Managing the Risk of Directors' Wrongful Conduct through D&O Insurance

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1. Introduction

Companies may suffer loss through the wrongful conduct[1] of their directors. There are various techniques to mitigate this risk, one of which is insurance.[2] This method transfers or shifts the risk to insurers and should assist a company seeking to mitigate this risk for the purpose of protecting the long-term interests of stakeholders[3]. Accordingly, the question that the article seeks to answer is whether the company is truly able to mitigate the risk through insurance or whether there are certain obstacles that may prevent it from doing so.

Being able to mitigate corporate risks by transferring the loss to the insurer is an important feature of corporate insurance policies. Such policy coverages are typically provided to the company under Directors and Officers Liability Insurance (hereafter D&O insurance), which was introduced by Lloyds of London in the late 1930s.[4] This insurance is a type of liability insurance that aims to protect both the companies and directors for loss suffered either by the companies or third parties. The company may seek to bring a claim under the insurance policy

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[1] In this article, wrongful conduct means more than negligence: it is illegal conduct that may increase the value of the company in the short-term, but it exposes it to risks in the long term that can be detrimental to the stakeholders. An example of such behaviour can be found in the case of *Safeways Stores Ltd v Twigger* [2010] EWCA Civ 1472.

[2] There are four techniques identified which are avoidance, reduction, retention, and transfer which is the category to that the insurance belongs. See Emmett J. Vaughan and Therese M. Vaughan, *Fundamentals of Risk and Insurance* (10th edn. John Wiley, 2008) 18 and 34.

[3] For the purposes of this article, all stakeholders are taking into consideration. This includes not only shareholders and creditors but also other stakeholders such as employees, suppliers, and consumers.

[4] Julie-Anne Tarr, 'Directors' and Officers' Insurance: Recent Critical Issues in Australia and New Zealand' (2016) 1 J.B.L. 1, 1.

for various types of loss due to the operational deficiencies of its business and behavioural shortcomings of its directors.

2. Operation of Liability Insurance as a Risk Management Method

2.1 Liability Insurance

Liability insurance is a type of insurance that indemnifies the insured for claims brought by third parties due to injuries to themselves or damage to their properties. Like all policies of insurance, liability policies require an insurable interest to exist for the contract to be enforceable.

In a general sense, insurable interest can be defined as the risk of suffering loss arising from damage being caused to the insured's assets or property, or from its potential legal liability to third parties. Having an insurable interest can be one of the first conditions to obtain a valid insurance coverage and legal liability against third parties is the relevant insurable interest in liability insurance. In this article, the focus will mainly be on the insurable interest of the company and how risk is managed under liability insurance, specifically under a D&O policy.

Liability insurance is a "recent phenomenon" compared to other types of insurance.[5] Until the 1880s, no such insurance existed[6] and its introduction could not escape public condemnation because the idea of protecting the wrongdoer was seen as unlawful and antisocial.[7] It started to be commonly used towards the end of the nineteenth century and has had a significant impact on the law, especially in the subject of tort liability for injuries caused by personal fault.[8]

Liability insurance is different from other types of insurance as its subject is "less obvious".[9] As Waller LJ in *Feasey v Sun Life Assurance Co of Canada*[10] stated, "there is no hard and fast rule that because the nature of an insurable interest relates to a liability to compensate for loss,

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[5] Peter Cane, *Responsibility in Law and Morality* (1st edn. Hart Publishing, 2002) 242.
[6] Tom Baker, 'Liability Insurance at Tort-Crime Boundary' in David M Engel and Michael McCann (eds), *Fault Lines – Tort Law as a Cultural Practice* (Stanford University Press, 2009) 66, 67.
[7] Mary C. McNeely, 'Illegality as a Factor in Liability Insurance' (1941) 41 Colum. L. Rev. 26, 26.
[8] n 6, 67-68
[9] Malcolm A. Clarke, *The Law of Liability Insurance* (1st edn. Informa, 2014) 16.
[10] [2003] EWCA Civ 885.

that insurable interest could only be covered by a liability policy rather than a policy insuring properties or lives".[11]

Various forms of coverage are provided under liability insurance. These include employers' liability insurance, public liability insurance, product liability insurance, D&O insurance, warranty and indemnity insurance, and commercial vehicle insurance.[12] Although liability insurance policies usually extend to cover "liability at law",[13] there are certain limitations on the coverage to restrict the policy from being available to the insured for those losses arising from certain types of liabilities.

These restrictions arise in a number of situations:[14] (i) where the policy in its formation is illegal, (ii) where the insurance covers an action which is prohibited by law, (iii) where the claim brought by the insured is tainted by illegality, (iv) where the conduct of the insured has a negative effect on public policy, (v) where the insured caused his/her own loss by acting deliberately and wilfully, and (vi) where the insured caused his/her loss by acting negligently.[15] For example, policy coverage is not often provided by the insurer for a punitive damages claim,[16] whereas recovery for compensatory damages may not be provided to the insured if it would be contrary to public policy, even if the insured has valid policy coverage for such claims. Although the insured is eventually debarred from recovering the loss from the insurer in all these situations, the difference between situations (i), (ii), (iv), and (iii), (v), (vi) is that while the entire insurance policy is itself illegal and void in the former, the insured is not allowed to recover the loss in the latter as his/her particular conduct is tainted by illegality, in spite of the fact that the illegal conduct does not automatically render the policy entirely void.[17]

Although these restrictions may seem very strict, there is some flexibility depending on whose interest is protected by liability insurance. They may be firmly applied against the wrongdoing insured to debar him/her from benefitting from his/her illegality but they can be applied differently when the interest of a third-party victim is involved. For example, in motor liability insurance, a third party victim can still be entitled to recovery even though the insured driver

[11] ibid, para [97].
[12] See Digby C. Jess, *The Insurance of Commercial Risks: Law and Practice* (4th edn. Sweet Maxwell, 2011) 135-288.
[13] Robert Merkin, *Colinvaux's Law of Insurance* (11th edn. Sweet&Maxwell, 2017) para [21.014].
[14] ibid, para [5.062].
[15] ibid, para [5.062].
[16] With an exception. See Section 4.2 below.
[17] n 13, para [5.062].

has intentionally set out to cause harm to him/her.[18] The same consideration is valid when the third party, who has been victimised due to the fraudulent act of the insured, seeks to bring a claim against the insured's insurer to recover the loss he/she suffered. In such a case, the victim of the fraudulent act can be indemnified despite the fact that the claim of the insured would be rejected.[19]

This gives rise to the question whether liability insurance is a protection fund for third party victims, or protection for the insured. The answer to this has significant implications for D&O insurance because it helps determine whether such insurance aims to provide protection to the insureds, who are the company and its directors; or to the third parties, who have been harmed by the company's business practices. For this reason, the next section examines whether liability insurance is a protection for the insured, or the third-party victim.

