was to make a profit easily, to the detriment of the company, was tortious, and could even have criminal repercussions (Art. 27-D, Law of Corporations) besides civil ones, due to his unjust enrichment[32]. So, since insider trading is illicit, he is required to restitute to the company the profit received unduly, *rectius*, unjustly.

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[31] The so-called 'Kamikaze cats': the arson fire set at a two-story bakery that only destroyed the first floor, and the 'clever' insured who burned his valuable cigars, were the subjects of astute analysis of Ricardo Bechara Santos in *Direito de seguro no novo código civil e legislação própria*, Rio de Janeiro: Forense, 2008, pp. 494-495.

[32] It can be claimed that the idea of unjust enrichment is applicable to the present case because the executive obtained a financial advantage to the detriment of the company. The natural order of things was inverted, and instead of looking out for the company's interest, the executive paid heed to his own interest. Hence, there is an absence, according to the etymology of the idea, of lawfulness in his conduct. Miguel Maria de Serpa Lopes highlights the essence of unjust enrichment, because the legal system cannot remain indifferent to the shift of wealth without reason, causing unjust imbalance between two net worths. As a consequence, 'a measure is imposed and the remedy consists of giving to the impoverished party a credit against the enriched party, just as granted to the victim of a tort against the cause of the damage. Thus, unjust enrichment becomes a source of obligations, as happens in non-contractual wrongdoing or mismanagement of business'." (SERPA LOPES, Miguel Maria de. *Curso de direito civil: fontes acontratuais – responsabilidade civil*, p. 56-57, cited by NANNI, Giovanni Ettore. *Enriquecimento sem causa*. São Paulo: Saraiva, 2004. Coord. Renan Lotufo. p. 88). For an interesting comment on the denial of coverage to executives who, in violation of the duty of loyalty, obtain financial gain to the detriment to the company, Joshua Phares Ackerman mentions the idea of 'personal profit exclusion' in the following terms: "Like other types of liability insurance, D&O policies do not provide universal

Even though the director did not originally (at the start of the policy) intend to receive the indemnity (either to pay defense costs or to cover a penalty imposed at the end of the case), the insurance contract was not conceived to protect clearly intentional misconduct. Based on the type of conduct specified in Art. 166, numeral VI, of the Civil Code, the policy can under no circumstance cover the conduct, because it had the purpose of defrauding a law that is mandatory, in this case the Law of Corporations (Art. 155). Furthermore, numeral VII also applies, nullifying the contractual transaction, as set out by the law (Art. 762 of the Civil Code).

In summary, intentional misconduct, whether or not with the direct objective of violating the insurance contract, cannot be protected.

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coverage. One common exclusion – the personal profit exclusion – prevents coverage of losses caused by the insured's wrongful conduct from which he inappropriately profited. For example, this provision would preclude coverage of a judgment against an executive for accepting kickbacks from a corporate supplier. (…) Personal profit exclusions generally state that they apply when executives have "in fact" profited from their conduct." This "in fact" formulation has caused confusion both about the question when the insurer can invoke the exclusion and about the quantum of proof necessary to establish that the exclusion applies. To understand the problem, imagine a situation in which an organization's directors misappropriated company information and used it to start their own firm. The shareholders of the original organization bring suit, alleging in their complaint that the board members breached their duty of loyalty by usurping a corporate opportunity. Imagine further that these board members make a claim under their D&O policy. The insurance carrier, naturally, seeks to prevent coverage-to avoid paying for the board members' defense and for any ultimate judgment-by invoking the policy's personal profit exclusion. (…) The purpose of the personal profit exclusion is to avoid a mismatch of incentives between the insured executive, the insurance carrier, and the organization. (…) In other words, without the exclusion, shareholders would essentially be financing their own damages award. In this hypothetical situation, shareholders would bear the costs associated with the loss-making contracts and would also partially finance any judgment award through higher D&O premiums while the executive would walk away with his undeserved gains." (ACKERMAN, Joshua Phares. A common law approach to D&O insurance "in fact" exclusion disputes. Available at Hein on line. Source: 79 U. Chi. L. Rev. 1429 2012., pp. 1429-1435, www.heinonline.org, consulted on March 12, 2017).