

Carter Newell LAWYERS

A Guide to Directors' and Officers' Liability and Insurance



1st edition

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This Guide was prepared by reference to current case law and legislation in force as at 30 April 2014. Due to the extensive nature of this Guide, there may be some references to case law and legislation that are no longer current. This Guide attempts to draw out the most significant points in the relevant case law and legislation. Whilst all care has been taken to ensure that the most up to date information has been included, not all aspects of the case law and legislation have been covered. The material contained in this Guide is in the nature of general comment only, and neither purports nor is intended to be advice on any particular matter. No reader should act on the basis of any matter contained in this publication without considering, and if necessary, taking appropriate professional advice upon his or her own particular circumstances.

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PREFACE

This guide is about the liability exposure faced by company directors and officers in Australia, and the extent to which that liability – and the associated costs of defending claims brought against directors and officers – can be indemnified.

It is generally accepted that Directors' and Officers' (**D&O**) insurance cover needs to be arranged by companies for the protection of their directors and officers, without which it would be much more difficult to secure their appointment. This is because claims against directors and officers often involve substantial damages or financial penalties and significant defence costs, and are amongst the most high profile and contentious aspects of third party liability insurance.

It can be argued D&O insurance is vital to an entrepreneurial society because without it, personal exposure would operate as a disincentive for the riskiest of business decisions on which innovation and success are often based. The contrary argument is that D&O insurance encourages too many risks to be taken, or encourages litigation against directors due to plaintiffs' expectations any damages will be indemnified.

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In the context of the duties owed under the *Corporations Act 2001* (Cth) (**Act**), directors' conduct has come under the scrutiny of regulators and shareholders. The increasing availability of litigation funding and class actions, the awareness of shareholders of their ability to make claims, the role assumed by the Australian Securities and Investments Commission (**ASIC**) as corporate watchdog, and the availability of D&O insurance have given rise to the trend for those claims to be vigorously pursued, particularly in the wake of the so called global financial crisis and the rising number of insolvencies.

The list of high profile cases has grown since 2000, such as those involving HIH, One.Tel, James Hardie, Fortescue Metals, AWB, Opes Prime, Sons of Gwalia and most recently the Bridgecorp case in New Zealand and the related Great Southern case in Australia. More is being expected of directors at a time when the environment in which they operate is becoming increasingly complex.

It is therefore critical for directors (including non-executive directors) to have a thorough appreciation of their obligations to both minimise their potential exposure and understand the scope of indemnity they require. In that context, this guide examines the sources of claims against company directors, the scope of D&O insurance and some of the key issues that arise including:

- Who is a director?
- What are a director's duties?
- To whom are those duties owed?
- What are the consequences of a breach of that duty?
- What protection is available for directors and officers?
- What is the position with respect to the advancement of defence costs to directors and officers?
- What are the key exclusions which need to be considered?



2 THE SCOPE OF DIRECTORS' AND OFFICERS' LIABILITY

Who is a director?

Section 9 of the Act defines 'director' as:

- (a) a person who:
 - (i) is appointed to the position of a director; or
 - (ii) is appointed to the position of an alternate director and is acting in that capacity;
 regardless of the name that is given to their position; and
- (b) unless the contrary intention appears, a person who is not validly appointed as director if:
 - (i) they act in the position of a director; or
 - (ii) the directors of the company or the body are accustomed to act in accordance with the person's instructions or wishes.'

The term 'officer' is defined in the Act as:

- (a) a partner in the partnership if the entity is a partnership; or
- (b) an office holder of the unincorporated association if the entity is an unincorporated association; or
- (c) a person:
 - (i) who makes, or participates in making decisions that affect the whole, or a substantial part, of the business of the entity; or
 - (ii) who has the capacity to affect significantly the entity's financial standing.'

It is therefore important to note the title a person is given within the company and whether they are noted as a director or officer in the company records will not of itself be determinative as to whether the legislation considers them to be a director or officer. The Court will instead consider the duties that person undertakes and whether those duties fall within s 9 of the Act in the individual circumstances of each case.

