



## Financial Lines Costs and Expenses Solution

### The Impact of the 'Steigrad' Ruling and the AIG Solution

In December 2013, the Supreme Court ruled that under Section 9 of the Law Reform Act 1936, where a statutory charge exists over a policy with a single monetary limit, the insurance fund cannot be used for defence costs.

The ruling has implications for any insurance policy that has a shared limit for both defence costs and any liability which might ultimately be established. Therefore, if an insured person or company is faced with actual or potential claims in an amount close to or exceeding the limit of its policy limit, the insurer will be obliged to preserve the entire insurance fund intact to pay possible damages, and the insured cannot use it to cover civil or criminal defence costs.

### Background to the Supreme Court Ruling

The Supreme Court decision stems from a dispute over whether former directors of the Bridgecorp companies could obtain an advancement of their defence costs under the company's Directors' & Officers' ("D&O") policy in circumstances where those directors faced potential third party civil claims significantly in excess of the D&O limit.

Their policy, like most within the insurance market, aggregated cover for liability and defence costs. The potential damages and compensation owed in respect to civil claims was greater than the policy limit and, as a result, the High Court ruled that the whole "insurance fund" was subject to a statutory charge created by section 9 of the Law Reform Act in favour of the civil claimants. The D&O cover could therefore not be used to meet the directors' defence costs.

The decision became known as the Steigrad ruling, after Peter Steigrad, a director of Bridgecorp.

For AIG, the Steigrad ruling had two key consequences:

1. It could force insurers into a breach of contract under existing policies which included defence costs.
2. It could prevent innocent directors from affording specialist legal expertise to defend themselves against a third party allegation.

To clarify the implications of the High Court decision, AIG – on behalf of the insurance industry – took another case on this same issue (Feltex) through the Courts in tandem with Bridgecorp. While the Court of Appeal agreed with AIG's stance that a statutory charge should not prevent the reimbursement of defence costs, the Supreme Court affirmed the original High Court ruling that section 9 does apply and therefore, where a statutory charge exists over a policy with a single monetary limit, the insurance fund cannot be used for defence costs.

### What is a Charge?

Under Section 9 of Law Reform Act 1936:

- Where an insured has a policy indemnifying against liability to pay damages or compensation; and
- An event occurs which gives rise to a claim for damages or compensation; then
- The amount claimable becomes a charge over the amounts payable under the policy as at the date the claim arose

Any insurer who pays defence costs for the insured in this scenario does so at their own risk and may result in paying more than the limit of indemnity under the policy.

### AIG's Single Policy Solution

AIG recognises that our clients carry out their business in a tough regulatory and litigious environment, and need to be able to make tough decisions with confidence. As such, AIG has developed a solution to address the consequences of the Supreme Court decision. This solution works in the current legal environment, thereby protecting potential damages for claimants, while achieving the right balance between the interests of policyholders, brokers and underwriters.

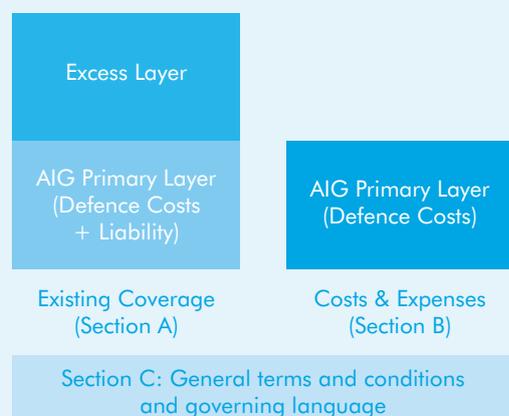
Specifically, this option ring-fences defence costs through a separate "Costs & Expenses only tower" ("tower" meaning limit of indemnity) that will respond only in the event that a section 9 charge prevents payments from the existing insurance tower. This Costs & Expenses tower will be a new section within the insured's existing policy.

The solution is a single insurance policy with three sections:

- Section A – includes all coverage available under an existing policy. This is the only section that has the potential for a section 9 charge to apply.
- Section B – a new Costs & Expenses section that responds only if there is a charge over all of Section A.
- Section C – the General Terms & Conditions and governing language of the policy.



**Fig 1. Policy Structure under AIG Solution**



### The “Wash Up” Clause

If defence costs are initially advanced under the new Costs & Expenses tower (Section B), but could ultimately have been taken from Section A, Section A can reimburse Section B. This “wash up” clause allows for separate defence costs cover to be reinstated that may be accessed in the event of a second claim provided that some funds remain available under Section A following the settlement of the previous claim.

### Key Points

- The Cost & Expenses tower (Section B) covers all costs afforded under the existing policy, including defence costs reparations, punitive & exemplary damages, investigation costs, extradition costs, public relations expenses, etc;
- Cover under the Costs & Expenses tower (Section B) replicates that of Section A. To ensure transparency to all parties, all limits and sublimits will be stated in the schedule. Existing sublimits will be split over Section A and Section B and higher limits can be purchased if required and available.
- Where multiple insured sections already exist (e.g Gold Complete or PrivateEdge), these will all form part of Section A and one Costs & Expenses tower (Section B) will be created that will be triggered in the event that any of the coverage afforded in Section A is subject to a charge.
- As the two towers (Section A and Section B) are governed under one policy, there will only be one retention applicable across both towers for the same claim.
- The policy will include a clause that AIG will not pay more than the limits of indemnity in the schedule. This will bring clarity to all parties (including excess layers) regarding an insurer’s obligation to pay defence costs when a charge applies (not covered by the Supreme Court decision).

### Solution Benefits

- The solution is contained within one policy document;
- Minimal changes are required to insureds' existing insurance programmes. The only requirement is to choose the Costs & Expenses limit of indemnity in Section B
- The Costs & Expenses tower (Section B) seamlessly reacts when a section 9 charge applies to Section A – there is no requirement for the insured to get a court order to confirm the existence of the charge;
- The “wash up” clause concept increases the probability that AIG will be primary Costs & Expenses insurer in the event of a second claim;
- Available via our multinational team for overseas companies that need local policies issued in NZ;

### What should you do next?

You and your clients should discuss the Section A and Section B limits of indemnity that are best in light of the client’s circumstances, and obtain any legal advice required.

The insured will need to advise AIG the limit of the new Costs & Expenses tower limit (Section B) that it wishes to purchase prior to the new structure being effective, with the minimum limit set at \$500,000. Ensuring the appropriate limits is important, as if Section B is required and is exhausted, no further cover for Costs and Expenses will be available unless the charge on Section A is subsequently lifted.

If you or your clients are concerned about the limits that they currently have insured or which would apply to any restructure, it is possible to seek higher limits of indemnity.

AIG will adopt this new approach for all renewals that aggregate cover for liability and defence costs. If you wish to implement this Costs & Expenses solution into an existing policy before renewal, please speak to AIG. We would welcome the opportunity to speak to you, your staff or any clients as required. We pride ourselves on understanding and dealing with these complex issues and are always available to discuss your needs.

*IMPORTANT: This is not financial advice. Please refer to the policy wording for full details of the cover and to ensure a full understanding of the scope of cover offered, and that it is suitable for your purposes and requirements and/or those of your client.*