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Editorial

This issue of the Journal demonstrates once again the breadth of issues with which the insurance industry and insurance professionals have to deal. Paul Budgen reviews some of the important decided cases in relation to transfers of insurance business under Part VII of the Financial Services and Markets Act 2000. He highlights, amongst other things, the importance of dealing effectively with policyholder objections and the FSA's current policy (adopted with the encouragement of the judges of the High Court) of setting out its views on each transfer in a report for the court, instead of simply indicating that it does (or does not) object to a transfer. Philip Orange's review of the EC Competition inquiry into insurance notes both the potential demise of the Block Exemption Agreement in 2010 and the European Commission's interest in the disclosure of brokers' commission on commercial insurance policies. The latter is an issue that the FSA is now itself pursuing in its Discussion Paper 08/2 on "*Transparency, disclosure and conflicts of interest in the commercial insurance market*", published in March 2008. Frank Stadermann and Chris Banis note the questions of interpretation and effectiveness that can arise when insurance contract language that is standard in one jurisdiction is transplanted into another jurisdiction. Finally (and in keeping with the Committee's policy that the Journal should include in-depth articles, when they are available), Charles Phipps reviews the law on confidentiality and legal professional privilege, as it applies between the parties to a contract of insurance who jointly instruct legal advisers.

As always, my thanks to the contributors and also to Barlow Lyde & Gilbert LLP for their help with the production of the Journal.

Dr Robert Purves
3 Verulam Buildings, Gray's Inn
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From 'Severability Clause' to 'Innocent Directors Clause' in Dutch D&O Policies

by Frank Stadermann and Chris Banis

And all people cried out, 'what beautiful clothes the emperor is wearing!'

Introduction

For some time now, Dutch insurance policies providing cover for the liability of managing directors and supervisory directors have included what is known as a 'severability clause'. This clause of American origin is intended to secure the rights of managing and supervisory directors vis-à-vis insurers in case the latter invoke non-disclosure. The severability clause provides that non-disclosure or misrepresentation may not be invoked against managing and supervisory directors who were not aware of the relevant facts. The question arises whether the intended purpose is achieved in this way.

The position of the co-insured third party after non-disclosure is invoked

If a policyholder includes a third party under a policy, the third party's entitlement to coverage also depends on the policyholder's honesty and sense of duty. Often the third party does not know what information the policyholder has supplied to the insurer before the insurance contract was concluded. If the policyholder fails to disclose information or provides inaccurate information such that this has consequences for the relevant cover, the third party – who believes that he is properly insured and submits a claim under the policy – may be in for unpleasant surprises. He may face the consequences of the insurer invoking non-disclosure, (below, the term 'non-disclosure' includes 'misrepresentation') under Art. 928 et seq. of Book 7 of the Dutch Civil Code, even though he has had no share in this non-disclosure. This is because the consequences mentioned in Art. 930 of Book 7 of the Dutch Civil Code equally apply to the co-insured third party. The latter only enjoys a certain degree of protection if the policyholder has acted with the intention to mislead; in that event, paragraph 5 provides that the principle that the insurer is never required to pay out in the event of intention should be set aside. This is because in the event of intention to mislead by the policyholder, the third party continues to be covered in accordance with paragraphs 2 and 3 of Art. 7:930 of the Dutch Civil Code. (On this subject, see also Asser-Clausing-Wansink, Deventer: Kluwer 2007, no. 179 and L. Dommering-van Rongen, 'De mededelingsplicht van de verzekeringnemer bij het aangaan van de verzekering', in *Het nieuwe verzekeringsrecht Titel 7:17 BW belicht*, Deventer: Kluwer 2005, pp. 50-51).

In theory, every insurance policy taken out for the benefit of a third party may give rise to the situation of a co-insured third party being confronted with the consequences of the policyholder's non-disclosure. Examples include personal liability insurance, companies' liability insurance and care insurance under which the policyholder's family members are also covered. Even so, there are hardly any reports about victimised family members or employees who are not covered as a result of the conduct of a father, mother or employer. With respect to other types of insurance, however, there are such reports about victimised third parties included under a policy. This applies, for example, to construction all risks-insurance, where a party involved in a construction project assumes on the basis of the specifications that the main contractor will ensure that this party is also adequately covered. If it turns out at a later date that the main contractor has failed to do so, the third party's only option is to claim compensation from the policyholder.

