The last few years have seen a considerable amount of upheaval in the financial services sector: the collapse of Lehman Brothers in September 2008; the discovery of the Bernard Madoff fraud in December 2008; rogue trading at Société Générale and UBS; the liabilities arising from the sale of Payment Protection Insurance, not to mention the effect of the worldwide economic downturn and its impact on the financial services sector.Whilst these (and there are many more not mentioned) are high profile events, there are far more lower profile events that regularly lead to insurance claims and insurance coverage disputes.

It is only once coverage disputes arise in insurance claims that policy wordings are truly tested and a significant amount can be learnt both by buyers and sellers of insurance from a review of such disputes and the arguments taken by both sides. Certain clauses which may appear innocuous on the purchase of an insurance policy can prove, later on down the line, to cause substantial hurdles when an insured attempts to secure an indemnity;

whilst for insurers, clauses in the policy wording may not have the effect that they were intended to have.

The various scandals and events, some of which are mentioned above, have led over the years to an influx of insurance notifications and claims, primarily on bankers blanket bond (BBB)/crime; directors' and officers' (D&O); errors and omissions (E&O) and professional indemnity (PI) policies. This article focuses on a number of coverage issues and considerations that arise or have arisen in the last few years on these policies.

**BBB/Crime Policies**

These are first party policies in that they are taken out by the insured (the employer) to protect it, primarily against a dishonest employee's fraud. However the scope of the cover available does vary depending upon the insured's requirements. In addition to employee dishonesty it is possible to extend cover to include loss suffered from forged instruments,
computer and telephonic misuse, physical loss of property (for example currency; bank notes; bullion and precious metals), and extortion. Despite the initial intent to protect an insured against acts of dishonest employees, a number of these other covers are not restricted to acts of employees but extend to acts of third parties.

There are a number of considerations that should be borne in mind when either purchasing this product or in a claim situation:

1. Direct loss. Cover is usually provided for direct loss which is normally defined in the policies. It will usually include: direct financial loss of the insured; claims preparation costs; legal fees and verification and reconstitution of expenses costs. The latter relates to expenses incurred in the reconstitution or removal of electronic data that has been affected. As a result it is not necessarily a given that all the losses suffered fall within the definition and scope of cover.

2. The criteria required by the insuring clause. In terms of employee dishonesty insurance claims, there are often three main criteria, usually set out in the insuring clause, which must be met for a loss to be covered:
   - The act must be carried out by an employee as defined within the policy.
   - The loss must be caused by a dishonest, fraudulent or malicious act.
   - The act must be committed with the intent to either make an improper financial gain or cause loss to the employer. Usually salary, fees, commissions, bonuses, salary increases are expressly excluded from the definition of improper financial gain. This can often be a coverage concern arising on insurance claims for loss suffered from rogue trading events. It is not unusual for traders not to have the intent to make an improper financial gain or to cause loss to the employer. The act often begins with a trader taking certain loss making unauthorised trading positions and so the trader borrows money from other accounts in order to take further trading positions in the hope of making a profit to cover up that loss. The intent is then to return the money to the account it was borrowed from. As a result, there is often no intention to cause a loss to the employer and there is no improper financial gain to the broker.

3. Proof of Loss. A further area of potential difficulty in BBB/Crime policies is the Proof of Loss:
   - Policies usually require an insured to provide insurers with a Proof of Loss setting out all the facts about the loss, the amount of loss and the supporting documentation in order to prove the loss suffered. The Proof of Loss will normally be required as a condition precedent to be provided within six months of the discovery of the fraudulent act or when the facts were such that the insured should have been alerted to the circumstances of the fraud. Confusion can often occur as to when exactly time starts to run and the exact date on which the Proof of Loss is due. To dispense with such uncertainty and the risk of breaching a condition precedent in the policy, it is always worth agreeing the date that the Proof of Loss is due with insurers. As the provision of a Proof of Loss is usually a condition precedent, it is essential to monitor its progress. If more time is required, a request should be made to insurers well before the deadline to ensure that the condition is not breached.
   - The nature and complexity of the fraud can also make the formulation of a Proof of Loss a complex issue. Particularly where covered and excluded losses are involved.

