

davies arnold cooper  
reviews the year's highlights



d&o / financial  
institutions

top ten 2006

DAVIES ARNOLD COOPER

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# d&o / financial institutions top ten 2006

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## foreword

The substantial press coverage of issues affecting company directors and officers seen over the past twelve months has not been restricted to the financial pages. The story regarding the so-called "NatWest 3" made headlines in both the broadsheets and the redtops; rarely has the plight of company directors been the focus of so much public attention. Whether by coincidence or design, 2006 has also seen substantial legislative activity surrounding corporate and financial affairs, the **Corporate Manslaughter and Corporate Homicide Bill** and the new **Companies Act** being the most newsworthy.

Meanwhile the UK D&O market continues to mature at a fast pace with ever more complex terms and benefits being offered, often influenced by events and trends in the US. There is little doubt that insured directors and officers and their brokers are becoming more knowledgeable and sophisticated as they recognise the limits which apply to the traditional wording of D&O policies. There remains oversupply in the market, although recent indications are that the general decline in UK D&O premium costs is slowing, notwithstanding it has probably not yet bottomed out. Part of the reason must be the relatively benign climate for directors and officers in this country compared with the more aggressive position in, say, the US. The indications are that pharmaceutical, telecoms and technology companies lead the list of most suitable targets in the US, usually in relation to downturns in financial forecasting; an emerging issue is back-dated options.

Whilst the usual types of claim against directors have been passing through the courts such as breaches of fiduciary duty, disqualification, non-party costs orders, personal guarantees and the like, we have concentrated in our review on the forthcoming legislative changes and emerging commercial issues which may have a more resonant impact on the D&O market in the future.

On the financial institutions side, hedge funds have received considerable attention from the regulatory bodies with increased regulation more or less guaranteed in the medium term. Whether that will signal a reduction in the City's future Christmas bonuses remains an open question. What is clear however is that banks and other

financial institutions should be delighted with the majority of the decisions emanating from the courts this year, with the House of Lords' decision in **Customs & Excise v Barclays Bank** being a particular high point.

Watch this space for the trends and events of 2007.

**Davies Arnold Cooper**  
January 2007

The Insurance Top Ten 2006 publications are not a substitute for detailed advice on specific transactions and problems and should not be taken as providing legal advice on any of the topics discussed.

# polluter pays?

## environmental / pollution costs

In recent years there have been many changes to the legislation that governs environmental liability. Company and director responsibility for pollution is a growing global concern, especially in light of the forthcoming transposition of the **EU Environmental Liability Directive** (2004/35/EC) into national law (by 30 April 2007). The full extent of the changes this will bring is unknown but the main objective of the Directive is that the polluter will pay. It follows on from Part IIA of the **Environmental Protection Act** 1990, which came into effect in England and Wales on 1 April 2000. This Act introduced a statutory regime aimed at identifying and securing the clean-up of contaminated land. It continues to be updated and was recently extended in August 2006 to include land contamination by radioactivity.

Although this legislation has been in force for some years, the steady increase in the volume of determinations and notices means that directors are now beginning to recognise the real risk that if they "*cause or knowingly permit*" a contaminating substance to be present on, or under, land they are likely to be held personally responsible for addressing the harm it causes, namely, the remediation and compensation costs.

Typically D&O policies have specifically excluded losses that arise as a result of a director or company falling foul of environmental legislation. This is largely due to its being a criminal offence. Currently, some policies do offer limited cover for the costs of defending criminal, civil or regulatory proceedings that arise from a polluting incident, but it is extremely uncommon for these policies to cover remediation or compensation costs arising out of the same polluting incident.

With the continual changes to the law in this area and the possibility that the forthcoming Directive may create further exposure to directorial responsibility, it may be time for D&O insurers to consider broadening their policy cover for these types of environmental liability. The need for this type of cover will be more apparent where directors and officers know that possible exposure to this type of claim naturally

arises from the kind of work they undertake, for example, if they risk contaminating land or water supplies, engage in redeveloping brownfield sites, or create dangerous waste products and the like.

The **Corporate Manslaughter and Corporate Homicide Bill** is currently working its way through the British parliamentary system. The Bill will abolish the existing common law offence of manslaughter as it applies to companies and create a new offence of corporate manslaughter (to be called corporate homicide in Scotland). The Bill has been drafted in response to the Law Commission's recommendation that a new statutory offence of corporate killing should be created. The Bill introduces changes to the current law that will affect the insurance cover of D&O as well as employers' liability and professional liability policies.

