

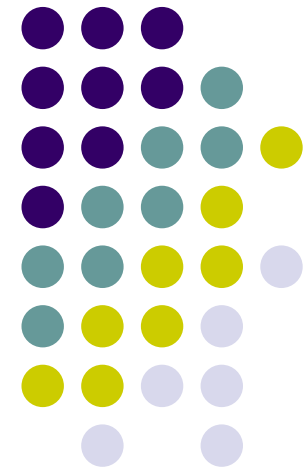


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The effect of allegations of illegality or dishonesty on D&O cover

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Introduction

- The impact of allegations of illegality or dishonesty
 - Allegation re conduct before contracting/renewal → non-disclosure, misrepresentation, avoidance
 - Allegation re conduct after contracting/renewal → dishonesty exclusion
- Not a close reading of *Wilkie v Gordian Runoff*, *Rich v CGU* but rather a more general consideration of the relationship between issues in tension with one another
- Comparative law: more concerned with raising questions about your own law than about finding alternative answers



On the one hand, on the other hand...

- Presumption of innocence vs. unlikelihood of successful recovery of costs advanced if allegation established
- Insurer's determination vs. final adjudication
 - Making insured pay both defence costs and the costs of seeking an indemnity
- Different standards of proof in civil and criminal cases
 - Allegation is a fact but any determination in criminal proceedings is not conclusive for civil
 - Perverse or technical acquittal or tactical abandonment of prosecution – innocent or “not proven”?
 - Appealable conviction – innocence vindicated?
- These tensions are played out in timing issues

Timing issues: avoidance



- Allegation made and proven false prior to contracting/renewal
 - Disclose the fact anyway?
- Allegation made but not disclosed before contracting/renewal, proven false after contracting/renewal
 - Harmless non-disclosure or can insurer avoid?
- Allegation made but not disclosed before contracting/renewal, proven false after insurer's avoidance for non-disclosure
 - Conclusive, or where there's smoke there's fire?
- Allegation made but not disclosed before contracting/renewal, unresolved at trial
 - Insurer's judgment sufficient?

Timing issues: dishonesty defence



- Allegation made and proven false after contracting/renewal but before insurer's decision
 - Insurer bound to reimburse or can it substitute its own judgment?
 - Different standard of proof
- Allegation made and proven false after contracting/renewal and after insurer's decision not to indemnify
 - Triumphant vindication of director's position?
- Allegation made after contracting/renewal, unresolved at trial
 - Insurer's judgment sufficient?



Truth a simpler case...?

- If the allegation is made out at any time, the insurer is entitled to refuse to indemnify, or to recover sums already indemnified
- Or is it?
- *Ary v Cincinnati Insurance Co*, 2006 WL 1360095 (D.Kan. 2006)
 - Director convicted at criminal trial
 - Sought payment of defence costs under D&O policy
 - Insurer had denied coverage before conviction
 - No determination of guilt yet at that moment
 - Subsequent vindication of insurer's position sufficient?

Ary



- Director *might* have been entitled to coverage before conviction
 - Like *Wilkie*
- What effect should the later fact of conviction have?
- Retroactive denial of pre-trial coverage?
 - “Case law states that the duty to defend is measured from the beginning of the action...Yet, courts have acknowledged that subsequent factors may be taken into consideration...Both approaches clearly have limitations. The former creates coverage where the insured may later be found guilty. The latter approach is problematic because it potentially eviscerates any coverage initially provided and it encourages secondary litigation following a verdict rather than merely ending any continuing coverage.”
- US District Court for the District of Kansas chose latter



Avoidance

- Allegation made but not disclosed before contracting; proven false/dropped after contracting
- Can insurer avoid anyway?
- *North Star Shipping Ltd v Sphere Drake Insurance Plc (The North Star)* [2006] 2 Lloyd's Rep 183 (CA) – Yes, insurer may avoid
 - The fact of the allegation itself was a material circumstance that should have been disclosed
 - “Moral hazard”
 - Only verifiable fact knowable at time of placement of risk was allegation of criminality



The North Star

- English marine insurance contract
- Insurer has an unmodified right to avoid for material non-disclosure if it would have induced contract
 - Marine Insurance Act 1906 (UK), s 18
 - Marine Insurance Act 1909 (Cth), s 24
- How different under Insurance Contracts Act 1984 (Cth)?
 - Risk/relevance not materiality
 - *Permanent Trustee v FAI* (2003) 214 CLR 514: focus is on particular insurance hazard not commercial willingness of insurer to accept the risk
 - More susceptible of objective ascertainment than insurer's response, which must be determined retrospectively
 - Would an as-yet-unproven allegation of dishonesty or illegality objectively affect the insurance hazard?



Avoidance

- Thus, in Australia, the timing of disproof of allegation is immaterial in most cases
 - Might affect the insurer's attitude but not the objective insurance hazard posed by the insured
- But what if the truth of the allegation remains unresolved when the court must determine whether insurer entitled to avoid?
 - *North Star* view presumably unrepentant: the allegation itself is material
 - Where does *Permanent Trustee* point in such a case?



Dishonesty defence

- Depends on the wording of the policy exclusion
 - *Wilkie* and *Rich* compared
 - Importance of insurer's discretion
 - Enhanced significance of insurer's determination
 - Callinan J in *Wilkie*: insurers "in a real and practical sense...the final arbiters of the extent of their obligations" – insured no money to proceed, or to proceed with suit re indemnity – easy enough to make the contract say that if that is what you want
- Many US cases with the same result as *Wilkie*: cover if "final determination" not yet made
 - *National Union Fire Insurance v Brown*, 787 F.Supp. 1424 (SD Fla 1991)
 - *In re WorldCom Securities Litigation*, 354 F.Supp.2d 455 (SDNY 2005)
 - Greater emphasis on *contra proferentem* interpretation – like Callinan J in *Wilkie*

Substituting the insurer's judgment?



- Allegation made and proven false/discontinued after contracting/renewal
 - Insurer bound to reimburse or can it substitute its own judgment?
- Again, will depend on the wording
- *Wilkie*
 - “In fact” means “subsequently established to have occurred following the adjudication of any court, tribunal or arbitrator”
 - Negative finding means it did not “in fact” happen
 - Definition provides the conclusiveness
- And if it does not?
 - Insurer can still argue that insured was *in fact* dishonest or guilty of illegal conduct, notwithstanding acquittal or discontinuance of prosecution
 - Particularly if exclusion is re “dishonesty”: not all criminal charges use that term



Conclusion

- *Wilkie* and *Rich* turn to a large extent on the policy wording
 - Like many insurance cases
 - HCA therefore usually reluctant to consider
 - Reluctance vivid in *Rich*
 - Not very influential – yet
 - *Rich* mainly cited re summary disposal
 - *Wilkie* cited re interpretation technique
- Two small slices of a larger picture about the relationship between risk, timing, proof and truth