E&O/PI Policies

These policies have taken the lion’s share of the notifications and insurance claims, particularly following the collapse of Lehman Brothers and claims arising from the Madoff fraud. Issues that have arisen in the last few years which are worth noting include:

1. Civil Liability. Insuring clauses in these policies usually require there to be a civil liability in order for the policy to respond. What constitutes a civil liability is often set out or defined. There are a number of areas where this can cause difficulties:
   - An issue arising from the Payment Protection Insurance
mis-selling was that some insureds made “commercial” payments to those customers who raised complaints. These payments followed an internal strategy to provide a compensatory payment to such customers to deal with the complaint at an early stage. Such strategies were not necessarily based upon whether the insured had a legal or civil liability but rather the fact that it was more cost effective to deal with such complaints at an early stage before further management time and potential legal costs were incurred. Issues therefore arose on the insurance claims as to whether for each payment made there was an actual civil or legal liability owed.

- Civil liability does not include contractual liability. In policies there is often a specific exclusion of contractual liability in respect of: “[l]oss resulting from any Claim for legal liability assumed by the Assured under the specific terms, conditions or warranties of any contract, unless such liability would nevertheless have attached by law in the absence of such term, condition or warranty.” This exclusion is one that causes a considerable amount of concern given the tendency for claimants to bring a claim for breach of contract. Often many claims allege concurrent duties in tort and so the policy will usually respond to such claims; however, where disputes relate to a breach of transactional and contractual obligations only, there is a high risk of such disputes being caught by this exclusion.

2. Notification. Since the 
   **HLB Kidsons v Lloyds Underwriters & Others [2008] EWCA Civ 1206** Court of Appeal decision and the notification cases that have followed, such as **Kajima UK Engineering Limited v The Underwriter Insurance Company Limited [2008] EWHC 83 (TCC)**, there has been a heightened awareness and concern in notifying circumstances and claims to insurers promptly and as fully as possible.

- Timing of the notification. The practical effect of late notification has been well-publicised in case law and has heightened the awareness of insureds and insurance brokers who try to ensure notifications are made as early as possible once there is an awareness of a circumstance or claim. This concern has been driven by the fact that most notification clauses are drafted to ensure that the notification provisions are construed as condition precedents. In practice, a breach of a notification clause which is a condition precedent entitles insurers to deny liability for the claim irrespective of whether the breach has caused loss or prejudiced insurers.

- Scope of the notification. This is another important issue which certainly caused a significant amount of tension in the insurance notifications that followed the media reporting of the Madoff fraud in December 2008. Many financial institutions’ E&O policies renew their insurance on a calendar year basis and so once the fraud had been reported there was a concern by both financial institutions and their insurance brokers that notifications should be made to the expiring policy and disclosure should be made to the renewing policy prior to the expiry and inception of the respective policies. However, in many instances the true scale of the fraud and exposure faced was unknown by some insureds. Issues therefore arose, after renewal on 1 January 2009, in relation to the scope of some notifications made to the expiring policy, which were not drafted broadly enough providing a limited indemnity. In addition, there were instances of renewing insurers relying upon the prior awareness of circumstances and exclusions for circumstances notified to prior policy years to exclude notifications and limit cover to those insureds who either had not made notifications or had made limited notifications into their expiring policy. These issues highlight the need to give a considerable amount of thought to the construction and drafting of a notification in order to ensure the notification is broad enough to encompass all potential exposure that an insured considers it faces from a circumstance.

3. Restitution claims. The intent of E&O and PI insurance policies is to cover compensatory liabilities to a third party. Claims for restitution are not usually considered to be claims for compensation but rather claims for a return of monies to which the defendant was not entitled in the first place - in other words unjust enrichment.
• Restitution claims therefore are normally excluded under E&O and PI policies or do not fall within the insuring clauses of such policies. An example of the difficulty this has caused is in respect of the litigation arising from the Madoff fraud where claims have been brought by the trustee of Bernard L. Madoff Investments Securities LLC against the “feeder funds”, the funds that invested in Bernard L. Madoff Investment Securities LLC. In addition, feeder funds have also claimed against their investors, in restitution, in order to claw back redemption payments made to those investors. For those entities defending such claims for restitution, substantial legal costs have often been incurred which are potentially not covered as the defence costs cover is usually restricted to covered claims.

• Some insureds, however, who have been defending restitution claims on behalf of their client investors have mitigation costs cover included in their insurance policies and therefore have had their defence costs incurred in defending such restitution claims paid on the basis that their defence of the restitution claims mitigates potential claims brought against them by their investor clients.