Currently, work-related deaths are prosecuted under the **Health and Safety at Work etc Act 1974 (HSWA)** and the common law offence of gross negligence manslaughter. The HSWA imposes general duties upon a company to ensure, so far as is reasonably practicable, the health and safety of its employees and those who are affected by its business (ie members of the public). Where a company is found guilty of breaching its general duties under the HSWA, it is liable to pay a fine and, if the offence is committed with the consent or connivance of, or is attributable to the negligence of its directors, officers or managers, they may be held personally liable (and subject to a fine and / or term of imprisonment).

Corporations can also currently be found guilty of the criminal offence of gross negligence manslaughter if an employee or member of the public is fatally injured because of the grossly negligent way in which the company's health and safety responsibilities were carried out. However, it is notoriously difficult to convict a company of manslaughter, as in order to prove that the breach of duty of care owed by the company to the victim amounted to gross negligence, it is necessary to prove the guilt of an identified human individual which can be attributed to the corporate defendant.

The Bill removes the "identification" requirement, which has made prosecutions so difficult under the offence of gross negligence manslaughter. Instead, it looks at the conduct of senior management collectively. Under the Bill it will be possible to convict

a company where there is a gross breach of a duty of care owed to the deceased as a result of management failure at a senior level.

The Bill itself specifically excludes liability for individuals, but a natural consequence of the investigations into the conduct of senior management will be the requirement for legal representation for the members of senior management investigated. Further, individual prosecutions for manslaughter and under the HSWA will still be possible. As investigations carried out under the proposed Bill will identify members of senior management, it may prompt prosecution for manslaughter or under the HSWA of those individuals. This could lead to a corresponding increase in individual prosecutions.

To date, there have been very few investigations of directors and officers in the context of corporate manslaughter. As such, D&O policies often do not contain a relevant corporate manslaughter provision. However, insurers should be aware that there is the potential for more prosecutions, and in particular more investigations, in the future when the Bill is passed. We have yet to see what the ripple effect on insurance cover will be, but the passing of the Bill may well lead to increased demand in D&O policies, in claims under such policies and in the level of defence costs incurred by the directors and officers investigated and / or prosecuted.

# protection from the long reach

## extradition

The massive publicity accorded to the “NatWest 3” and consequent realisation of how easy it is to fall foul of US legislation even from outside the jurisdiction, has caused questions to be raised in boardrooms all over the country as to whether or not they have extradition cover. Many leading D&O insurers have responded to market queries from brokers giving confirmation of extradition cost cover with varying degrees of exactitude.

Extradition itself can be a complex and lengthy process notwithstanding the apparent simplicity with which many countries (and not just the US) are entitled to make use of the fast-track procedure.

The extradition process when broken down can comprise the following:

- initial contact from the foreign country authorities concerned seeking co-operation and / or information under threat of extradition application
- various extradition hearings before the UK courts.

Additional matters that could come within the compass of extradition cover and which are already being recognised by D&O insurers to one extent or another can include:

- obtaining advice from lawyers in the country seeking extradition as to the nature of the alleged crime
- approaches to relevant government departments here in the UK
- further representation in the country to which extradition is being made with particular reference to bail applications.

Certain leading insurers are already offering further ancillary elements of cover such as:

- costs of PR consultants
- counselling for insured and immediate family
- travel and accommodation costs
- cost of bail bonds.

Many policies still lack exactness of wording, making it difficult to construe the extent to which cover is available. All insurers who have not already done so may wish to consider following the example of market leaders in setting out specific and clear terms describing the extent of cost cover that they are prepared to offer in relation to extradition, either in the body of the policy or by way of specific extradition endorsement.

Pressure will come to bear from the insured market on matters such as sub-limits for extradition cover, especially for companies exposed to the increasingly zealous approach adopted in the US to corporate fraud and matters relating to share price. It is to be expected that European countries, including the UK, will follow the US line.

Another area where greater clarity can be called for is the way in which any D&O policy will operate as regards either refusal to advance costs or a clawback of costs where fraud is alleged. In the former regard, the Court of Appeal in Australia in the case of **Silberman v CGU** 2003 allowed an insurer to refuse to pay defence costs in advance where only an initial allegation of fraud arose.