2.2. Liability Insurance as a Protection for Whom?

Based on the definition of liability insurance provided by Merkin, this insurance protects the insured against third party claims, as the insured is provided with indemnity for the loss arising from its liability to the claimants.[20] If it is so, the rules on public policy will be strictly applied to debar the wrongdoing insured from recovery. Merkin, however, also opined that the courts have narrowed the principle of public policy by deciding that the real beneficiary of the insurance policy is not the insured but rather the third party victim who has been harmed by the insured and who may not be able to recover the loss he/she suffered from the insured in another way.[21] Wagner has demonstrated the common tendency among lawyers and politicians to consider liability insurance as protection for the victim, and has argued that "victim compensation should not be counted among the purposes of liability insurance".[22] He has also asserted that the argument that the objective of insurance is to protect the third party victim is rejected by most of the economic literature.[23] In addition, Baker argued that "liability insurance is a victim compensation fund, but it is not only that – and not even primarily that".[24] By

[18] *Charlton v Fisher* [2002] QB 578.
[19] *Total Graphics Ltd v AGF Insurance Ltd.* [1997] 1 Lloyd's Rep 599.
[20] Robert Merkin, 'Motor and Other Liability Insurance' in Robert Merkin (ed), *Insurance Law: An Introduction* (1st edn. Informa, 2007) 275, 275.
[21] n 13, Section 21.1.
[22] Gerhard Wagner, 'Tort Law and Liability Insurance' in Michael Faure (ed) *Tort Law and Economics* (2nd edn. Cheltenham, 2009) 377, 384.
[23] ibid.
[24] n 6, 69.

contrast, McNeely has shown that liability insurance is gradually becoming a tool which provides a fund for the injured party, and it is moving away from being a tool that can be used to protect the insured.[25] She defined this as a "substantial shift".[26] Fleming supported this argument in stating that "liability insurance is now generally recognised as in essence a contract for the benefit of third parties".[27]

The starting point of this approach (the 'first approach') was based on the idea of providing indemnification to victims of speeding[28] and drunken[29] driving. In such cases, it would normally be contrary to public policy to allow the insured driver to recover the loss from insurance when he/she has acted wilfully and culpably; however, regardless of how wilful the insured was, a third party harmed by him/her can still claim against his/her insurance policy.[30] This is because the one who has suffered the actual loss in such a case is the innocent victim. In a nutshell, illegality on the part of the insured, for which it will normally be contrary to public policy to award indemnification, may not be a reason to prevent the third-party victim from being indemnified for the loss suffered due to the insured's wrongdoing. The justification of this lies in the fact that the recovery would be awarded to the third-party victim rather than the wrongdoing insured. Such situations arise especially when a third party is deprived of the indemnity due to the insured having insufficient funds.[31] Therefore, the view that insurance may be a third-party protection fund was formally recognised for the first time in the Third Parties (Rights Against Insurers) Act 1930 (TPA30).[32] This Act mainly transferred the rights of the insured under his/her policy to the victim that has suffered loss due to wrongdoing by the insured when the latter was unable to pay due to insolvency.

An example of the application of the TPA30 was seen in *Total Graphics Ltd v AGF Insurance Ltd.*[33] In this case, despite the insured's claim under his insurance policy being rejected on the basis of his fraudulent conduct, the third party injured by the act of the insured was allowed to

[25] n 7, 60.
[26] ibid.
[27] John G. Fleming, 'Insurance for the Criminal' (1971) 34 M.L.R. 176, 177.
[28] *Tinline v White Cross Insurance Association Ltd* [1921] 3 KB 327.
[29] *James v British General Insurance Co* [1927] 2 KB 311.
[30] Ray Hodgin, *Insurance Law: Text and Materials* (2nd edn. Covendish, 2002) 131-132.
[31] n 12, 427.
[32] This Act was repealed by the Third Parties (Rights against Insurers) Act 2010 which has come into force on 1 August 2016; however, the Act 2010 has introduced the more extended version of providing a protection to victim third parties. See CMS, 'Third Parties (Rights against Insurers) Act 2010 – Commencement Date' (2016) Available at: < http://www.cms-lawnow.com/ealerts/2016/05/third-parties-rights-against-insurers-act-2010--commencement-date> accessed 22 June 2018.
[33] n 19.

recover the loss from the insurer. In addition, the Court of Appeal adopted a similar approach in *Charlton v Fisher,*[34] although not under the TPA30. In this latter case, the defendant driver drove his car deliberately toward the stationary car of the claimant in a hotel car park and rammed it. The damage caused to the third-party victim by the insured driver was regarded as "accidental". The reason for this approach was based on the idea of protecting the interest of the third-party victim, even though the wrongdoing insured intentionally caused the loss. As can be seen in both cases, protecting the third-party victim is a major consideration for liability insurance and courts will be willing to disregard how wilful the act of the wrongdoing insured was. From this perspective, it is obvious that insurance is a protection fund for the victim.

We now focus on the second approach, where insurance is regarded as protection for the insured against any possible loss suffered. This is actually the main objective that underlies the choice made by both individuals and companies to acquire insurance, because they prefer to mitigate the risk of liability and loss through insurance. Those who are insured would not pay such considerable premiums to purchase policy coverage for the sake of protecting any potential third-party victim; rather, they seek to recover the loss suffered due to any liability they may encounter.

However, the likelihood of recovering under an insurance is not as high as under the first approach. This is because in this second approach, the illegal behaviour by the insured is an important concern that determines whether providing recovery is against public policy. The rationale of public policy bear heavily on the outcome, as it seeks to prevent recovery by any wrongdoing insured who has acted deliberately, wilfully, or intentionally.