In *Shafron v Australian Securities and Investments Commission*,¹ the High Court was required to consider whether Mr Shafron, who occupied the dual role of general legal counsel and company secretary for James Hardie Industries Limited, was acting as an officer of the company when, it was alleged by ASIC, he breached his duty in providing advice to the board of directors concerning the exposure of the company to significant asbestos litigation, and whether information about a 'Deed of Covenant and Indemnity' entered into by the company should be disclosed to the Australian Securities Exchange (ASX).

Mr Shafron argued that he was acting as the company's 'general counsel' when advising the board, and not in the capacity as an 'officer'. That is, he said that there was a demarcation between the advice he provided as 'general counsel' and the discharge of his duties as the company secretary. In providing the contentious advice, he argued he was acting as 'general counsel', but not in his role of a company officer (as its secretary). He argued the discharge of his duties as company secretary were purely administrative, whereas the advice he was providing to the board as 'general counsel' was substantive and significant to the company – and therefore not provided in his role as a company 'secretary'.

¹ (2012) 286 ALR 612.

The High Court did not agree that there was any demarcation between the capacities in which Mr Shafron acted. The Court observed:

*'A fundamental difficulty with Mr Shafron's submission is that there was no evidence demonstrating or suggesting that Mr Shafron performed certain tasks in one "capacity" and other tasks in another. Mr Shafron did not give evidence at trial. What evidence there was about the role of a "company secretary and general counsel" of a listed public company did not support the distinction Mr Shafron's submissions sought to draw.'*²

The High Court held that the extent of the responsibilities Mr Shafron had to discharge to the company was a question of fact and concluded that, whilst his duties included the 'purely administrative functions' of transmitting necessary material to the ASX, 'Mr Shafron's responsibilities did not end at that point. His responsibilities were wider than administrative and extended to the provision of necessary advice.'³

In this regard, the Court concluded:

*'All of the tasks Mr Shafron performed were undertaken in fulfilment of his responsibilities as general counsel **and** company secretary. More particularly, because of his qualifications and the position in which he was employed, his responsibilities as general counsel and company secretary extended to proffering advice of how duties of disclosure should be met. And when he procured the advice of others and put that advice before the board for its use, his responsibilities could, and in this case, did, extend to identifying the limits of the advice that the third party gave.'*⁴ (Bold emphasis added).

In any event, the Court held that even if, which it did not accept, there was any demarcation between the capacities in which Mr Shafron provided advice to the board and dispatched material to the ASX, that was of no consequence because his responsibilities under s 180(1) of the Act were not confined to statutory responsibilities, but rather extended to include:

*'Whatever responsibilities the officer concerned had within the corporation, regardless of how or why those responsibilities came to be imposed on that officer.'*⁵

The High Court did not accept Mr Shafron's argument that merely because he provided advice to the board concerning the ramifications of entering into the deed of covenant and indemnity and its disclosure obligations to the ASX, this did not mean that he 'participated' in the board's decision. The High Court observed that in determining whether a person is an 'officer' for the purposes of considering the discharge of their statutory obligations:

*'Inquiry . . . must be directed to what role the person in question plays in the corporation. It was not an inquiry that is confined to the role that the person played in relation to the particular issue in respect of which it is alleged that there was a breach of duty.'*⁶

In making this enquiry, the Court considered it appropriate to have regard to how the director in question acted on occasions other than the ones the subject of the enquiry alleged to have given rise to a breach of duty.

² Ibid [617].

³ Ibid [617].

⁴ Ibid [617].

⁵ Ibid [617].

⁶ Ibid [619].

