



## **The Double-Edged Sword**

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**Directors' and Officers' Insurance Policies are one of the most important weapons available to those in charge of companies confronted by litigation and investigation. But indemnity under such policies can be a double-edged sword in which directors find their own insurer out to make a case against them. The existence of a valid policy, and a claim covered by that policy, does not always mean an insurer is obliged to pay up.**

In the flood of litigation and investigation flowing out of recent major corporate collapses, it is not surprising that there has been some recent activity in the area of directors' and officers' insurance policies ("D&O policies"). No doubt to their horror, directors of One.Tel Limited have recently found themselves standing without the backing of their own D&O insurer. This is so, even though there has been no final determination on whether the insurer is entitled to refuse indemnity. Further, the Court has allowed the insurer to seek to prove the directors guilty of conduct disentitling them from indemnity, even where no one else is alleging such conduct.

*Re One.Tel Ltd* [2002] NSWSC 1081 concerned a claim by Messrs Silbermann, Rich and Greaves against CGU Insurance Limited trying to force it to honour the terms of a D&O policy in their favour, and pay the legal costs of various proceedings in which the directors were involved. These proceedings included:

- An investigation by ASIC;
- Two proceedings by ASIC in the Supreme Court (Equity Division);
- Corporations Act examinations;
- Various other proceedings.

CGU declined to grant the directors an indemnity under the D&O policy. It relied, in part, on an exclusion clause (clause 3.1) relating to Dishonesty & Fraud. This was so, even though the clause contained these words:

“this exclusion shall only apply to the extent that the subject conduct has been established by a judgement or other final adjudication adverse to the Director or Officer.”

There had been no such final judgment against the directors, and so the directors sought to force the insurer to cover the mountain of legal bills no doubt being incurred in the various courts in which the directors found themselves. In response, the insurer sought to rely upon the exclusion in clause 3.1. The insurer argued that there would be a judgement for the purposes of clause 3.1 when it's own proceedings were determined.

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### **Defender turned Attacker**

In light of the wording of clause 3.1, the directors thought it unfair that the “judgement” which would trigger the exclusion, could be obtained in proceedings by the insured against the insurer for refusing indemnity. The directors argued that there was an implied term in the insurance contract that an insurer would not take such a step.

The insurer, on the other hand, suggested that it should be entitled to raise whatever defences might be available to it in response to the directors’ claims for indemnity. If this was by proving dishonesty and fraud, then so be it. Otherwise, the insurer said, people would claim against directors without raising the grounds which would allow the insurer to deny coverage, and there would be nothing the insurer could do about it.

The Court decided unanimously that there was no difficulty with the insurer being the one who was trying to prove the alleged dishonesty and fraud. The only relevant implied term the court found was that the insurer would not breach its obligation of good faith. So as long as the insurer was acting in good faith it could allege dishonesty and fraud to avoid having to pay up under the policy, even where no one else was alleging this.

### **Unproven Dishonesty and Fraud**

Perhaps unsurprisingly, the directors also argued that the wording of clause 3.1 meant that until dishonesty and fraud were **proven**, the insurer was obliged to indemnify the directors in relation to their legal costs of the various proceedings.

The insurer, on the other hand, said that it had a discretion to decline indemnity, where it alleged dishonesty and fraud. The directors were obliged to sue the insurer for indemnity, and the insurer would defend it by seeking to prove the dishonesty and/or fraud.

By a majority, the Court of Appeal agreed with the insurer. “The policy was not intended to provide a form of “up front” indemnity for the Defence Costs to the insured” said His Honour Mr Justice Tobias (at [77]). The court did find that the insurer had an obligation of good faith. This obligation meant that the insurer:

“could rely on any defence only if it has reasonable grounds to do so; and generally this would require legal advice given on the basis of full instructions as to the facts and evidence known to the insurer. Of course, because of privilege, the insured and the Court will not generally be able to put that to the test, so that to some extent this must depend upon the integrity of the insurer” (Per Hogson JA at [51]; with which Tobias JA agreed at [78])

So it appears that as long as an insurer **says** that on reasonable grounds they believe that they are not required to indemnify the directors, a D&O policy cannot be relied upon by the directors for funding the legal costs of investigations and actions against them. Instead the directors would have to sue the insurer and get a judgement before the insurer was obliged to pay a cent.

It is interesting to speculate what might happen if the insurance proceedings were not decided should judgement be obtained against the directors. The directors would be liable for damages, without any recourse to their own insurance policy, even if they were subsequently found to be entitled to claim on the indemnity. This would be small comfort to a bankrupted director forced to try and untangle the mess created by this timing gap.

The appeals were dismissed and the directors were ordered to pay the insurer's costs. The directors have sought leave to appeal to the High Court. In the meantime, the insurer has been unsuccessful in an application to have its proceedings heard together with the claims against the directors.

**Each policy needs to be looked at separately, but directors would be well advised to examine their own D&O policy carefully to ensure they understand the 'real' protection it offers. Directors may find themselves battling not only the claims of third parties but also their own insurer.**