# bankers and the big freeze

Customs & Excise v Barclays Bank  
House of Lords 21 June 2006

## facts

Customs & Excise intended to bring proceedings for payment of outstanding VAT against two companies that held accounts with Barclays. In January 2001 freezing injunctions were obtained over the accounts which specifically prohibited disposal of or dealing with the companies' assets up to £1.8m and £3.9m respectively, including any money in the accounts. Customs faxed Barclays copies of the injunctions. Shortly after receipt of the faxes, transfers of substantial sums were authorised from the bank's payment centre. Having obtained judgment in default against the companies but not recovered any monies, Customs brought proceedings against the bank claiming damages in respect of the sums paid out by the bank in breach of the injunctions.

Barclays argued that it could not owe a duty of care to Customs to avoid causing it financial harm since it had not voluntarily assumed a responsibility to it. Customs argued that the assumption of responsibility was only one factor to be taken into account. The correct approach was to adopt the threefold test, namely whether (i) the loss suffered was reasonably foreseeable, (ii) the parties were in a relationship of proximity and (iii) it would be fair, just and reasonable that Barclays should owe it a duty of care.

The judge at first instance found no duty of care to exist. The Court of Appeal unanimously disagreed. The bank appealed to the Lords.

## decision

The "voluntary assumption of responsibility" test did not provide the answer in all cases, although it might be decisive in many situations. In the absence of any single touchstone of liability and where a court was faced with a novel situation, the court had to apply the threefold test. The purpose of the freezing injunctions was to protect Customs by preventing the companies from dissipating their assets. Although Barclays would be in contempt of court if it knowingly authorised transfers of sums from the supposedly frozen accounts after being notified of the court orders, the failure to

operate a system for freezing accounts did not mean that it was liable to Customs. Notification imposed a duty on the bank to respect the order of the court; it did not of itself generate a duty of care to Customs.

Having notified Barclays of the freezing injunction, Customs could expect but not rely on the bank to respect the order. There was no voluntary assumption of responsibility by the bank for the way in which it would freeze the companies' accounts and nothing that involved Barclays in entering into a relationship with Customs that required it to exercise such care as was required. In the circumstances the parties were not in a relationship of proximity and it would not be fair, just and reasonable to hold that Barclays owed a duty of care to Customs.

## comment

This Lords' decision comes as a huge relief to banks and other financial institutions, particularly those whose internal systems do not automatically prevent errors of this nature from occurring. Claimants however will be unimpressed that they have no genuine remedy against those who fail to comply with a court order – the possibility of a finding of contempt will be of little consolation when assets thought to be available have disappeared.

# what about the fine print?

Peekay Intermark and Pawani v ANZ Banking Group  
Court of Appeal 6 April 2006

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## facts

Peekay was a company used as an investment vehicle for Mr Pawani. He regularly invested in emerging market instruments by liaising with one of ANZ's regional managers. The manager gave Mr Pawani a rough outline of an opportunity to invest in Russian government bonds, known as GKO's. Mr Pawani agreed to invest US\$250,000 in the product. He was not told that the bonds were financial derivatives, or that should the Russian government default, investors would have no control over the way the investment was liquidated. However, Mr Pawani was later sent a document which explained the true nature of the investment. He did not read these terms and conditions, but signed and returned the document together with a signed risk disclosure statement. The Russian government subsequently defaulted and Peekay lost almost all its investment. Mr Pawani and Peekay brought a claim in misrepresentation against ANZ.

The first instance judge found that the nature of the investment had been misrepresented by ANZ giving the impression that Peekay would obtain a proprietary interest in a GKO and that Mr Pawani had been induced by that misrepresentation to make the investment. ANZ appealed.

## decision

The Court of Appeal held that it would be very slow to interfere with the judge's finding that Mr Pawani understood Peekay would be acquiring an interest in a derivative product. It noted that the terms in which the bond was described were not such as to enable Mr Pawani to obtain a clear understanding of the nature of the product. Nevertheless, Mr Pawani was an experienced investor and if Mr Pawani had read the terms and conditions he would have realised that the investment was a derivative and fundamentally different from what he expected. The judge's finding that Mr Pawani was induced to enter into the contract by the statements previously made to him could not be sustained. The only conclusion open to the judge was that

Mr Pawani was induced to sign the documents not by what ANZ told him, but by his own assumption that the investment to which they related corresponded to the description he had previously been given. Further, by signing the risk disclosure statement, Mr Pawani confirmed that he had understood it, and so could not assert that Peekay was induced to enter into the contract by a misunderstanding of the nature of the investment derived from what ANZ's manager had said about the product beforehand.