It can be seen that this discussion is more about which purpose of insurance is given more weight, because when the vulnerability of the victim is considered, the need to provide indemnification is the priority. The basis of the first approach is mainly distributive and compensatory justice.[35] This is also identified as "ethical compensation" by Williams.[36] In the second approach, the aim of deterrence is prioritised, therefore the gravity of the act of the insured will be subject to determination. The question of how the insured, and others involved

[34] n 18.
[35] Gary T. Schwartz, 'The Ethics and the Economics of Tort Liability Insurance' (1989) 75 Cornell L. Rev. 312, 328.
[36] Glanville Williams, 'The Aims of the Law of Tort' (1951) 4(1) Current Leg. Probs. 137, 141.

in such wrongdoing, should be deterred is to be answered. The foundation of this approach is the promotion of corrective and retributive justice, which is an important objective of tort law.[37]

Although the question who should benefit from the insurance is a difficult matter to determine in liability insurance, the difficulty arises from looking at the issue from different perspectives. From the perspective of the third-party victim, it is surely regarded as a protection fund; however, it is a form of relief for the wrongdoing insured from the liability.[38] Discussions as to whether liability insurance seeks to maintain distributive justice or corrective justice are ongoing. The answer can differ depending on the context which is dealt with. Underlying the different perspectives is the nature of the particular type of liability insurance because there are some compulsory types of liability insurance that primarily aim to protect the third party who has been harmed by the insured. This is actually the main reason why there are compulsory types of insurance: they aim to ensure the victim is not being left without any compensation should his/her claim not be satisfied by the wrongdoer. Motor insurance is one such form of insurance. On the other hand, there are other types of liability insurance that are optional purchases for individuals and companies. The aim of these is primarily to provide recovery to the insured for loss, rather than providing a fund to the victim third party. In the next section, we will examine how these considerations apply to D&O insurance.

3. D&O Insurance and the Mitigation of Corporate Risk

As can be seen, the answer of the question as to whether liability insurance is a protection fund for the third-party victim, or the insured, may differ depending on whether the insurance is compulsory or optional. The next section examines whether D&O insurance is compulsory or optional for the company to purchase and whether it aims to protect the third party or the insured.

3.1. Coverage of D&O Insurance

Understanding the operation of D&O insurance requires some basic knowledge of the types of coverage this insurance provides. Although the extent of D&O insurance coverage varies depending on the requirements of the particular company and directors, it usually applies to

[37] See Malcolm A. Clarke, *The Law of Insurance Contracts* (5th edn. Informa, 2006) 578.
[38] n 9, 2.

the "judgement, settlements, defence and legal costs incurred by directors as a result of claims against them for wrongful acts".[39] This can be interpreted in different ways but it typically covers the loss arising from "actual or alleged neglect, error, misstatement, misleading statements, omission or other breach of duty".[40]

Coverage provided by D&O insurance is typically split between three different clauses. These are termed as Sides A, B, and C. Sides A and B are a type of uniform coverage provided by the insurer as they are usually purchased simultaneously. They are named Personal Coverage (Side A) and Corporate Reimbursement Cover (Side B).[41] While Side A provides coverage to directors for their personal liability to third parties due to a breach of contract, or to the company for breach of fiduciary duties (owned by directors to the company); Side B provides coverage for reimbursing the company when it has indemnified its directors and officers.[42] These are not only the main areas of coverage provided by D&O insurance but also the main ways through which the company indemnifies its directors. This is because, under Side A, the directors are directly indemnified by the insurance policy purchased by the company, whilst the company is reimbursed by the insurance for the amount that it has indemnified its directors under Side B.

Additional protection is also offered by some policies to the company under Side C for the claims brought against it.[43] Such coverage is needed by the company when it is named defendant in a D&O claim. This has become common practice, especially in US based securities claims and employment disputes, where the company and its directors are targeted by the litigants.[44] That is why it is called "entity" or "corporate" cover.[45]

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[39] Noel O'Sullivan, 'The Demand for Directors' and Officers' Insurance by Large UK Companies' (2000) 20(5) European Management Journal 574, 575.
[40] ibid.
[41] ibid.
[42] For this reason, Side B is considered as 'balance sheet protection'. See Arthur J. Gallagher International, 'Directors' & Officers' Liability Insurance (D&O)' (2012) 3. Available at: <http://www.ajginternational.com/media/95298/airmic-do-guide-dec-2012.pdf> accessed 15 September 2018.
[43] Gregory Boop, 'Directors and Officers Insurance' (2016) Available at: <http://businessinsure.about.com/od/liabilityinsurance/a/Directors-And-Officers-Insurance.htm> accessed 31 June 2018.
[44] n 42. See also Chris Parsons, 'Directors' and Officers' Liability Insurance: A Target of a Shield' (2000) 21(3) Comp. Law. 77, 80.
[45] Adolfo Paolini and Deepak Nambisan, *Directors' and Officer's Liability Insurance* (1st edn. Informa, 2008) 60

3.2. D&O Insurance as a Protection for Whom?

D&O insurance is an optional form of liability insurance the company purchases to protect its directors and itself against the risk of loss. As D&O insurance is not mandatory, there must be some underlying reasons that incentivises the company to pay a considerable premium for the coverage. Based on the types of coverage provided by D&O insurance, these reasons can mainly be classified into two categories, namely the demand of individual directors and the company's desire to protect itself against potential corporate risk.

The first reason is the directors' high demands, as they intend to protect themselves against any type of potential personal liability to which they may be subjected as a result of being the director of a company. This is because, as Kirman stated,

> [A]n effective D&O insurance program, in combination with well drafted indemnification and exculpation provisions in corporate charters and by-laws, is a critical component of protection for directors and officers at a time of increased scrutiny by shareholders, courts, and regulators.[46]

The level of directorial demand can differ depending on the litigation risk that they may encounter, as insurance can be considered part of the director's compensation package, in addition to their remuneration. In this way, directors are also encouraged to take higher risks to increase the value of the company because directors with D&O insurance can be "less risk-averse and consequently are less likely to reject attractive new, risky projects".[47]

In addition, future directors may request policy coverage before they are appointed. Directors typically consider D&O insurance as an "indispensable prerequisite" for the company[48] because they tend to ensure that the risk of personal liability for the conduct in which they are involved on behalf of the company is as low as possible. As Hon. T.F. Bathurst observed,

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[46] Igor Kirman, 'Directors' and Officers' Insurance' (2009) Available at: <https://corpgov.law.harvard.edu/2009/08/07/directors-and-officers-insurance/> accessed 15 July 2018.
[47] n 39, 576.
[48] Kevin LaCroix, 'Executive Protection: Private Company D&O Insurance' (2010) Available at: <http://www.dandodiary.com/2010/09/articles/d-o-insurance/executive-protection-private-company-do-insurance/> accessed 20 September 2018.

