UK OFFENCE OF 'FAILURE TO PREVENT FRAUD': D&O INSURANCE CAN HELP THE BOARD TO MITIGATE RISK

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UK Litigation and Dispute Resolution Alert

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In 2023, the UK Government introduced the Economic Crime and Corporate Transparency Act (the Act) with the aim of reducing economic crime in the UK. The Act introduced a number of measures including a new offence of "failure to prevent fraud" whereby organisations may be held to account where a person associated with the organisation commits fraud with the intention of directly or indirectly benefitting the organization (the Offence).

On 6 November 2024, the government released its long-awaited guidance on the Offence, as introduced by the Act, which gives organisations time to prepare and implement fraud prevention procedures before the Offence comes into effect on 1 September 2025 (as discussed in our UK Policy and Regulatory Alert: Guidance to Organisations on the Offence of Failure to Prevent Fraud.)

The Offence has been created with a view to ensuring that organisations[1] will be criminally liable if they benefit or profit from fraud committed by an associated person, such as an employee or agent. Criminal liability for the Offence can even be established in circumstances where the directors or senior managers of the organisation were unaware of the fraud. Types of fraud that are covered by the Offence include: fraud by failing to disclose information, false accounting, false statements by company directors, and fraudulent trading, amongst others. Essentially, the purpose of the Offence is to ensure that the organisation takes responsibility for preventing such conduct, by exposing it to potentially unlimited fines if found guilty. An organisation will have a defence if it can prove that it had reasonable fraud prevention procedures in place.

This alert considers the potential interaction between the Offence and Directors & Officers (D&O) insurance, and steps which organisations may want to consider with a view to enhancing the insurances they have in place in anticipation of the Offence coming into effect.

THE ROLE OF D&O INSURANCE

Most D&O policies are designed to cover individual directors and officers of a company against their liability for claims made against them in that capacity, including funding the costs of defending both civil and criminal claims. Such policies typically provide additional coverage for the cost of responding to regulatory and criminal investigations, but not for criminal fines, which cannot be insured on the grounds of public policy. Some D&O insurers also provide coverage for claims made against the company (commonly referred to as entity cover) though this is usually limited to a particular type of claim.

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Once the Offence comes into effect, there will inevitably be an increased number of criminal investigations and proceedings against companies, which will result in significant legal spend. Organisations may seek to offset that risk with D&O insurance, particularly if they are able to secure broad entity cover.

While the Offence is not focused on the prosecution of individuals, separate investigations may be opened into any individual employee or agent alleged to have committed or assisted the fraudulent conduct. Individual directors or senior managers could also be exposed to potential claims by the company itself for failing to implement appropriate fraud prevention procedures. Careful consideration will need to be given to the terms of the D&O policy to determine whether all relevant individuals are covered. Some D&O policies cover employees acting in a managerial or supervisory capacity, but more junior employees and independent consultants may not be insured.

WILL THE D&O POLICY RESPOND?

Most D&O Policies are written on a "claims made" basis and are designed to respond to claims (or investigations) commenced against the insureds during the policy period, regardless of when the alleged wrongful act occurred. The prompt notification to D&O insurers of any claim, or circumstances which may give rise to a claim or investigation, is therefore an important step in accessing the D&O insurance coverage.

D&O policies usually seek to exclude coverage for claims or investigations involving dishonest or fraudulent conduct, although such exclusions typically apply only to the individual liable for such conduct and only where such conduct has been established by final adjudication. This means that funding of defence costs remain available pending or in the absence of such findings. Careful scrutiny of such exclusions is important to ensure that they are not unduly broad and that the conduct of any relevant individual cannot be attributed to another insured person (or to the company where entity coverage is in place).

Some D&O insurers are willing to negotiate bespoke forms of coverage, which may better reflect recent trends in the D&O context. Policyholders should adopt a proactive approach with a view to negotiating the broadest coverage available and should carefully consider which individuals to include as insured persons. It may also be beneficial to provide D&O insurers with details of any risk assessments and fraud prevention measures put in place, in accordance with recent guidance, as well as details of ongoing monitoring.

CONCLUSION

Whilst the number of investigations and prosecutions of corporates will inevitably increase due to the Offence, D&O insurance may provide directors and officers with protection against any related losses and liabilities, including the funding of legal costs incurred in defending any related claim or investigation.

An everchanging and increasingly complex regulatory and liability framework makes it difficult to predict exactly how D&O insurers will approach the implementation of the new criminal regime. What is assured, is that careful and experienced advice will be needed in negotiating the terms of D&O insurance policies to ensure that companies and directors are both suitably covered and aware of any uninsured risks that future criminal and civil actions may present.

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The Firm's Insurance Recovery and Counseling Practice is dedicated to assisting policyholders in reviewing policy terms, managing the notification process and maximising recoveries on D&O insurance claims, seeking to avoid litigation and other costly dispute resolution processes where possible.

FOOTNOTES

[1] The Offence only applies to large organisations, which are defined as those with two of three out of the following criteria: (i) more than 250 employees, (ii) more than £36 million turnover, (iii) more than £18 million in total assets.

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