As to the distinction which Mr Shafron sought to draw between his mere provision of advice and the making of the decision, the High Court held that Mr Shafron was still a participant in that decision and stated that the concept of ‘participation’:

*‘... directs attention to the role that a person has in the ultimate act of making a decision, **even if** that final act is undertaken by some other person or persons. The notion of participation in making decisions presents a question of fact and degree in which the significance to be given to the role played by the person in question must be assessed.’⁷ (Bold emphasis added).*

However, in making this assessment, the Court held that participation in ‘any decision’ does not make a person an ‘officer’, but only the decisions in which he or she participated which have ‘significance for the business’ should be taken into account.⁸

In the final analysis, the Court concluded that:

‘The fact that Mr Shafron was an employee of the company, and not an external advisor, is important. What he did was not confined to proffering advice and information in response to particular requirements made by the company. And what he did went well beyond his proffering advice and information to the board of the company. He played a large and active part in formulating the proposal that he and others chose to put to the board as one that should be approved. It was the board that ultimately had to decide whether to adopt the proposal, but what Mr Shafron did, as a senior executive employee of the company, was properly described as his participating in the decision to adopt the separation proposal that he had helped to devise.’⁹

As a consequence, Mr Shafron joined Ms Meredith Hellicar (whose case is discussed below) and the other directors when their conduct was ultimately adjudicated upon by the High Court.

In *Grimaldi v Chameleon Mining NL (No 2)*¹⁰, the Federal Court considered whether Mr Grimaldi, who had been engaged as a ‘consultant’ to assist in the management of a company, was in fact a director or officer of it. The Federal Court noted that as a consultant Mr Grimaldi participated in directing the affairs of Chameleon Mining, and was also a director of several subsidiary companies of Chameleon Mining and a consultant to another subsidiary company.

The Federal Court stated:

‘The Corporations Act 2001 definition of “director” . . . extends to a person who, though not appointed as a director, nonetheless assumes to act in the position of a director. Accordingly, we consider the words “be appointed as” were not intended to be words of limitation but, rather, having regard to the purpose of the provision in its context, they signify no more than would have been the case had only the word, “be” been used.’¹¹

That is, the concept of ‘appointment’ employed in the Act is not determinative of the issue.

⁷ Ibid [620].

⁸ Ibid [620].

⁹ Ibid [621].

¹⁰ (2012) 287 ALR 22.

¹¹ Ibid [37].

In this regard, the Federal Court further stated that:

*'The [Act's] definition of director . . . extends to a person who, though not appointed as a director, nonetheless assumes to act in the position of a director . . .'*¹²

and:

*'Whether a person has acted in the position of a director is a question of substance, and not simply of how the person has been nominated in, or by, the company.'*¹³

Accordingly, the Federal Court held that a 'consultant', if provided with a limited and specific scope for the performance of consultancy services, will be unlikely to be caught within the definition of director or officer in s 9 of the Act, but that a 'consultant', engaged in a 'general and unconstrained [role] which permitted taking an active part in directing the affairs of the company, even if not on a full time basis' will likely be found to be a director.

Auditors

A company's auditor can also be considered an officer of the company,¹⁴ however the auditor will more usually (or coextensively) owe obligations to the company in a professional capacity for which it would ordinarily be expected to be covered by professional indemnity insurance.

In the UK case *Stone & Rolls Ltd v Moore Stephens*,¹⁵ a single director and shareholder company defrauded its bank. The bank, unable to pursue the insolvent company and director, sought to pursue the company's auditors on the basis the auditors owed the bank a duty of care *on behalf of the company* to ensure the company's creditors were not defrauded.

The UK House of Lords considered the proceedings were an indirect attempt by the bank to obtain compensation from the auditors' professional indemnity insurers, and dismissed the claim (by majority 3:2).

The bank was unable to bring a claim directly against the auditors, because the auditors did not owe a duty of care to third party creditors.

What are a director's duties?

Directors have duties under the Act, at common law, and in equity. The significant obligations under the Act – breach of which may give rise to the imposition of civil penalties of \$200,000 per breach in addition to liability in common law or in equity – comprise:

- an obligation to discharge one's duties with a degree of care and diligence that would be exercised by a director in the company's circumstances.¹⁶ The discharge of this duty requires the application of '*business judgment*', which must be exercised in good faith and for a proper purpose;
- the director must not have a material personal interest in the subject matter of a decision;¹⁷
- the director must inform himself or herself appropriately, and rationally believe that the judgment is in the company's best interests;¹⁸

¹² Ibid [37].

¹³ Ibid [45].

¹⁴ *Mutual Reinsurance Co v Peak Marwick* [1997] 1 Lloyd's Rep 253.

¹⁵ [2009] UKHL 39.