## comment

The decision at first instance caused banks and other financial institutions considerable concern. What, after all, was the point of sending experienced investor clients detailed explanations of what were often complicated financial instruments, if investors could effectively ignore them and simply rely on a verbal précis? This decision should therefore provide comfort to those advising investors that the explanatory "fine print" can be relied on should investments not provide clients with the hoped-for returns. However, the cursory original explanation of the product and the sophisticated nature of the client were crucial to the Court of Appeal's decision. The claim thus emphasises the importance of ensuring that those tasked with promoting or selling financial products must not only understand the products themselves, but also be capable of clearly explaining their operation to customers. The volatility of some financial instruments is such that any confusion is bound to lead to claims.

# more regulation? hedging your bets...

spotlight on hedge funds as  
Amaranth Advisors crashes

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The press discussion as to the size of this year's City bonus pool was only one aspect of intense press coverage of hedge funds in the past twelve months. Talk of numerous hedge fund managers expecting stratospheric Christmas pay packets following bumper profits by the funds was tempered by a reminder of the fine line between financial success and crippling failure. In September, Amaranth Advisors lost a reported US\$6bn of its clients' money as result of a single trader's bet on the natural gas market. The Amaranth debacle was a poor advertisement for the stability and security of hedge funds and cast a dark and heavy cloud over the sector's reputation. Or did it?

In October, there were calls for pension funds to devote as much as a third of their assets to hedge funds. Currently it is thought that the UK has only 3% of its pensions allocated to hedge funds as compared with approximately 11% in continental Europe. With most FTSE-100 companies still suffering substantial pension deficits in the wake of losses made when the dotcom bubble burst, it is argued that they could match their liabilities by turning to hedge funds. Why hasn't this happened already?

One explanation may be the traditional lack of understanding on the part of pension consultants of how hedge funds operate; the consultants do not therefore press trustees of funds to think beyond traditional investments. But that is changing as both consultants and pension trustees receive greater education as to the merits of investing in hedge funds. It is perhaps ironic therefore that, in the shadow of the Amaranth losses, pension advisers and trustees should now consider carefully whether they are opening themselves up to criticism and claims if they fail to spread investment into an area which, although having very real risks, also contains the prospect of substantial gains.

What was inevitable however was the flood of calls for increased regulation of the hedge fund sector. The level of effective control of the industry in the US was

doubted after a court in June struck down a rule from the Securities and Exchange Commission requiring hedge fund managers to register with the regulator. This concerns those who think hedge funds need to be regulated because of the risk they could pose to the overall financial system; the worry is that banks and prime brokers may not be asking for sufficient collateral from hedge funds. The doomsday scenario is that were a large hedge fund to go the way of Amaranth, it could drag with it a major investment bank and cause a systemic crisis.

Some overall perspective from the insurance industry is perhaps necessary. Hedging can reduce the risk to the individual taking out the insurance, but it increases the risk for the banking system as a whole since the presence of insurance tends to lead people to become less risk-averse. The incentive structures governing hedge fund behaviour also encourage the taking of risks with a small probability of severe adverse consequences. This generally contributes to financial system stability but has the possibility to cause huge instability in bad times. When this is allied to the decline in risk premiums, the threat to the financial system is clear.

To date, regulation has concentrated on ensuring banks control their exposure to hedge funds and settle trades promptly. Although the Treasury is said to be sceptical over the case for toughening up regulation of hedge funds, the Deputy Governor of the Bank of England has warned of "*aggressive risk-taking*" by the sector and the FSA has said the industry is "*testing the boundaries of acceptable practice*". With these comments in mind it is not a matter of if the hedge fund sector will become more heavily regulated but when and how.

The **Companies Act 2006** received Royal Assent on 8 November 2006. The current statutory regime for companies has been in place since 1989 and the 2006 Act repeals and restates the existing companies legislation, including the law as it relates to directors' and officers' duties.