> The rationale for providing such insurance is clear. In its absence, capable and talented individuals may be unwilling to join boards of directors…or may become excessively risk averse on boards, to the detriment of the individual company and the broader commercial community.[49]

Neither of the scenarios in this statement is palatable for the company, and thus it provides insurance coverage to its directors.[50]

The second reason that underlies the corporate demand for insurance is the company's desire to mitigate the potential risks that may arise from its day to day business. Although directors' motivation to possess insurance is an important factor in terms of protecting their personal interests, insurance is also a significant tool by which the company can run its business efficiently, as it may possibly be subjected to a number of risks whose occurrence may even jeopardise its existence in the market. Therefore, it purchases insurance as part of its corporate programme to reduce risk.[51]

According to O'Sullivan, there are three types of large companies which are more likely to purchase D&O insurance.[52] These are companies with a higher probability of distress, companies with greater growth opportunities, and companies with significant managerial ownership. Core agreed with O'Sullivan in respect of the first type of company and also discussed how companies with higher litigation risks are more likely to purchase D&O insurance.[53] Mayers and Smith also argued that "firms whose managers have greater discretion over the choice of hazard-reducing projects will be more likely to purchase insurance".[54] In addition, MacMinn analysed that the purposes of eliminating and reducing the bankruptcy/or agency costs incentivises the company to purchase insurance.[55] Moreover, Baker and Griffith

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[49] Hon. T.F. Bathurst, 'Insurance Law – A View from the Bench' (2013) 3-4. Available at: <http://www.austlii.edu.au/au/journals/NSWJSchol/2013/35.html> accessed 15 October 2018.
[50] Tom Baker and Sean J. Griffith, *Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation* (1st edn. The University of Chicago Press, 2010) 57.
[51] n 39, 574.
[52] ibid, 575.
[53] John E. Core, 'On the Corporate Demand for Directors' and Officer's Insurance' (1997) 64(1) The Journal of Risk and Insurance 63, 84.
[54] David Mayers and Clifford W. Smith, 'On the Corporate Demand for Insurance' (1982) 55(2) The Journal of Business 281, 286.
[55] Richard D. MacMinn, 'Insurance and Corporate Risk Management' (1987) 54(4) Insurance and Corporate Risk Management 658, 658.

demonstrated that the purpose of the company in purchasing entity cover is agency costs.[56] The factors of managerial ownership, growth opportunities, and managerial discretion over hazard reducing projects differ depending on the structure and strategy of a particular company; however, bankruptcy, litigation, and agency costs are common risks to which companies are subjected and the common reasons for purchasing insurance.

Taking the two reasons underlying the demand for D&O insurance into account, it can be considered beneficial to both the company and directors. Despite the fact that premiums and deductibles of D&O insurance are paid by the company and, for this reason, it may be regarded as "corporate owned",[57] the company and directors are both insureds that are protected from the risk of loss they may encounter. In order to determine who the insured is under D&O policies, "it is immaterial that…the company solely pays the premiums, since such payment may be viewed as consideration for the insurer's promise to indemnify both the directors and the company".[58] Even though the company has obtained the policy in its own name and has directors as beneficiaries, they can be still identified as the contracting party who can rely on the contract in their own right. Accordingly, they can be considered as the insured entitled to bring a claim under the policy.[59]

A misunderstanding may arise from the fact that there are a number of policy coverages within D&O insurance that solely aim to protect directors or the company. Whereas the directors are the insured under Side A, as their personal liability is the subject to coverage, the company can be considered as the insured under Sides B and C,[60] since it can be reimbursed for the loss suffered due to indemnifying directors and claims brought against it by third parties. However, it may be a misconception to label each of these types of coverage as exclusively protecting directors or the company, because the company and directors can be recognised as direct and indirect beneficiaries under Sides A and B. For example, even though the company is insured under Side B, directors are still indirectly benefitted from this coverage.[61] A similar case is valid regarding Side A: directors are insured but the company indirectly benefits from the

[56] n 50, 72. Defence costs can be included in the agency cost as the company may possibly bear the defence cost arising from litigation.
[57] n 53, 63.
[58] n 45, 60-61.
[59] This is valid as long as the Contracts (Rights of Third Parties) Act 1999 is not excluded by the particular policy contract. ibid, 61.
[60] ibid, 60-63.
[61] n 50, 48.

policy, for instance when it brings a claim against its directors for the loss it has suffered due to their behaviour. Also, the company indirectly protects itself and its reputation under this coverage when the claim is brought by third party because directors have cover for their defence costs and can protect themselves this way. Accordingly, although the demand by and request of current and future directors may seem to be the primary underlying reason for purchasing Side A coverage of D&O insurance, the company also considers its own protection as it can also recover some of its loss under D&O insurance. Nevertheless, it submitted that the company purchases insurance to protect its directors.

The company however may not want all types of behaviour by directors to be covered and this statement, therefore, applies only as long as the directors do not go beyond a certain point. Also, since not all conducts of directors that may harm the company is illegal, this article only focusses on situations where such harmful conduct amounts to illegal behaviour. The company does not wish its directors to become involved in such behaviour on its behalf. In this situation, the company does not tend to protect directors who expose it to a number of corporate risks but rather considers how it can mitigate these risks through insurance. The next section examines the ability of the company to achieve this.

4. Recovery for Loss under D&O Insurance

Wrongful conduct of directors may cause the company to be subjected to the following exposures: regulatory risk, litigation risk, reputational risk and insolvency risk. Based on these types of risks, there are four types of loss that it may suffer. These are: (i) loss arising from regulatory sanctions, (ii) third party litigation loss, (iii) reputational loss, and (iv) loss arising from bankruptcy.