¹⁶ *Corporations Act 2001* (Cth) s 180 (1).

¹⁷ Ibid s 180 (2)(b).

¹⁸ Ibid s 180 (2).

- the director must exercise powers and discharge his or her duties in good faith, in the company's best interests, and for a proper purpose;¹⁹
- the director must not use his or her position to gain an advantage for him or herself, or to cause detriment to the company;²⁰
- the director must not use information to gain an advantage for him or herself that would cause detriment to the company;²¹
- the director must not act in a way that is intentionally dishonest or reckless;²² and
- the director must not permit the company to incur a debt when it does not have the capacity to repay the debt and the director knows, or ought to know, that to be the case – that is, the director must not allow the company to engage in insolvent trading.²³

That is not the end of the statutory liabilities. Directors also face criminal liability if the company has committed an offence under a variety of regulatory provisions, such as the *Taxation Administration Act 1953* (Cth), the *Australian Consumer Law* (Cth) and the *Environmental Protection and Biodiversity Conservation Act 1999* (Cth).

Directors also owe common law duties of care and skill, and equitable duties which are codified (although not exhaustively) in the Act.

To whom are the duties owed?

Whilst ASIC has a keen interest in policing and prosecuting breaches of directors' duties, it is not to the regulator that the duties are owed. The proper claimant in respect of any alleged breach of those duties is the company, or its subsidiaries, and not individual shareholders or third parties. This is because a director's obligations are owed to the company, not third parties.

This point was illustrated in *Williams v Natural Life Health Foods Limited*,²⁴ which involved a director of a company who had negotiated with, and misled, potential franchisees by presenting an unrealistically healthy picture of the business and the likely income to be generated by the franchisees.

The franchisees entered into the arrangement and sustained significant losses. They then sought to pursue a claim against the director for negligence. That claim was dismissed, with the House of Lords holding that the director was acting, in his dealings with the disappointed franchisees, on behalf of the company, and had not assumed any personal responsibility to the franchisees.

However, that House of Lords judgment did not deter the plaintiff in *Stone & Rolls Limited v Moore Stephens*²⁵ (referred to earlier) from mounting a similar argument. In that case, a bank was defrauded by a dishonest director of a one-man company, who had embezzled millions of dollars financing fictional trading deals which manifested into all too real debts. When the bank could not recover from the insolvent company or the impecunious director, it sought to pursue a claim against the company's auditors, arguing that the auditors owed the bank a duty of care, on behalf of the company, to ensure that the company's creditors were not defrauded.

As noted above, the House of Lords dismissed that claim too, which they characterised as an attempt by the bank to obtain funds from the auditor's professional indemnity insurers. The House of Lords held that the claim could not be sustained because the auditors did not owe a duty of care to third parties, but only to the company itself.

¹⁹ Ibid s 181.

²⁰ Ibid s 182.

²¹ Ibid s 183.

²² Ibid s 184.

²³ Ibid s 588G.

²⁴ [1998] 2 All ER 577.

²⁵ [2009] UKHL 39.

Breach of directors' duties

Having regard to the variety and breadth of duties incumbent on directors, and the manner in which the regulators and the courts seek to impose and police those obligations, it is instructive to consider recent leading cases to illustrate the significance of those obligations and the consequences for their breach.

Hellicar

In *Australian Securities and Investments Commission (ASIC) v Hellicar*,²⁶ the seven directors and the company secretary (Mr Shafron, referred to above) of James Hardie Industries Limited were found to have contravened s 180 of the Act, in failing to exercise due care and diligence in approving an announcement to the ASX to the effect that a compensation scheme, founded by James Hardie Industries Limited, held sufficient funds to meet anticipated future asbestos claims. It was held that the announcement to the ASX was misleading insofar as it failed to deal with several significant qualifications and limitations on the capacity of the scheme to meet 'all' future claims.

The contentious announcement made by the board to the ASX on 16 February 2001 was to the effect that an asbestos compensation foundation established by the company '*has sufficient funds to meet all legitimate compensation claims anticipated from people injured by asbestos products that were manufactured in the past by two former subsidiaries*' of the company. It further stated that the foundation was '*fully funded*' and that '*James Hardie is satisfied that the foundation has sufficient funds to meet all anticipated future claims*'. It transpired the foundation did not, and it was found at trial and on appeal that the directors of the company should have known that.