Certain provisions of the Act, including those concerning transparency rules relating to the disclosure of major holdings of voting rights and corporate governance, commenced on Royal Assent. Provisions on company communications and the **Takeovers Directive** will be implemented in January 2007, while the government plans to consult in February 2007 on detailed plans for the implementation of the remainder of the Act and intends to commence all parts of the Act by October 2008.

The 2006 Act increases the scope for shareholder derivative actions and in view of the new legislation, boards should review their directors' and officers' liability insurance policies to ensure that those policies provide cover for the defence of derivative claims. Another significant aspect of the 2006 Act is its codification of directors' duties, which will replace most of the existing common law rules on directors' duties, although some will remain uncoded. For those that are codified the common law will remain relevant to their interpretation.

In summary, the main directors' duties codified under the 2006 Act are as follows:

- a director of a company must act in accordance with the company's constitution and exercise powers only for the purposes for which they are conferred
- a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole
- a director of a company must exercise independent judgment

- a director of a company must exercise reasonable care, skill and diligence. This means the care, skill and diligence that would be exercised by a reasonably diligent person with:
  - (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
  - (b) the general knowledge, skill and experience that the director has
- a director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company
- a director of a company must not accept a benefit from a third party conferred by reason of:
  - (a) his being a director, or
  - (b) his doing (or not doing) anything as director
- if a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors.

The codification of these directors' duties means that corporate governance practices may need to be reviewed and adjusted accordingly, with for example, the taking of more detailed board minutes in order to be able to demonstrate compliance with the duties. Although it had been hoped that the general thrust of the 2006 Act would be to lighten the regulatory burden on companies, the redrawing of the scope and extent of directors' and officers' duties will oblige them to consider more carefully their respective relationships with shareholders, prospective investors and indeed the community at large and the liabilities arising therefrom.

# no relief for bankers

Riyad Bank and Others v Ahli United Bank (UK)  
Court of Appeal 13 June 2006

## facts

In 1994 Ahli United Bank, then known as the United Bank of Kuwait (UBK), established a Sharia-compliant income fund whose assets were invested in operating leases of heavy equipment. Riyadh Bank was interested in developing similar Sharia-compliant investment products. Discussions took place with a view to Riyadh Bank marketing the UBK fund through its branches. However, since Riyadh Bank was unwilling to market a product bearing the UBK name to its Saudi investors, UBK suggested that Riyadh Bank should set up its own fund using UBK as advisers.

Once agreed, the venture involved Riyadh Bank establishing a new company (the Fund) to act as an open-ended investment fund with the overall investment structure closely modelled on that of the UBK fund. Notably no contractual relationship between UBK and the Fund existed, even though it was clear the Fund would be reliant on UBK's advice.

The Fund began business in 1997 when it purchased its first leases and the initial investors bought shares. In 2000, independent valuations confirmed concerns that the value of the Fund might be overestimated. Riyadh Bank decided it was in its best commercial interest to purchase investors' shares in the Fund at a cost of US\$75m. Riyadh Bank and the Fund then sought to recover their losses from UBK.

## decision

The Court of Appeal addressed the question of whether the fact that the arrangement had been structured intentionally without any contract between UBK and the Fund precluded a tortious duty of care being owed by UBK. At first instance, a duty had been found.

Consideration was given to whether the situation was analogous to a chain of building contracts between employer, contractor and subcontractors where no duty of care was owed by a subcontractor to the employer. The court did not accept the analogy and

found that despite the absence of a contractual relationship, UBK assumed responsibility to the Fund. The lack of a contractual relationship arose because Riyadh Bank believed it would be commercially unattractive if the Fund were seen to be UBK's rather than its own. Where there had been direct dealings between UBK and the Fund, the mere fact that the contractual structure meant advice was passed from UBK to the Fund via Riyadh Bank did not prevent a duty of care from arising.

## comment

Although arguably an unwarranted interference in the dealings between commercial partners, the decision reflects the substance of the business relationship between the parties rather than a reliance on the legal, contractual form of the project. It serves as a warning that the courts will examine closely a business structure to ascertain the identity of the intended recipient of advice. A denial of a duty of care by reliance on the strict contractual relationship between the parties may not be sufficient to escape liability for negligent advice.