In the third and fourth situations, the loss suffered by the company is one that it suffers by itself, while in the first and second situations, the company suffers the loss due to the imposition of regulatory fines by authorities, and claims brought by third parties against it for compensation. These losses form the basis of the potential claims that the company may bring under the D&O insurance to mitigate the risk caused by its directors’ wrongful conduct. The availability of recovery for such losses is an important issue for the company in terms of decreasing the level of risk upon it and protecting the long-term interests of its stakeholders. In

order to assess the ability of the company to mitigate these risks, the availability of policy coverage will be examined separately for each of the losses identified above.

4.1 Regulatory Loss

Civil fines and penalties can be imposed on the company by legal authorities as a result of a breach of regulatory rules. The question whether the company is able to recover such a loss from the insurer is a "hot topic in the insurance market".[62] The company, as an entity, is always at risk of facing regulatory fines and penalties and it eventually seeks to pass on this risk to the insurer in a direct way by bringing a claim against the insurer, or an indirect way by bringing a claim against its wrongdoing directors. However, violations of statutory laws resulting in fines or penalties are among the types of exposure[63] for which the D&O insurance may not provide policy coverage.[64]

If market coverage is not available for the company, it can still bring a claim against its directors to pursue an indirect recovery under their D&O insurance; however, such a claim is unlikely to succeed. An example can be seen in *Safeway Stores Ltd v Twigger*.[65] In this case, the company was prevented from recovering the loss it suffered due to a regulatory fine imposed on it by Office of Fair Trading (OFT) because of its directors' anti-competitive behaviour. There were various considerations that the court took into account in the case; however, the initial point that it considered was not allowing the company to pursue the insurer indirectly through bringing a claim against its directors because the court was aware of the fact that the ultimate aim of the company was to recover the loss from the D&O insurance.[66] Pill LJ stated that,

> The policy of the [Competition Act 1998] is to protect the public and to do so by imposing obligations on the undertaking specifically. The policy of the statute would be undermined

[62] Simon Goldring, 'Insurers' Liability for Civil Fines and Penalties' (2011) Available at: <http://www.lexology.com/library/detail.aspx?g=762e2955-82dd-45f0-86f6-6a6dc1d57cbe> accessed 6 July 2018.
[63] Such as intentional acts, dishonest acts, and criminal acts. See John Edie and Jane Nober, 'Directors and Officers Liability Insurance and Indemnification' (Council of Foundation, 2007) 16 available at: <http://www.cof.org/sites/default/files/documents/files/DandOinsurance.pdf> accessed 05 October 2018.
[64] ibid. See also Richard Barham and Denton Wilde Sapte, 'England' in Christian Campbell (ed), *International Liability of Corporate Directors* (3rd edn. Yorkhill, 2007) Volume I 323.
[65] n 1.
[66] Anna Morfey and Conall Patton, '*Safeway Stores Ltd v Twigger*: The Buck Stops Here' [2011] Comp Law 57, 63.

> if undertakings were able to pass on the liability to their employees or the employees' insurers.[67]

For this reason, the claim of the company was rejected to prevent it from claiming a recovery under D&O insurance policy. It was also emphasised by Morfey and Patton that,

> The reference to the employees' directors and officers (D&O) insurers is significant. It was common ground that Safeway would not have been able to insure itself against the risk of being subject to an OFT fine. However, unless its claim was barred by the *ex turpi causa* doctrine, Safeway would in principle have been able to recover the fine from its former directors and employees, who were all beneficiaries of D&O insurance policies. The claim thus potentially offered a means of accessing insurance cover indirectly, in circumstances where Safeway could never have obtained cover in its own right for the penalties.[68]

Hence, the rule preventing the company from recovering loss caused by regulatory penalties led to the outcome in favour of the directors. This statement of the court was, however, challenged by Watts, who stated that,

> It is hard to see that this is so. One might not want business owners insuring themselves against the penalties, civil and criminal, that flow from illegal action by their servants, but it is quite another thing to eviscerate the contractual and other rights that they have against their servants who have failed in their duties. Business owners in such circumstances are not "passing on the liability to their employees", but suing those employees who were the very cause of the liability in the first place.[69]

The court disregarded this point and overemphasised the issues around the attribution of the directors' act, as well as the maxim of illegality whose applications caused the company to bear the loss. Consequently, a company can neither obtain an insurance policy itself for the risk of regulatory loss, nor can it bring a claim against its directors to recover the regulatory loss with the intention of recovering from the D&O insurance.

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[67] n 1, para [44].
[68] n 66, 63.
[69] Peter Watts, 'Illegality and Agency Law: Authorising Illegal Action' [2011] J.B.L 213, 220.

In order to understand the different approaches of the courts to the issue of recoverability of regulatory loss from insurance, the judgement of the Supreme Court in *Jetivia SA and Another v. Bilta (UK) Ltd (in liquidation) and Others*[70] also needs to be analysed. This was a case where directors had been involved in a fraudulent scheme to the detriment of the company. In *Bilta*, the company was allowed to recover the loss it suffered from its directors, and this outcome may open the door to a company seeking to recover the loss from directors' insurance. The question that arises at this point is whether the difference between the intentions of the directors involved in misconduct in both cases matters, in respect of the company's ability to recover the loss of regulatory penalties.

In *Bilta*, the directors' express aim was to perpetrate fraud and to gain personal benefit, which caused the company to suffer loss. In *Safeway* the purpose of the directors was to increase the value of the company through increasing the prices. The difference between the purposes of these directors obviously matters regarding the availability of recovery, as Safeway was precluded from recovering whereas Bilta was allowed. This is because, on the face of it, Bilta was considered a victim targeted by its own directors, while Safeway was considered a villain seeking to make more profit by breaching the statutory law. However, the fact that the breach of the statutory rule by the directors of Safeway was damaging to the long-term interests of the stakeholders, even if it increased its short-term benefit, was overlooked. Even though the company was not directly targeted, it was harmed by its directors as their breach of law exposed it to regulatory risk in the long term. The question whether directors perpetrate fraud on the company for their personal benefit, or are involved in illegal conduct to make the company more profitable, should not normally make a difference because, in both cases, the company was exposed to heightened risk due to their conduct and the long-term interest of the stakeholders was harmed.

4.2 Third Party Litigation Loss

The liability of the company for the harm suffered by a third party due to the wrongful conduct of directors is the second category of exposure under consideration. In this case, the third party can bring a claim against the company to recover the loss suffered, and the company eventually seeks to transfer this loss to the insurer. The risk of facing such claims is one of the main

[70] [2015] UKSC 23.

reasons underlying the company's demand for policy coverage and such coverage is provided not only by D&O insurance but also in some cases by professional indemnity insurance. The availability of recovery for loss caused by third party liability is an important issue for the company, as it may affect the financial stability of the company, which may in turn jeopardize its future in the market.