If, however, it is impossible to take recourse against the policyholder, the third party is left empty-handed. This situation is particularly relevant to directors' and officers' policies for managing and supervisory directors. (The Dutch term for D&O policies is *Bestuurders- en Commissarissen Aansprakelijkheidsverzekeringen*; *BCA policies*. As far as the English term *Directors' and Officers' Insurance* is concerned: we have not found a single Englishman who is able to explain to us the difference between a *director* and an *officer*).

The position of the third party in D&O policies

As is generally known, D&O policies grant cover for the personal liability of a company director. In this context, the term 'director' relates not only to a 'managing director' (or 'executive director') but also to a 'supervisory director'. Usually, these are taken out by the company. The director's liability may take two forms: the director may be liable to a third party, such as a supplier of the company or a shareholder, but he may also be liable to the company itself. Both forms of liability are covered under the D&O policy.

It is general practice, however, that both types of liability are invoked only if the company itself is financially at the end of its tether too. Third-party victims generally bring their claims against directors only if they know or expect that the company will be unable to satisfy their claims. This is only natural, for the road leading towards the director is longer than the road leading towards the company. This is because in the former case, the victim must also prove the director has mismanaged the company or is otherwise personally liable.

Generally, claims of the company itself are brought against the director personally only if the company is financially at the end of its tether too. This explains why most company claims against the company's own directors are brought by bankruptcy trustees.

That is why, in the context of D&O policies in particular, third parties included under a policy run the risk of suffering a personal financial loss if they are personally held liable. If the company has failed to insure the director properly – for example, because facts have not been disclosed – the director is unable to invoke the policy. Admittedly, if the company has undertaken to effect adequate insurance, for example, through an employment or other contract, the director may hold the company liable for any damage or loss suffered as a result thereof, but if the company is also insolvent, this kind of claim cannot be successful. Situations like this occur in practice. In addition, the very nature of D&O policies is such that great financial interests are involved, naturally.

It is also important to note that to the extent that Dutch businesses are active abroad as well, the D&O insurer is in a greater need of information. This increases the chance of the policyholder failing to provide accurate information, which, in turn increases the chance of the insurer invoking non-disclosure. For example, insurers of companies listed on the U.S. stock exchange want to know whether these satisfy the requirements of the Securities and Exchange Commission. In order to assess this, the person who informs the insurer and signs the application needs to possess thorough knowledge, which by no means all directors possess, and the relevant person often has to engage the assistance of the company's auditor.

When a D&O policy is taken out, a member of the Management Board or the legal department usually completes or causes to complete an application form and subsequently signs it. The relevant person obviously does so on behalf of the company, which – after the insurer's acceptance – results in the insurance being concluded. If, however, the person signing the application form fails to disclose information that is material to the assessment of the insured's risk and if, at a later stage, the insurer discovers this non-disclosure during the claim investigation, the latter may perhaps be in a position to refuse to grant cover, either in full or in part, by invoking Art. 928 et seq. of Book 7 of the Dutch Civil Code. In this context, it is not even necessary that the non-disclosed information was available to the person who signed the application. It is sufficient for a successful invocation of non-disclosure that this information *should* have been available to him. In addition, Art. 928(2) of Book 7 of the Dutch Civil Code shows that the obligation to disclose

extends to material information that is not available to the person himself but to other directors whose interests are included under the insurance cover. This may comprise knowledge with respect to any imminent liability notice.

If the insurer invokes non-disclosure and if this means that the insurer need not pay out, either in full or in part, this may also be invoked against the co-insured innocent director.

Definition of the problem

Accordingly, the problem is that directors who are not involved in the conclusion of the insurance contract simply have to rely on the correct completion of the application form, even though they may face very serious consequences if the application form is not completed correctly and if, at a later date, the insurer refuses to grant cover or grants only limited cover when confronted with a claim under the policy because of non-disclosure at the time of the conclusion of the insurance contract.