# three sides to every story

## Side A / DIC policies

D&O policies are now available in three basic forms:

- Side A, providing cover for individual directors and officers
- Side B, reimbursing the company for payments it makes to directors and officers covering the cost of claims, settlements and legal defence
- Side C, reimbursing the company itself for securities claims made against it.

The wider, Side C cover, however, is becoming increasingly less prevalent with the main selling point for D&O insurance being the protection it offers individual board members. With Side C cover in place it is possible for a D&O policy to have its limits seriously eroded by indemnifiable losses of the company or a security claim against the company. In some circumstances, company assets which have included the traditional D&O policy have been frozen. These circumstances of course leave the directors and officers without the benefit of policy indemnity.

Side A cover, under which the company itself is not insured, can provide cover for directors and officers in circumstances where they cannot be reimbursed by the company.

As the maturing UK market looks to provide new and more comprehensive D&O cover, a more recent arrival on the scene in the UK is the Side A / DIC (Difference in Conditions) policy.

Under a Side A / DIC policy there are a number of specific benefits now potentially on offer. For example, such a policy not only provides cover to directors and officers alone; it can also drop down to provide primary insurance where it gives broader cover than the underlying primary wording of the company policy. Elements and benefits of cover available can include:

- dedicated limits of cover available to directors alone
- bodily injury / property damage exclusions reduced so as not to exclude pollution claims

- secondary claims arising from pollution activities
- the cover being non-rescindable even where original financial statements relied upon by an underwriter might turn out to be incorrect
- coverage available where an underlying insurer has become insolvent
- payment where an underlying insurer has a wrongful repudiated claim payment.

There are many possibilities depending upon the nature of those seeking the cover in conjunction with a traditional company D&O policy, but essentially such policies eliminate a number of the most serious uncertainties that can arise when a company gets into such difficulties that may, in turn, affect the scope and the availability of cover for individual directors.

We can see that Side A / DIC policies have the capacity to give a much greater sense of security to those acting as directors of UK companies with international activities, who feel personally exposed in today's increasingly risk-laden corporate environment. Their future use, take-up and development will continue to be interesting to observe.

# you said how much?

## punitive damages

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In recent years, there has been a noticeable increase in both the magnitude and frequency of punitive damage awards. Insurers competing in a maturing D&O market are continually looking to add extra elements of cover to their standard insurance policies. Accordingly, as we can expect to see a continued increase in the use of punitive / exemplary damage awards, there could be a corresponding increase in insurers' willingness to allow a degree of cover for punitive damages rather than simply excluding this type of loss.

Punitive damages, or exemplary damages as they are known in the UK, are an extraordinary remedy. They are generally reserved for cases where the defendant's intentional, malicious or wilful conduct has resulted in damage to a claimant. Punitive damages are imposed to punish a wrongdoer and deter others from following that example. Historically, punitive damages have been more readily awarded in the US, although the UK courts have awarded, and continue to award, "exemplary damages" in limited circumstances, namely those highlighted in the leading House of Lords' judgment in **Rookes v Barnard** 1964. They are:

1. oppressive, arbitrary or unconstitutional actions by the servants of the government
2. where the defendant's conduct was "calculated" to make a profit for himself
3. where a statute expressly authorises them.

There has been much debate in the US as to whether awards for punitive damages ought to be insurable. Although it has been suggested that such coverage would negate the underlying intent of punitive damages, to punish and deter, a slight majority of states in the US do allow cover. Further, most of the states which have disallowed cover draw a distinction between a direct and vicarious liability, finding that punitive damages are insurable if they are based on the defendant's vicarious liability rather than the defendant's own wilful wrongdoing.

Whilst such damages are not generally available under English law, there is little authority as to the insurability of punitive damages, save for the Court of Appeal decision **Lancashire County Council v Municipal Mutual Insurance Limited**, in 1996. Here, the English court held that it was not against public policy to enforce the insurance policy provision covering punitive or exemplary damages. The court went further and stated that there is a public policy recognising the need to hold parties to their contractual obligations and if the insurer has taken a premium for insuring against punitive damages, such coverage should be afforded. Unfortunately, this case does not clearly define when that threshold for insurability is crossed.

