Directors' and officers' policies

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advises directors to call their insurance brokers

Nearly a year to the day after the Court of Appeal, in *Steigrad v BFSL 2007 Ltd* [2012] NZCA 604, [2013] 2 NZLR 100, gave insured directors a Christmas present, the Supreme Court has played Scrooge for directors and Santa for liquidators and receivers of, and investors in, failed finance companies. This is because the Supreme Court has held that s 9(1) of the Law Reform Act 1936 prevents a director from being paid defence costs under a policy of insurance if to pay those costs would deplete the insured sum available under the policy to meet an eventual liability to a third party. In *BFSL 2007 Ltd (in liq) v Steigrad* [2013] NZSC 156, by a three-two majority, the Court reversed the decision of the Court of Appeal. In doing so the Supreme Court has effectively cut across the terms of a large number of directors and officer liability policies held by directors and prevented them from obtaining costs to defend claims where the amount claimed against them exceeds the policy limit.

The decision dealt with two separate cases which were consolidated in the Court of Appeal. The first involved a claim by the liquidators of Bridgecorp and associated entities against its directors; the second was an application brought by the former directors of Felxtex Carpets Ltd in the class action suit brought against them by investors. Both cases dealt with the same issue, namely the application of s 9(1) to directors and officer liability policies.

Section 9(1) of the Law Reform Act 1936 creates a "charge in favour of [a] third party over any insurance money "that is or may become payable" in respect of the insured's liability to the third party" (at CA [15]). In simpler terms, where third parties suffer loss caused by an insured, and the insured has insurance to cover the loss suffered by the third party, then the third party has a "charge"' over the insurance moneys paid. The obvious example is where person A has third party car insurance and causes an accident that damages B's car. In that case, B has a charge over the money paid out under the third party policy; that means B has a claim to those proceeds ahead of any of A's other creditors.

The question confronting the Court in the two cases dealt with in *Steigrad* was how s 9(1) works where directors have a policy that covers both the liability of directors to third parties for losses caused by breach of their directors' duties and by breach of the Securities Act 1978 and associated defence costs, up to a specified limit and the level of the claim exceeds that limit. In both cases there was a single cap on the directors and officers policies held by the directors; the effect was that any defence costs taken by the directors in defending the claims against them would reduce the amounts available from the insurance to payout for any losses suffered by the investors.

As the majority (Elias CJ and Glazebrook J in a joint judgment, with which Anderson J concurred) succinctly put it at [1]:

> [t]he issue in these appeals is the nature and effect of [the s 9(1)] charge and in particular:
> (a) whether the charge secures whatever is eventually held to be the full amount of the insured's liability to the third party claimant (subject to any insurance policy limit), with no payments under the policy able to be made that would deplete the insurance money available to meet the third party claim if it is established; or
> (b) whether the charge secures the insurance money that remains at the time of judgment on, or settlement of, the third party claim against the insured, allowing in the meantime the payments of other sums that fall for payment under the policy, even if that depletes the sum available to meet the third party claim.

The majority, having analysed the text, legislative history and general policy arguments, favoured the first option. The minority (McGrath and Gault JJ, reasons by McGrath J) having undertaken the same exercise favoured the second option. Why the divergence, and what are the consequences?

THE APPROACH OF THE MAJORITY

The majority focused on a number of different aspects of s 9. First, they considered that s 9(1) operated so that the charge over the insurance proceeds arose immediately on the event giving rise to the claim between the third party and insured. They further considered that (at [34]):

> [u]nder s9(1) the charge attaches not only to insurance money that is payable but also to insurance money that "may become payable in respect of that liability". It also arises "notwithstanding that the amount of such liability may not then have been determined". Section 9(1) therefore recognises that, on the happening of the event giving rise to the claim for damages or compensation, the amount of the liability to the third party may not yet be ascertained.

Second, the view of the majority was that the scheme of s 9 and, in particular, the provisions of s 9(3), provided priority to the charge generated in favour of the third party over other priorities and also over "any contractual provisions as to priority of claims" (at [42]). In other words, even though the insurance policy provided for amounts to be used to meet liability to the third party or to meet other liabilities (such as defence costs), the effect of s 9(3) was to over-ride the contract and create a charge over the whole amount available under the policy in favour of the third party.

The majority also emphasised the effect of s 9(6). This sets out that payment by an insurer under the contract of insurance without notice of the existence of the charge will be a valid discharge. The majority considered that if payments under the insurance contract could be made with "impunity" then there would be no need for s 9(6); accordingly, it pointed towards an interpretation of s 9(1) that saw the charge descend over all sums available under the policy. The effect of that was that because of the exception in s 9(6) the inverse must be true. For s 9(6) to have relevance, any payments made by the insurer with notice of the charge must not be a valid discharge (even if the payments are not in respect of that liability).