There are two types of claims that third parties can bring against the company. These are claims for compensatory damages and punitive damages. Compensatory damages can be defined as compensation for actual harm suffered by a third-party victim. The purpose of this type of damages is to put the third party in the place that he/she would have been if the incident had never happened. Within this context, the third party harmed by the act of directors is likely to bring a claim against the company which consequently seeks to recover the sums with which it has indemnified the third party from insurance.

In *Stone & Rolls Ltd v Moore Stephens,*[71] the fraud of the director was attributed to the company and allowing it to recover the loss it suffered due to its own fraud was considered as being contrary to public policy. Lord Walker cited the statement given by Langley J. in the High Court that, "*Stone & Rolls* lost nothing to which it was ever entitled" because it was the one who perpetrated the fraud on the banks.[72] Based on this approach, the loss suffered by the company was regarded as a deserved punishment, as the fraud was its own, due to the rules of corporate attribution. Although the recovery for the loss was not sought by the company from D&O insurance in this case, any possible claim against the insurer would arguably be precluded by the maxim based on the consideration of public policy. The liability of the insurer is excluded for loss suffered by a particular insured person or a company who is engaged in a dishonest and fraudulent act.[73] This means that the company would not be able to invoke D&O insurance to mitigate the risk of loss arising from the compensatory damages owed to the third party as a result of the wrongful conduct of directors.

The second category is punitive damages. The question of whether liability insurance provides market coverage for a loss arising from punitive damages has been addressed by the courts and the insurance market for a considerable period of time.[74] The approach usually adopted by

[71] [2009] UKHL 39.
[72] ibid, para [198].
[73] Nicholas Davidson, 'A Sideways Look at Stone & Rolls' (2010) 26(2) PN 66, 69.
[74] John D. Long, 'Punitive Damages: An Unsettled Doctrine' (1975) 25 Drake L. Rev. 870, 870.

insurers is that a claim for punitive damages is outside the "customary language of liability policies [which] restricts coverage to "damages because of" bodily injury or destruction of property".[75] They argued that such a liability policy should not cover punitive damages arising from the imposition of civil law penalties.[76] Another approach adopted by insurers is based on the understanding that liability insurance covers punitive damages when (i) they arise from an unintentional action, (ii) the insurance policy does not specifically exclude its coverage, and (iii) awarding the damages is not considered against public policy.[77]

In order to determine the availability of insurance for punitive damages, the nature of the loss suffered needs to be examined. Punitive damages, unlike compensatory damages, aim to "punish flagrant wrongdoers and to deter them and others from engaging in flagrant conduct in the future" by imposing certain sanctions on them rather than indemnifying the victim that has suffered actual loss.[78] The court in *Huckle v Money,*[79] which was the first case that recognized punitive damages in English law, adopted the approach that such an award not only compensated the claimant but also punished the wrongdoing defendant; however, Lord Devlin in *Rookes v. Barnard*[80] demonstrated that, "punitive damages can properly be awarded whenever it is necessary to teach a wrongdoer that tort does not pay".[81] Stoll argued that "this maxim expresses the punitive principle in private law. Punitive damages thus serve the legitimate purpose of deterring a calculated wrong".[82] Indemnifying the victim can be considered the consequence of deterring and punishing the wrongdoer, which is the primary purpose of punitive damages. For this reason, the availability of recovery for the loss suffered due to indemnifying the third party for punitive damages is determined based on "the defendant's wrongdoing rather than the claimant's injury".[83]

In this sense, providing coverage for punitive damages is obviously contrary to the nature and main purpose of imposing such damages because their aim is to punish and deter the

[75] ibid, 871.
[76] ibid, 871.
[77] ibid, 870.
[78] ibid, 876. See also Joseph W. Cotchett and Mark C. Molumphy, 'Punitive Damages: How Much Is Enough?' (1998) 20(1) Civil Litigation Reporter. Available at: <http://www.cpmlegal.com/pp/publication-17.pdf> accessed 17 September 2018; Columbia Law Review Association, 'Public Policy Prohibits Insurance Indemnification against Awards of Punitive Damages' (1963) 63(5) Columbia Law Review 944, 945.
[79] (KB 1763) 95 Eng Rep 768
[80] [1964] A.C. 1129.
[81] ibid, para [1227].
[82] Hans Stoll, 'Penal Purposes in the Law of Tort' (1970) 18(1) The American Journal of Comparative Law 3, 5.
[83] Bruce D. Hall, 'The Validity of Insurance Coverage for Punitive Damages- An Unresolved Question? (1973) 4 N.M. L. Rev. 65, 65.

wrongdoer, rather than provide indemnification to the third-party victim. Allowing the wrongdoer to transfer onto insurance the loss he/she suffered is likely to make the existence of punitive damages in law inadequate, as it would be contrary to its punitive elements. The basis of this prohibition is public policy, which is a "formidable obstacle to coverage" as deterrence is an important consideration.[84] This may be the reason behind the fact that awarding recovery under liability insurance for the loss arising from punitive damages is very rare in English law.[85]

In the corporate context, the potential claim of punitive damages is typically brought against the company by third parties for the loss they have suffered due to the action of its directors. In such a case, the company may have to indemnify the third party for the loss, and it can bring an action against wrongdoing directors to recover the loss from the D&O insurance. However, recovery for punitive damages is a standard exclusion under D&O for which the insurance policy is almost never available.[86]

The issue of policy coverage for punitive damages was not extensively considered by the English courts until *Lancashire County Council v Municipal Mutual Insurance Co*.[87] The outcome of this case has led to a change in the general approach to the recoverability of punitive damages under liability insurance.[88]

In this case, Lancashire County Council (the Council) had a public liability insurance from Municipal Mutual Insurance Ltd (the insurer) and the former brought an action against the latter to recover the loss arising due to the imposition of punitive damages that were awarded to a third party, who suffered loss due to the action of its police officers. The Council argued that the insurer had agreed to indemnify, "in respect of all sums which the insured shall become legally liable to pay as compensation".[89] The insurer, however, refused to provide recovery for these punitive damages based on the argument that the concept of 'compensation' excludes the

[84] ibid.
[85] n 20, 282.
[86] Ian Youngman, *Directors' and Officers' Liability Insurance: A Guide to International Practice* (2nd edn. Woodhead, 1999) 35 and 39.
[87] [1996] 3 All E.R. 545, [1997] QB 897.
[88] n 37, 757.
[89] The sums that arise 'out of (a) accidental bodily injury or illness (fatal or otherwise) to any person. . . .; (b) accidental loss or accidental damage caused to property; (c) wrongful arrest, malicious prosecution and false imprisonment by a constable, when such injury illness loss or damage occurs during the currency of the policy and arises out of the exercise of the functions of a local authority'. See [1997] Q.B. 897 para [903].

recovery of punitive damages. The insurer also pleaded that awarding such damages to the insured would be contrary to the deterrent objective of both punitive damages and public policy.

