Can you prevent pre-judgment garnishment by receiver of D&O insurance?

October 17 2017

Litigation, Netherlands

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Introduction

Directors and supervisory board members of public and private companies are increasingly being sued by receivers in bankruptcies on the basis of the following articles of the Civil Code:

- Articles 2:248 to 2:259 (private companies);
- Articles 2:138 to 2:149 (public companies);
- Article 2:9; and/or
- Article 6:162.**(1)**

This trend ensues from a receiver's duty to investigate, in the interest of creditors, potential director liability in the context of a company's bankruptcy. If the company's directors are held liable for damage that they have caused (Articles 2:9 and 6:162 of the Civil Code) or the company's bankruptcy deficit (Article 2:248), they may face large financial claims against their private assets. At present, directors are protected to a certain extent by indemnification or director and officer (D&O) liability insurance. If a director is sued and he or she fails to comply voluntarily, the receiver will initiate proceedings on the merits against the director. In this context, directors seem to be increasingly confronted by receivers that levy pre-judgment garnishment on the insurer with which the director is insured in order to secure their recovery.**(2)** In reality, such garnishment is undesirable for directors, insurers and receivers.

D&O insurance

Cost-inclusive D&O insurance offers cover for both the director's liability and relevant defence costs. Because such policies have, as a rule, one insured sum covering both damage and defence costs, in principle, the entire insured sum is included in the garnishment levied by the receiver. In the pre-judgment phase, this type of garnishment can be problematic.

Director's interests

As a result of pre-judgment garnishment, an insurer will be unable to compensate the costs that must be incurred by a director in order to conduct a defence against the receiver's liability claim in proceedings on the merits. Most directors are dependent on D&O insurance to compensate defence costs. The direct result of a receiver's levy of garnishment is that the director cannot pay for the defence, which subsequently means that he or she cannot conduct a proper defence. According to the lower courts' case law, the inability to conduct an adequate defence is contrary to the equality of arms principle.

Insurer's interests

Based on the *non peius* principle applicable under Dutch attachment law, a third-party garnishee (in this case, the insurer) cannot be put in a position that is more disadvantageous than that in which it would have been had the garnishment not occurred. If the director in question cannot be adequately assisted, this can have a direct impact on the insurer's obligation to distribute or compensate damage.**(3)** Thus, as is the case with directors, insurers do not benefit from a receiver's garnishment of D&O insurance either.

Interests of receiver as garnishing party

Garnishment prevents a D&O insurance policy from being 'emptied' due to excessive defence costs. However, in a bankruptcy, it is in the interests of the receiver (and, by extension, the creditors), the director and the insurer for the director to have the financial ability to conduct a proper defence. This is because not conducting a proper defence is often a ground for exclusion under the applicable terms and conditions of a D&O insurance policy. If the director fails to conduct a proper defence, this will be contrary to the policy's terms and conditions and the insurer's interests will be harmed. For that reason, there may be no cover under a policy and the insurer will not proceed to distribute payment. Thus, if a receiver levies and completely upholds pre-judgment garnishment on D&O insurance, this also poses a risk to the estate.

Preventing third-party garnishment

At present, there are two practical solutions for preventing the garnishment of D&O insurance.**(4)** The first solution is organising the cover provided by a D&O insurance policy and the policy's terms and conditions differently. For example, an insurer could distinguish between:

- the part of the insured sum intended for the compensation of damage; and
- the part intended for the costs of conducting a defence.

Doing so could prevent garnishment of the part of the insured sum that is intended to compensate defence costs. However, insurers should go one step further than merely splitting the insured sum by ensuring that their policy terms and conditions concerning defence costs give directors no right of action against the insurer. In this regard, a policy's terms and conditions could stipulate that the insurer will pay the director's firm directly for conducting a defence. This gives the insured party a claim against the insurer for defence costs that is ineligible for garnishment.**(5)**

The second possible solution for preventing garnishment of D&O insurance is converting a director's claim against his or her insurer for the compensation of legal counsel costs into a claim for compensation in kind. In such cases, the insurer will bear responsibility for the defence and the attorney, in its capacity as principal. This would involve payment in kind to the director, who could thus count on legal counsel. If an insurer organises the policy terms and conditions in this manner, pre-judgment garnishment is impossible on the basis of Article 718 of the Code of Civil Procedure in conjunction with Article 475(1). The amount ultimately remaining for the compensation of damage (in the event that the director's liability is established by law) will be the maximum cover available under the policy after the deduction of defence costs.

Comment

Where possible, pre-judgment garnishment by a receiver of D&O insurance should be prevented. However, in practice, this can be problematic.

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Endnotes

(1) For the sake of brevity, this update refers only to directors of private companies.

(2) These types of case involve garnishment being levied on the insurer on the basis of Article 3:276 of the Civil Code in conjunction with Article 475 of the Code of Civil Procedure.

(3) This is dependent on the policy's terms and conditions, which often include an exclusion clause that determines that no distribution will take place if the director fails to conduct a proper defence.

(4) At present, the courts deem pre-judgment garnishment of D&O insurance possible and grant leave for the same.

(5) Whether a director no longer has a claim against the insurer must be determined on the basis of an interpretation of a policy's terms and conditions of the policy. At present, no case law is available on this point.

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