A number of competing rationales were offered for this result. A focus of the majority was on how any other result would effectively see the successful party in a proceeding, the third party, bear the costs of the unsuccessful party because the amount available to meet the claim would be reduced by the deduction of defence costs (at [52] and [107]). Further, the majority felt that the legislative history of this section, which replaced and made of general application similar provisions in the Workers' Compensation Act 1922 and the Motor-vehicles Insurance (Third-party Risks) Act 1928, supported this approach (at [99]):

> given the link to human suffering and also the social cost of injury or death, it may be thought that the protection of the claimant with regard to insurance money was paramount. That uncharged claims (such as defence costs) could diminish the money available for injured persons would, it might be thought, not fit in with this policy aim.

The majority also drew support from prior decisions, notably *Pattinson v General Accident, Fire, and Life Insurance Corp Ltd* [1941] NZLR 1029 (SC) and *National Insurance Co of New Zealand Ltd v Wilson* [1941] NZLR 639, which they considered as having decided the issue the same way. Indeed, as they put it in relation to *Pattinson* "the legislature, if it did not consider that *Pattinson* accorded with the purpose of the legislation, has had a long time to correct the situation by amending the legislation".

In contrast, they chose not to follow a decision of the full bench of the New South Wales Supreme Court, *Chubb Insurance Co of Australia Ltd v Moore* [2013] NSWCA 212 on an identical provision in the law Reform (Miscellaneous Provisions) Act 1946 (NSW).

Further, the majority considered that the general policy considerations in this area pointed towards this outcome as desirable; they did not accept that their approach would inhibit access to justice as insurers might still fund defences and lawyers might act on a contingency basis.

THE MINORITY

In contrast, the approach of the minority was to focus on the plain wording of the section and in particular s 9(1). They considered the wording "a charge on all insurance money that is or may become payable in respect of that liability" as crucial and concluded that (at [168]) "[t]he charge does not attach to "all insurance money that is or may become payable" under the terms of the policy, but only to that insurance money that can be said to be payable 'in respect of' the insured's liability to pay damages or compensation".

In arriving at this conclusion, the minority analysed the text of s 9 in light of its purpose. They viewed the purpose as narrower than that favoured by the majority (at [173]):

> [t]he purpose of s 9 was to provide a mechanism to ensure that the money that would otherwise be paid to the insured was instead made available to claimants and not dissipated by the insured or paid to its general creditors. The legislative history gives no indication of a wider protective concern that would further intrude on the contractual rights of the insurer and insured under the policy.

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Further, the minority considered that the statutory context of s 9 supported this approach. At [142] and [143] they considered s 9 in the context of the relationships on which it impacts, namely the third party claimant and insured, the insured and insurer and the third party and the insurer. As was pointed out, the last relationship is in fact created by s 9 and it seemed clear from the minority decision that the impact of s 9 on the second relationship, between the insured and the insurer, was limited.

In particular, the minority did not consider that in order to give effect to s 9(6) — providing that payments made by an insured without notice of a charge were a valid discharge — the inverse, that all payments made with notice were not a valid discharge, needed to be true (at [177]). Instead, the focus of s 9(6) was very much on ensuring that the rights of the third party were not affected by any compromise agreed between the insured and the insurer in relation to the claim made under the policy (at [178]).

Further, s 9(3) which provided for priority over other charges was not read so as to encompass differing contractual entitlements which are not "charges"' (at [180]). As the minority succinctly put it, s 9(3) gives priority over the secured interests of creditors and prevents the insurer making payments for subsequent liabilities, but it does not "prevent the insurer from making payments to meet other obligations under the policy" (at [181]).

This overall approach was seen as consistent with Australian authority on the equivalent New South Wales section, including the decision of the High Court of Australia in *Bailey v New South Wales Medical Defence Union Ltd* (1995) 183 CLR 399 and *Chubb*.

IMPLICATIONS

The effect of the decision is clear; where a claim is made against directors, and the amount claimed exceeds the policy limit, then if the insurer makes payments of defence costs it will be doing so "at its own risk". Clearly, then, unless the claim is considered spurious or the amount claimed inflated, directors may be left to fund their own defence costs.

What is less clear is whether the majority decision is correct. It seems a peculiar result that legislation originally designed to protect those involved in personal injury claims by giving them priority over creditors in situations of insolvency (as noted by the minority) should now be used to interrupt the allocation of risk in insurance contracts of a different nature. That is particularly the case given the introduction of the accident compensation system which has effectively removed the harm that was been addressed by the original legislation. This is, perhaps, a prime example of the law of unintended consequences in action. Given that, and the recent spate of case law around s 9, it might be time for its purpose and effect to be examined by the Law Commission.