Based on these assertions, there were two questions for the court to deal with. The first question was whether the policy held by the insured Council had coverage for punitive damages, and the second question was, if it did so, whether providing such coverage would be contrary to public policy.[90] Regarding the first question, the court accepted that the term 'compensation' could be interpreted as not including punitive damages; however, it was expressly stated in the policy that punitive damages were included, so the insurer had to provide coverage.

As far as the second question is concerned, although the court accepted that nobody should be insured against his/her liability arising from his/her illegality, as it would be contrary to public policy, it held that public policy could not be a defence of the insurer to reject recovery as the basis of the liability of the Council was vicarious, and not personal, for the deliberate act of its agents. The court also opined that allowing such a recovery would not be contrary to public policy but rather the opposite since, if the punitive damages were not recovered from the insurer by the Council, then the public would have borne the burden of such liability through higher taxes.[91] In addition, it was considered that the deterrent effect, which seeks to prevent the insured from recovering the loss, could be achieved by the Council through deductibles and higher future liability insurance premiums.

Accordingly, the claim of punitive damages brought by the Council was allowed and it can be seen that the use of the word "compensation" was extended to include punitive damages. The outcome of the case can be considered to have removed the barriers to recovering the loss of punitive damages from insurance; however, similar conclusions may not have been reached in corporate cases that involve directors' wrongful conduct.

The first reason is based on the requirement that the entity should be found vicariously liable for its agents' conduct to recover the punitive damages from the insurer. In respect of the company/directors relationship, the only exception to the personal liability of the company arises when directors perpetrate fraud on the company. Since the wrongful conduct of directors

[90] Lyanne Loucas, 'Exemplary Damages: Policy Terms' (1996) 4(7) Int. I.L.R. 131, 131.
[91] For discussion on similar consequences of not awarding punitive damages, See ibid 74, 872.

is not usually perpetrated as against the company, a claim by the company to recover punitive damages would be prevented as it would be personally liable for its directors' behaviour. The exception of vicarious liability thus cannot be applied to a company that had to pay punitive damages due to the wrongful conduct of its directors. In *Lancashire*, the Court of Appeal saw no public policy reason to prevent the insured Council from recovering the loss suffered as a result of punitive damages because it was vicariously liable for its agents' behaviour. If the liability of the Council was based upon the attribution of the act itself, the insurer would not have been called upon to assist as the Council would be personally liable and public policy would have operated to prevent it from benefitting from its own wrongdoing.[92]

The second reason is that, in *Lancashire,* the Council's insurance policy specifically stated that punitive damages were covered. Providing such coverage to the insured is ordinarily considered contrary to public policy; however, punitive damages arising from the arbitrary conduct of the government or public officials is one of the few exceptions for which recovery can be provided by the insurer.[93] In such a case, allowing recovery for the loss punitive damages would protect the public, which is the purpose of public policy. Consequently, even though the loss arising from punitive damages was awarded to the insured Council in *Lancashire*, this does not mean that the same conclusion can be reached for corporate cases, as the rules concerning public policy and corporate attribution represent major obstacles preventing the company not only from obtaining coverage for itself, but also from recovering the loss under D&O insurance. The company suffers loss as a result of indemnifying the third party, and insurance leaves the loss where it falls.

4.3 Reputational Loss

The third category of loss that the company suffers due to the wrongful conduct of directors, and which it may seek to recover from insurance, is reputational loss. Mitigating such risk is an important consideration for the company, as it potentially has short term and more importantly long term, implications. For this reason, companies not only "need to mitigate

[92] Rob Merkin and Jenny Steele, *Insurance and the Law of Obligations* (1st edn. Oxford, 2013) 319.
[93] n 13, para [21.023].

against the effect of loss of reputation, but they also need to be looking for the upside opportunities to enhance their reputations".[94]

Reputational risk can be avoided and managed to a certain extent by the company before it occurs but, after it has occurred, it is very challenging to mitigate. This is because reputational risk has distinctive characteristics that differentiate it from the other risks to which the company is subjected. These are that: (i) reputational risk is an exclusive risk to which only the company as an entity can be subjected, and (ii) the reputational damage of the company cannot be expressed financially.

In respect of the first characteristic of this risk, although the company is an entity with a number of persons who make decisions on its behalf, such as directors and shareholders, it is the company that is subjected to reputational risk as it is a legal persona above its members. Secondly, the reputational loss suffered by the company cannot be determined when the risk occurs. According to a report published by the Chartered Institute of Management Accountants (CIMA), "the reputation damage cost can only be really known five to ten years after an event, and even that might be too soon".[95] In the short term, it is more about losing the public trust rather than monetary loss, which can only roughly be known in the long term. This is because of the public perception that the company has engaged in misconduct.[96]

The company may seek to transfer such risk through recovering the reputational loss from insurance; however, this is a type of risk for which insurance cannot be purchased. This may be because there are also a number of considerations to be taken into account by an insurer providing such an insurance policy. These considerations are defined by Honey as "barriers to cover".[97]

Six main barriers will now be considered, and the first of these is capacity. Both uncertain amounts of insurance coverage and uncertain limits on claims cause serious difficulties for the