# Smartforce CCC no force?

AIG Europe v Faraday Capital  
1st instance 31 October 2006

## facts

In November 2002 an Irish company, Smartforce, merged with an American corporation. The new management soon announced their intention to restate Smartforce's financial statements for previous years. This announcement and the subsequent fall in Smartforce's share price led to class actions against Smartforce and its directors claiming losses as a result of the allegedly artificially inflated value of the shares at the time of purchase. On 23 March 2004, the class actions settled for US\$30.5m. AIG, Smartforce's D&O insurer, notified Faraday, its reinsurer on 19 April 2004. AIG paid the claim for the full policy limit of US\$15m and sought to recover from Faraday.

Faraday disputed liability based on breach of a Claims Co-operation Clause (CCC) alleging:

1. the losses were notified too late
2. the CCC obliged AIG to notify Faraday of circumstances that might give rise to a claim against AIG, as well as actual losses. This was not done within the requisite period after AIG acquired the necessary "knowledge" and
3. even if the clause covered only actual losses when the shares fell in value.

## decision

The judge extracted the following points from the 2005 **Dornoch v R&SA** Court of Appeal decision:

1. the loss must be that incurred by the purchasers of the shares
2. the words "loss or losses" meant "actual loss or losses" and not "alleged" or "claimed" or "potential" losses. Had Faraday wanted this, it should have specifically said so
3. a claimant does not suffer a loss unless an actual loss was a "proved fact". This meant, that the shareholders had bought the shares at an inflated value due to the default of the company's directors and officers in the execution of their duties.

The court had to decide when a "fact" could be said to be proved in this case.

Having reviewed the background to the dispute, the judge found that there was not a loss known to AIG until, at the earliest, 23 March 2004 when the settlement was concluded. At that stage what "might be loss" was turned into an actual quantifiable loss notifiable under the CCC. Formal notification had been given on 19 April 2004, less than 30 days later, which was within the requirement of the CCC.

Until settlement had occurred, AIG had no knowledge of any "actual" loss. For example, the posting of reserves did not establish knowledge of a loss; rather, it is the process by which insurance companies anticipate the possibility of a loss.

## comment

On a commercial level, this decision makes no more sense than the decision in **Dornoch**. Cover under D&O policies is potentially triggered as soon as circumstances giving rise to claims exist, or actual claims are threatened or made. The intention of a CCC contained in a reinsurance of a D&O policy is to ensure that reinsurers are told about circumstances or claims as soon as they arise. However, the court has imposed its own literal interpretation on the words "loss or losses" with the result that the true intention of the CCC is ignored.

It is unlikely that the decision in **Dornoch** will be overturned. Therefore, when CCC notification clauses depend upon the reinsured's knowledge of "losses", rather than "claims" or "circumstances", reinsurers must understand that only knowledge of proved quantifiable losses suffered by the third parties claiming against the insured will trigger the requirement to notify reinsurers.

# about davies arnold cooper

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Our team of more than 80 specialist insurance lawyers advises in relation to fraud, professional indemnity, directors' and officers' liability and property and construction insurance for both insurers and corporate buyers of insurance as well as companies operating in the Lloyd's market, underwriting agents, brokers, intermediaries and risk managers.

## **Directors' and officers' liabilities / financial institutions**

We regularly advise on all aspects of directors' and officers' claims and in recent years, have been involved in a number of the significant cases that have hit the market. We have supported clients through regulatory investigations (including those controlled by the Department of Trade and Industry, the Serious Fraud Office, the Financial Services Authority, and the Health and Safety Executive) and the subsequent civil and criminal claims. We have experience in relation to a whole range of potential claims including disqualification proceedings, manslaughter charges, contract disputes, personal liability proceedings and wrongful trading.

Our team acts for many insured institutions and advisers over a range of issues. Our work includes M&A indemnity disputes, negligence claims regarding corporate acquisition advice, claims concerning market manipulation and breach of Stock Exchange rules, insider dealing claims, matters arising under BBB and computer crime cover, DTI, Lloyd's, FSA investigations, Alternative Risk Transfer, pension scheme administration and negligent miss-selling, hedge funds, derivatives and bond investment.

## **Our network**

Our London offices are complemented in the UK by our Manchester office, which has a strong commercial insurance team. Our Madrid office is widely recognised as Spain's leading insurance law specialists. The success of our work in Spain led to the opening of an office in Mexico City in 2003, which is dedicated to providing services to the London, European, Latin American and US insurance markets.

For further details, please visit our website [www.dac.co.uk](http://www.dac.co.uk).

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