The relevant legislation does not offer any solution for this problem but the field is in need of a solution, (see *Assurantie Magazine* dated 14 December 2007, p. 34).

The severability clause

The 'severability clause' is increasingly used to solve this problem. This clause originated in the U.S. where it has been common practice for quite some time to include a severability clause in D&O policies. In the United Kingdom, too, the clause has by now acquired popularity.

As a matter of fact, it is better to use the plural 'severability clauses', because there is a great variety of them. What they all have in common, however, is that they are designed to protect directors who did *not* have the knowledge that was not disclosed to the insurer (known as 'innocent directors') if as a result of this non-disclosure, the insurer refuses to grant cover either in full or in part. (Note that this specifically concerns the severability clause in D&O policies, which is not to be confused with severability clauses that are increasingly common in contracts and seek to prevent the nullity from a single provision leading to the invalidity of the entire contract. For a more detailed explanation of this and an example of such a clause, see the website www.expertlaw.com/library/business/contract_clauses.html.)

The following may serve as an example of a severability clause as included in Dutch policies written in English:

“In granting cover to any one insured, the insurer has relied upon the material statements and particulars in the proposal together with its attachments and other information supplied. These statements, attachments and information are the basis of cover and shall be considered incorporated and constituting part of this policy. The proposal shall be construed as a separate proposal by each of the insureds. With respect to statements and particulars in the proposal, no statements made or knowledge possessed by any insured shall be imputed to any other insured to determine whether cover is available for any claim made against such other insured.”

The general idea is clear: knowledge available to one director may not be imputed to other directors who did not have this knowledge, the innocent directors. This means that with respect to the knowledge that was not disclosed to the insurer, a distinction is made between directors who were aware of the relevant information and directors who were not aware thereof, the innocent directors. This explains the name of the clause: ‘severability’ means, as we understand it, ‘separability’. The question arises, however, whether the severability clause is a solution for the problem identified above.

The severability clause on closer inspection

Anyone who reads the severability clause quoted above cannot help wondering how this clause should fit into the Dutch insurance law system, particularly the rules concerning non-disclosure.

For example, the sentence *‘the proposal shall be construed as a separate proposal by each of the insureds’* is definitely puzzling. How is it possible to use the fiction that every insured himself, hence every director, makes his own proposal for the conclusion of a D&O policy? This kind of fiction is alien to the Dutch insurance law system, in which only the policyholder (hence, the company in the context of D&O insurance) is responsible for supplying accurate information.

Another question that arises is how statements in the application (‘the proposal’) could be or could not be imputed to other insureds in the context of non-disclosure, because the question of imputation of non-disclosed information to co-insureds is not relevant when it comes to non-disclosure. The insurer may rely on the statements the policyholder has made to it.

This is different in U.S. insurance law. Even though each U.S. state has its own non-disclosure laws, the general rule is that non-disclosure of material facts in an application entitles the insurer to refuse to grant coverage because it is able to

'rescind' the policy. However, the obligation to disclose material facts does not rest on the policyholder, as is the case in the Netherlands. It is the obligation of the insured who completes the application form (hence, a director in the context of D&O policies) to answer the questions in the application form fully and honestly.

If material facts are not disclosed in the application form, the policy is generally considered to be void against all insureds, including those who have not completed the application form and have not failed to disclose anything (the innocent directors). This is possible because D&O policies often include the requirement that the application form should be completed and signed by one of the members of the company's executive board and because the application form subsequently provides that the person who completes the application form also does so on behalf of all other directors. Without these provisions, too, U.S. courts assume in specific circumstances that the director who completes and signs the application form is an 'attorney-in-fact' of the other directors, in which context any non-disclosure of facts of this attorney-in-fact to the principals (the other, often innocent directors) is imputable. In the light of this background, where the obligation to disclose all material facts does not rest on the policyholder but on the insured, who represents all other insureds, the severability clause makes perfect sense. In that case, it is not illogical to use the fiction that every director who is included under the insurance policy independently enters into a contract with the insurer, and – as a logical consequence thereof – to provide that knowledge of the director who enters into the insurance policy for the benefit of another director cannot be imputed to this other director. This also explains why the relevant U.S. case law usually centres on the question whether or not knowledge possessed by one director may be imputed to other directors.