[94] Chartered Institute of Management Accountants, 'Corporate Reputation: Perspectives of Measuring and Managing A Principle Risk' (2010) 1. Available at: <http://www.cimaglobal.com/Documents/Thought_leadership_docs/cid_exrep_corporate_reputation_june07.pdf > accessed 16 June 2018.
[95] ibid, 24.
[96] See generally Robert G. Eccles, Scott C. Newquist, and Roland Schatz, 'Reputation and Its Risks' (2007) 85(2) Harvard Business Review 104.
[97] Garry Honey, *What is Reputation Worth?: How to Protect and Enhance Value* (1st edn. Gower, 2013).

insurer, because possible reputational loss is difficult to estimate.[98] Although this uncertainty is in the nature of reputational loss, it is likely to discourage the insurer to provide such cover. The second barrier is moral hazard. This is based on the possibility that the company deliberately influences the claim value to accidently increase the damages payable. As a result, the insurer may have to indemnify the company for an undeserved inflated loss. The third barrier concerns a lack of information about the company and its business in the market. The insurer can obtain such information from the public domain, but the company may not provide confidential information to the insurer as it may be uncomfortable with sharing such information in case it becomes public knowledge. In these cases, the insurer cannot be sure that all the required information is obtained from the company and this discourages it from providing coverage to the company because of the high risk.

The fourth barrier is the risk that there is no typical claim which can trigger reputational loss, because the company may claim under its policy for the recovery of loss arising from any incident that it has faced, based on the reasoning that the loss arose from reputational damage. Thus, there can be a wide range of loss for which the company can bring a claim, and this leads to a high degree of uncertainty from the perspective of the insurer. The fifth barrier concerns outage, which is an issue about the uncertainty of how damage to the reputation is measured, and indeed there is no clear way to measure what a company typically suffers from loss of public trust. This is because the loss is non-monetary in the short term but becomes monetary over time. With such a high level of uncertainty, the insurer is therefore dissuaded from providing coverage. The final barrier is notice, where again there is the issue of uncertainty as reputation cannot be "identified as an asset on the balance sheet".[99]

It should be mentioned that despite these limitations, many D&O insurance policies now includes reputational cost cover; however, such policies have significant downsides in terms of mitigating the reputational risks. Firstly, they provide a coverage for the costs of a PR consultant to mitigate the reputational damage and the insurer should consent to the choice of consultant. The insurer can also control the process. Secondly, these policies contain sublimits that are usually insufficient to satisfy substantial claims. For instance, if the company suffers reduction of its share price due to bad reputation, having a coverage with a £20,000 sublimit will not be adequate enough to manage the reputational risk. For these reasons, whilst the

[98] ibid.
[99] n 94, 6

introduction of some sort of cover for reputational risk under D&O insurance is a promising development, it is too limited to address the issues mentioned above. Reputational loss is typically intangible as goodwill, so proof of the exact loss is unlikely to be provided by the company. In summary, then, a company can almost certainly not be given insurance cover for reputational risk because of these limitations.

Even if it is assumed for the sake of the argument that policy coverage and recovery for reputational loss were available to the company, its risk would not be completely mitigated or transferred, as the existence of the risk is based on what Honey identified as "trust erosion".[100] In this sense, recovering the loss from the insurer would be a temporary solution as the "goodwill restoration" or "trust recovery" is unlikely to be achieved in this way.[101] Accordingly, the negative consequences of reputational loss upon the stakeholders could potentially be much harsher than regulatory and third party litigation losses.

4.4. Insolvency Loss

The last type of loss to consider is the potential for the company to suffer insolvency arising from directors' wrongful conduct. As a consequence of the wrongful conduct of directors, the company can suffer regulatory, litigation, and reputational losses, all of which can cause it to be unable to fulfil its financial obligations and lead to liquidation. From this point of view, insolvency can be considered a further consequence of the company's inability to transfer or mitigate these losses. However, insolvency is one type of loss for which the market does not provide insurance coverage. Therefore, insurance is unlikely to be a way for stakeholders, particularly shareholders and creditors, to protect their interests.

Even if there were market coverage for insolvency loss, there would be still serious issues that limit the ability of the company to protect the interests of its stakeholders against directors' wrongful conduct. The first issue would be the unavailability of recovery for the loss arising from directors' wrongful conduct. An example of such a loss was witnessed in *Stone*. In this case, the company went into liquidation as a result of the director's fraud which was perpetrated on the banks. Creditors on behalf of the company brought a claim against the auditors to recover the loss but the claim was rejected on the basis that the company was personally liable. No

[100] n 97.
[101] ibid.

claim was brought against insurance to recover insolvency loss, but even if there had been such a claim, the personal liability of the company would automatically prevent shareholders from bringing a claim against insurance.

In another scenario, assuming that the company were to obtain an insurance policy for the insolvency loss and could recover the loss from insurance, the company would still not be able to mitigate the insolvency risk. This is because, although the recovery was for the shareholders for the loss suffered, the interests of other stakeholders such as employees, suppliers, and consumers would be still impaired, as they would have lost their jobs, a continuing business relationship, and the opportunity to have a wider choice with fair prices in the market. Consequently, despite the negative consequences of insolvency loss being much harsher than that of other types of loss caused by directors' wrongful conduct, insurance provides no protection remedy for the long-term interests of stakeholders.

5. Concluding Remarks

The article has examined the insurance sector's response to company's insurance policy demand and claims for losses arising from directors' wrongful conduct. The question which was addressed was whether the company is able to mitigate through insurance the risks of wrongful conduct by directors for the purpose of protecting the long-term interests of stakeholders. The article outlined the foundations of liability insurance as they determine the availability of market and policy coverage in general liability insurance, and D&O insurance which is a type of liability insurance. It analysed how liability insurance and D&O insurance operate in practice and the considerations that are usually taken into account when the company demands policy coverage or brings a claim under D&O insurance to recover the loss it has suffered due to wrongful conduct.

The article initially examined how liability insurance operates in practice by considering whether its aim is to protect a third-party victim or the insured. The same question was also analysed in the concept of D&O insurance and it was determined that both the company and directors are protected by the insurance.

Based on the four types of risk of wrongful conduct four types of loss were identified and the article considered whether coverage for these losses is available under D&O insurance. Where

available, the article considered whether the policy coverage obtained by the company could provide recovery for them. Despite the fact that a company can arguably bring a claim against D&O insurance for third party litigation loss, a recovery is not available for such loss caused by directors' wrongful conduct. However, market coverage for regulatory, reputational and insolvency losses is also usually not available for the company to purchase. Accordingly, insurance leaves the loss where it falls.