Supreme Court D&O decision affects all liability insurance

All cost-inclusive insurance liability policies need to be reviewed following a Supreme Court judgment late last year, the effect of which is to deny insured persons access to defence costs where the money may be subject to a third party claim.

The decision, based on a statute which is almost 80 years old and never before applied in this way, overturns well-established industry practice, deprives the insureds of a critical benefit for which they contracted, and makes New Zealand something of an outlier in the international liability insurance market.

A legislative fix would be the best response but this is unlikely, at least in the short-term. So if you are potentially affected, you will need to examine your options promptly.

All liability policies are in the gun

The case concerned consolidated appeals arising from the failure of Bridgecorp and Feltex Carpets. In both applications, the directors were seeking access to liability policies to fund their defence against civil claims under the Securities Act 1978. Both policies had one aggregate limit for both defence costs and any liability which might ultimately be established.

Because the decision came out within days of Christmas, business has had little time to digest its implications and may have assumed that it only affects D&O insurance. That assumption is wrong.

It also affects professional indemnity policies (covering professional negligence), prospectus liability, employers’ liability, statutory liability and general or public liability, and may extend to prevent advancement of defence costs in any prosecutions which could result in a reparations award for the victim (e.g. for a workplace accident).
Organisations at particular risk are those with:

- low overall insurance limits, or
- those with tiered insurance arrangements (because, if the first layer is relatively low, a serious claim could lock up defence costs, forcing the insured to go cap-in-hand to excess layers, which may or may not respond).

Businesses should consult their brokers or insurance company, and seek expert advice to ensure that their liability insurance will still provide the protection required of it.

Reaction to the decision

Chapman Tripp acted for AIG, the insurer to Feltex and its directors, in support of the right of directors to advancement of defence costs.

Our concerns regarding the content and implications of the Supreme Court’s three to two majority judgment¹ are widely shared, not only in New Zealand but by overseas commentators.

- The D&O Diary, a blog by US D&O specialist Kevin LaCroix, described the decision as “surprising and unwelcome”² and said that, perhaps “owing to its antipodal provenance”, it stood on its head the idea that liability insurance exists to protect the insured, not to protect claimants.

- WillisWire, a global blog produced by the Willis Group, specialists in insurance and risk management, said it would dramatically change the landscape³ for D&O indemnity insurance claims and noted that, of the nine New Zealand judges who had now considered the matter (one in the Auckland High Court, three in the Court of Appeal and five in the Supreme Court), only four had found against the directors.

Both blogs urged the need for a legislative response.

- And corporate law firm DLA Piper has said that “pressure for legislative reform must intensify”⁴ in Australia should the Australian High Court (their Supreme Court equivalent) find the same way in an impending appeal of substantially the same issues.⁵ (Chapman Tripp’s commentary on the New South Wales Court of Appeal decision is available online⁶).

Practical implications

The essence of the judgment is that the rights of third party claimants will trump the insured’s right as policyholder to have defence costs covered if the combined claims might exceed the policy limit, and the policy provides an aggregate policy limit to cover both defence costs and liability to the claimant.

This result reversed the industry norm of costs-inclusive policy limits. Since the initial Auckland High Court decision in September 2011, there has been a strong movement in the New Zealand D&O market toward either separate policies for defence costs and third party liabilities, or toward separate indemnities within a single policy.

The Supreme Court has left open the question of whether an insurer is entitled to refuse to pay defence costs where the policy has one aggregate limit and there is a risk that the limit may be exceeded. This question will no doubt be tested in the courts at some stage. But the outcome is uncertain and in the meantime, those directors who are faced with claims or have claims pending under aggregated policies have been placed in an invidious position. So too have the insurers.

We now expect the new approach to be applied to other forms of liability insurance.

Supreme Court majority decision

The majority found “strong textual support for the proposition that the section 9 charge arises at the time the event giving rise to the liability occurs and that it secures whatever the full amount of the liability (if any) to the third party ultimately turns out to be”.

The fact that the insured’s defence costs will become payable before the quantum of the third party’s damages or compensation can be determined was irrelevant:

“[A]llowing defence costs to diminish the sum available to third parties is tantamount to requiring third party claimants to fund an unsuccessful defence, which would normally not occur under ordinary court cost rules.”
The Court did not accept arguments that the practical effect of its ruling would be to frustrate a director’s access to justice, saying:

“An insured would only be deprived of the ability to mount a defence if he or she had no other funds available... and where no lawyer would act on a contingency basis. Further, 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.”

No doubt directors and insurers will have their own views about this reasoning.

**Minority decision**

The minority agreed with the Court of Appeal that until the liability to third parties is determined, directors are entitled to be paid reasonable defence costs.

Any other interpretation would inhibit the ability of the insurer and the insured to defend third party claims and would be a “major interference” to the contractual relationship and rights established under the policy.

**Chapman Tripp commentary**

It is unfortunate that the Court criticised those who drafted the relevant policies. Two of the five judges would have “overlooked” the same point, and five of nine judges who have dealt with the problem since 2011 have taken a different view from the Supreme Court majority.

Moreover the judgment disturbs what has been entrenched industry practice for many years. We commented on why we consider that the 1936 Act sits uneasily with the modern application of liability policies in our Brief Counsel on the High Court’s initial ruling in 2011.

In our view it is unrealistic to expect directors to fund defence costs – that’s why they have the insurance in the first place. And the notion that they might find a lawyer to run a defence on a “contingency” seems unlikely given that a win for the directors will never produce enough in court-awarded costs to pay competent defence counsel.

**Possible remedy?**

The Law Commission prepared an Insurance Contracts Bill as part of its 2004 report on insurance. In the Bill, the Commission proposes a slightly different approach to section 9, one which does not rely upon a charge but on extending privity of contract to third parties under section 4 of the Contracts (Privity) Act 1984.

While this does provide a logical place to start, the Bill has yet to progress.

**Footnotes**

5. Chubb Insurance Company of Australia Ltd v Moore [2013] NSWCA 212
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