Attempt at interpreting the severability clause under Dutch law

The question arises whether it is possible, taking account of the origin of the severability clause, to put a meaning to this clause under Dutch law that makes some sense and that does justice to the parties' intentions. It is not inconceivable that the courts may want to involve this background of the severability clause in their decisions on the correct interpretation under Dutch law. This is not certain because D&O policies for Dutch companies are not concluded on the U.S. market. Compare the Dutch Supreme Court decision dated 17 February 2006, *NJ* 2006, 378: if the interpretation of a policy provision is unclear, the interpretation of the contract (Haviltex) must also be determined by reference to the meaning put on the relevant provision at the insurance exchange where the relevant policy is concluded.

What does it mean in concrete terms that the ‘insurer will not impute an insured’s non-disclosed knowledge to another insured person’ in the context of non-disclosure? As stated above, imputation is not an issue under Dutch law. The statements the company made as policyholder through the person signing the application are deemed to have been made by the company, (this follows from Asser-Van der Grinten-Kortmann 2-I (Representation), Deventer: Kluwer 2004, no. 81). If this information is incorrect and incomplete to such an extent that the D&O insurer is entitled to invoke non-disclosure, the general rule is, as said above, that the non-disclosure may be invoked against all insureds.

Should the clause be interpreted in such a manner that – contrary to current law – the knowledge of the person completing the application may not be imputed to the policyholder? This interpretation would make sense because in that case the clause protects the innocent director against the consequences of non-disclosure by the company, as stated above in the context of the definition of the problem. After all in this situation, the company did not possess knowledge to be imputed to it and consequently, it could not fail to disclose anything.

We believe, however, that the clause is stretched to an unacceptable extent in this way. The text itself does not offer any ground for this interpretation, because it refers only to ‘insureds’ rather than to ‘policyholders’. Consequently, this interpretation is possible only if the company is also considered ‘an insured’. The latter cannot reasonably be maintained, because the company itself does not have any cover with respect to directors’ liability. In addition, this interpretation would even deprive the insurer of the possibility to invoke non-disclosure against the non-innocent directors, because – let it be repeated – according to this interpretation, no knowledge is imputed to the company and consequently, it cannot have failed to disclose any facts.

Accordingly, it seems to be simply impossible to interpret the severability clause in the context of an insurance contract governed by Dutch law, at least not in such a manner that the intended purpose – protection of the innocent director – is achieved.

In the Netherlands there is no case law on the severability clause. When we cast our glance abroad, we find – to the best of our knowledge – that only a court in Germany has rendered a decision on the interpretation of the severability clause and the questions that arise in this context.

The decision of the Oberlandesgericht Düsseldorf

The case heard by the Oberlandesgericht Düsseldorf, (Oberlandesgericht Düsseldorf 23 August 2005 (Versicherungsrecht (VersR) 2006 (785-787).) was as follows: a company director had completed an application form before taking out a D&O policy. The director had answered the question whether he was aware of any circumstances that could give rise to a claim in the negative. He was aware, however, that the company (under his effective management) had falsified annual accounts and had drawn up false accounts for the purpose of making the turnover volume appear higher than it actually was.

After the insurer had discovered this, he 'rescinded' the insurance contract in accordance with German law, which meant that he was no longer required to make any payments under the policy. Another company director, who had not been aware of the company's fraudulent conduct at the time of the conclusion of the insurance, made a claim for insurance cover in relation to a civil-law claim that a shareholder might bring against him. In doing so, he invoked the severability clause included in the policy. The English translation of the clause reads as follows:

"For the purpose of establishing whether there is insurance cover, no facts or knowledge known to or possessed by other insureds are imputed to any insured person."