Further, the majority did not adequately deal with the key words in s 9(1) — "in respect of that liability". Instead, the focus appeared to be on avoiding an outcome that saw the third party effectively bear the costs of the defence by a reduction in the amount available under the insurance.

That concern, however, pre-supposes that the third party was entitled to the full amount available under the insurance and the argument is somewhat circular: s 9(1) allows the third party access to all sums under the cover (even when the contract allows for the funds to be used for other purposes) because the third party is entitled to all sums under the policy. Further, it does not marry well with the clear position that a third party cannot, by virtue of s 9, be in a better position than the insured under the contract.

However, that is effectively what the majority is allowing by cutting across the contract entered into and failing to address what appears to be the clear language of the statute. The answer of the majority — that the total amount available under the policy "may become payable" and, therefore, a s 9(1) charge arises over the entire amount if the claim is high enough (see [35]), appears to be a blunt approach that fails to recognise the discretion inherent in the contract. Even if it is accepted that, until the discretion to apportion the amounts available under the policy between defence costs and towards a substantive payment was made, the charge existed over the whole amount, it is difficult to see why the existence of the charge prevents the (proper) exercise of that contractual discretion. That is particularly the case in light of the minority's convincing analysis of the legislative history.

There is also a question as to whether the approach of the majority as to when the charge "descends" is correct. While it was common ground that the charge arises at the time of the event giving rise to the claim between the third party and the insured, there was divergence as to how the charge operated. The majority saw it as a fixed charge; the minority saw it as more akin to a floating charge. The difficulty with the approach of the majority is that it does not seem to deal with "claims made" policies, where cover is only provided for claims notified during the course of the policy term, regardless of when the claim arose. How can a fixed charge exist when neither the extent of the third party's liability, nor the level of cover available to the insured, have been ascertained? The minority approach of treating the s 9 charge as a 'floating charge' seems preferable.

The position has been compounded by the failure of the Court to give a declaration like that given by Lang J in the High Court. There His Honour provided a declaration that the defendants could not draw on the directors and officer policy to meet their defence costs, but the Supreme Court decline to repeat it, indicating that (at [115]) "the payment of defence costs is at the risk of the insurer because of the statutory charge for the claims". That leaves the question open as to whether payments can legitimately be made and whether directors can force insurers to accept claims for defence costs. No doubt further litigation on this will follow.

However, directors can take comfort from the suggestion of the majority, at [111], that lawyers might be prepared to act on a contingency basis and that "an insurer may well have an incentive to fund a good defence out of its own funds as that would reduce the insurer's exposure under the policy".

Beyond relying on the good favour of lawyers and insurers, what should directors do? They need to reassess their cover and speak with their brokers about having two directors and officer policies: one for defence costs, and the other for any liability actually owed to third parties. Alternatively, they could have the two covers in one policy but with different insured sums. For those with claims currently under way, they need to have immediate discussions with their insurers about how defence costs will be met. ❐

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of the IWC to that effect. Japan could design a new programme for Antarctic special permit whaling that meet the standards determined by the Court so that the sampling is valid, the lethal research issues addressed, and programme genuinely for scientific purposes. The result would most likely be a much smaller programme: probably smaller than the original JARPA programme given the Court's clear statement that lethal research should not be used on a larger scale than is reasonable in relation to the stated research objectives and that funding from the sale of whale meat is not relevant to sample size.

Australia filed its proceedings several weeks before the meeting of the IWC at Agadir in 2010. I had chaired a support group designed to bring peace at the IWC. Japan came a long way in the negotiations and an overall settlement could have been reached had Japan accepted 200 minke whales in the Southern ocean. Four years later, Japan may secure less from that than from a revised programme that conforms to the Court's rulings. But the case provides an opportunity to abandon whaling, a dying industry that is heavily subsidised. It would be a great relief to New Zealand if Japan at least abandoned its whaling in the Southern Ocean. Delicate negotiations will now ensue in which New Zealand will be an important player. The IWC meets in September.

New Zealand was right to intervene in the proceedings, although it was thereby limited to making legal arguments. Had New Zealand become a full party, Australia would have been deprived of an ad hoc Judge, an unwelcome prospect. The New Zealand legal arguments were well crafted and presented by the Attorney-General and his team. Australia carried the crucial responsibility on the facts. No great statements of law or resounding principle appear in the judgment. Japan has been held to account for its behaviour in the IWC, and stands judged for the use of dodgy science and for a programme that contained elements of a sham. Tight legal analysis can achieve much but whether it brings peace to the IWC remains to be seen. ❐