4. Breaches of the Securities Act 1933 and Securities Exchange Act of 1934. For those entities which are based in or have a business exposure in the United States, there are usually exclusions found in their E&O or PI policies excluding claims arising out of breaches of the Securities Act 1933 and Securities Exchange Act of 1934 or any similar State or Federal or Provincial law. It is not uncommon for such exclusions to be drafted broadly excluding claims “arising from, attributable to or connected with” such breaches. Where the breach of such legislation which has ultimately led to the loss was not that of the insured, an issue arises as to whether the exclusion is ambiguous and, if so, whether the exclusion was intended to relate to breaches by the insured or breaches by a third party which is connected with the claim brought against the insured.

D&O insurance

Whilst there have not been as many claims against directors in England & Wales as compared to the amount predicted following the financial services crisis, this type of policy is still an important asset to those companies and directors that operate in England & Wales, particularly to indemnify companies or pay directors’ legal costs incurred by regulatory and other investigations. D&O insurance is of added importance where companies operate in those jurisdictions where the laws are such that claims against directors are more common place. Such jurisdictions include the United States, Italy, Germany and Austria. There are however issues to consider and be aware of:

1. Insuring clause. There is a requirement for a claim to arise from a wrongful act by the director or officer. What constitutes a wrongful act will be defined in the policy. The policies do not have a single consistent definition in use and this definition can have a significant effect on the scope of cover.

2. Outside directorship liability extension (ODL Extension). This extension is regularly purchased by companies as part of their D&O cover where company directors or officers are likely to hold outside directorships. There are industry sectors where this is a common business practice, for example, the private equity sector where a director or officer of a private equity firm may be appointed to the board or supervisory board of a portfolio company. In the context of the claim against the director (in their capacity as a director of the outside entity) there is always a risk of double insurance as the outside entity will usually have its own D&O insurance. To resolve the issue, the ODL Extension is normally drafted in such a way to ensure that it sits in excess of the outside entity’s insurance, so long as that local insurance is valid and collectable. In situations where the outside entity’s insurance is not valid and collectable, the ODL Extension will apply as the primary insurance. However, issues have arisen where both policies are valid and collectable and are governed by different laws and jurisdictions. Complications can occur due to the different interpretations in those jurisdictions to the policies, particularly where the outside entity’s policy contains a clause indicating that it will sit
in excess of any other applicable insurance.

3. Professional Services exclusion. Such exclusions are usually drafted broadly in D&O policies incorporating language to ensure that the cover on offer excludes claims “arising from or attributable to or in connection with” the performance or failure to perform professional services “by or on behalf of” any director or officer. This is an exclusion that frequently causes difficulties for insureds whose business is to provide professional services. The rationale for the exclusion is that such claims should be covered by the insured’s E&O or PI policy.

4. Presumption of Indemnity. Side B cover of D&O policies provides an indemnity from insurers to companies where those companies have indemnified a director for a legal liability or paid the legal defence costs of the director. Normally such cover requires a deductible to be paid by the company. There are legal limitations on companies as to what they can indemnify a director for. Where a company cannot legally indemnify a director, that director can usually seek an indemnity under side A of the policy, which responds where the claim is a “non-indemnifiable loss” i.e. a liability that cannot be legally indemnified by the company. Side A insurance cover does not require a deductible to be paid. However, difficulties arise where a company refuses to indemnify a director even though it is able to legally. In such situations a director may be unable to claim under side A for a “non-indemnifiable loss” as the company should have indemnified the director but has simply chosen not to do so. Arguments arise as to whether the director has cover at all, although usually insurers permit cover so long as the Side B deductible is paid by the director. Some policies contain clauses (Presumption of Indemnification clauses) specifying that in such circumstances the Side B deductible, which can be substantial, is payable by a director to ensure there is no doubt over the position. A solution is to ensure a clause is inserted into the policy confirming that in such situations the insurers will indemnify the director in full and the company will pay the retention. This then allows the insurers to pursue the company for their retention after indemnifying the director.

5. Erosion of policy limit. All D&O policies are written with annual aggregate limits. A concern directors frequently have is the erosion of the aggregate limit by claims made by the company for indemnification where it has indemnified a director (a Side B claim). Some policies contain Order of Payments clauses which provide a degree of protection for directors, but such clauses will not stop the erosion of the policy aggregate limit. Often the solution lies in the way the insurance programme is structured. An excess Side A layer of insurance, for example, can provide a layer of cover which is ring-fenced specifically for directors’ Side A claims to allay their concern of Side B claims eroding the policy cover.

A substantial amount can be learnt from considering the issues that have arisen from insurance coverage disputes. These not only provide an insight into which clauses regularly are an issue, but are also useful for risk managers and insurers to ensure that the insurance cover reflects their requirements and operates as they expect it to do.

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