The Oberlandesgericht ruled that this clause was of no benefit to the innocent director. It took the following ground (translated) with respect to the clause:

"It regulates the imputation of knowledge between insureds, but it does not answer the question what consequences fraudulent conduct by the policyholder has for the insureds. The exclusion of imputation of knowledge of the insureds that requires the insurer to pay insurance benefits that would not have been payable otherwise does not mean that the insurer is also required to make insurance payments to uninformed persons if the insurer was intentionally deceived by a person who acts on behalf of the policyholder and who is also among the insureds as a member of the company body with representative authority, and if this very fact made it possible to conclude the contract. Nor is it the case that the policyholder represented by an insured person qualifies as an insured person within the meaning of § 6 AVB OLA 98 [i.e. the severability clause, added by authors] itself on the ground of this representation, which means that this clause is not applicable on the ground of its literal content alone."

As the severability clause, according to the reasoning of the Oberlandesgericht, applies only to the mutual imputation of knowledge between insureds and does not relate to the consequences of non-disclosure by the policyholder, the clause does not prevent the insurer from invoking the consequences of non-disclosure by the policyholder against innocent insureds. According to the Oberlandesgericht, the fact that the policyholder was represented by an insured when the insurance contract was entered into does not detract from the foregoing. This is because the policyholder does not qualify as an insured person as a result of the representation.

It follows from this decision that under German law, too, the severability clause does not result in the innocent director being protected if the policyholder has intentionally failed to disclose facts. (We cannot infer from the decision of the Oberlandesgericht whether the decision would have been different if the non-disclosure had been unintentional). This approach is in line with the position we defended above that under Dutch law, the severability clause does not achieve its object of protecting the innocent director.

Conclusion

We draw the conclusion that the severability clause of U.S. origin cannot be used for insurance policies governed by Dutch law. It fails to achieve its intended purpose, which is protection of the innocent director from the consequences of non-disclosure at the time of the conclusion of the D&O insurance. The phrase that in the event of non-disclosure, the insurer will not impute the non-disclosed knowledge of an insured person to another insured person is meaningless in Dutch policies. It is therefore reminiscent of the emperor's new clothes.

What should be the solution? Proposal for an 'innocent directors clause'

It is not too difficult a task to achieve the intended purpose after all. The policy could include a provision to the effect that the consequences of any non-disclosure will not be invoked against directors who are in good faith with respect to the non-disclosure of material facts and for this reason cannot be blamed for the non-disclosure. This kind of provision would protect, *inter alia*, directors who are not aware of circumstances that may give rise to a claim as well as directors who are aware thereof but who have internally reported these circumstances adequately. On the other hand, directors who are aware of the circumstances as meant above and who have not reported anything internally or who know or understand that these circumstances have not been disclosed to the insurer at the time of the conclusion of

a policy, can be confronted with the consequences of non-disclosure without any restriction.

A 'Dutch' severability clause could read as follows:

"Innocent Directors Clause:

The insurer will not invoke the consequences as referred to in Article 7:930 of the Dutch Civil Code of any inaccurate statement as referred to in Article 7:928 of the Dutch Civil Code against the insured who is not to blame for this inaccurate statement."

The text of this proposal does not say anything about the allocation of the burden of proof in relation to the question whether or not the insured is to blame. In our view, the allocation of the burden of proof is not clear. The insurer who wants to place the burden of proof on the insured could use the following clause: *'The insurer will not invoke the consequences as referred to in Article 7:930 of the Dutch Civil Code of any inaccurate statement as referred to in Article 7:928 of the Dutch Civil Code against the insured who proves that he is not to blame for this inaccurate statement.'*

We believe that this provision would do justice to the need to protect the innocent director against the consequences of the insurer invoking non-disclosure. (This deviation from the statutory non-disclosure regime is permitted, because pursuant to Art. 7:943 of the Dutch Civil Code, Articles 7:928 to 930 are of a mandatory nature only to the extent that (I) these may not be deviated from to the detriment of the policyholder or the benefit recipient and (II) in addition, this prohibition applies only if the policyholder – stated briefly – is a consumer. Neither of these situations occurs in this case.) As stated above, the severability clause, in whatever form, does not provide this protection.

By Frank Stadermann and Chris Banis, Stadermann Luiten Advocaten, Rotterdam

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