When the matter came before the High Court on ASIC's appeal, it was not contested that the announcement to the ASX was misleading, and it was not contested that the directors should have known that the announcement was misleading. What was in issue was whether the Court of Appeal had been entitled to find that ASIC had not proved that a draft of the ASX announcement, tabled at the February 2001 meeting of the board, had been approved by the board.

The Court of Appeal's finding was that no direct evidence had been adduced at trial as to what happened at the contentious February 2001 meeting concerning the board's consideration and approval of the draft announcement to the ASX.

One of the major aspects of the directors' case, in seeking to support the Court of Appeal's judgment before the High Court, was that the contentious draft announcement was changed after the February 2001 board meeting, and that those changes would not have happened had the announcement been considered and approved at that meeting. As for the problem that the directors subsequently approved the minutes of the February 2001 meeting in April 2001, which included references to the tabling and adoption of the ASX announcement, the directors contended that this was an error.

The High Court undertook a review of the amendments made to the ASX announcement after the February 2001 board meeting and concluded that those amendments were '*textual rather than substantive . . . None of them altered the sense of what was being said in the document as a whole*'.²⁷

As for the argument regarding the inaccuracy of the board minutes, which the directors contended supported the Court of Appeal's finding that the ASX announcement was not approved by them at the board meeting in February 2001, the High Court, whilst conceding that there were certain inaccuracies in the board minutes, nevertheless concluded that:

²⁶ (2012) 286 ALR 501.

²⁷ *Ibid* [525].

*'The fact that some parts of the minutes were inaccurate does not necessary imply that other parts of the minutes (in particular the minute that recorded the tabling and approval of a draft ASX announcement) were inaccurate. And similarly, the fact that the minutes were drafted before the meeting, does not necessarily imply that they did not accurately record what happened at the meeting.'*²⁸

The High Court also relied on the fact that there was no evidence of any protest by the directors after the publication of the final ASX announcement, that it had not been approved by them. The Court observed:

'Rather, absence of protest about the terms of the final ASX announcement was consistent with the board having approved the 7.24 draft announcement at the February meeting. It may also have been consistent with the directors not having read the final ASX announcement and with their not having been able or sufficiently interested to participate in the proposed telephone conference. But absence of protest was important to assessing whether, as the directors asserted, they, if asked, would not have approved the 7.24 draft announcement.'

*The evidence of that opportunity for, but absence of, protest about the final ASX announcement supported ASIC's case; at the very least, it did not show the minutes to be false.'*²⁹

In a separate but concurring judgment, Heydon J considered the position of the American directors of the company, Mr Gillfillan and Mr Koffel, who participated in the contentious February 2001 meeting by telephone, and without the benefit of having even seen the draft ASX announcement.

Apparently, Mr Gillfillan and Mr Koffel were silent when the issue of the approval of the ASX announcement was put to the vote. Their counsel argued that the general practice at James Hardie Limited board meetings, that silence meant consent, only applied where what was being decided was 'clear to all' and that, in these circumstances, the silence of Mr Gillfillan and Mr Koffel amounted to an abstention. Heydon J did not agree. He stated:

'Whether they (Gillfillan and Koffel) read the minutes of the 15 February 2011 meeting or not, they approved them, in company with every other director save the absent Mr Wilcox, on 3 April 2011, when the February minutes were retrospectively approved. They did not then indicate that they had abstained from voting. The board's practice was that the chairman could summarise the position and, unless any directors stated opposition, this was taken to be a unanimous board resolution. In their evidence, Mr Gillfillan and Mr Koffel accepted that this was the board's practice. Further, Mr Gillfillan and Mr Koffel were on notice that a public announcement would be made at the same time as the third quarter results were announced, if the 15 February 2011 meeting approved the separation proposal. That notice came from the board papers for both the 17 January 2011 and the 15 February 2011 meeting.'

...

*Given the activity of management and directors in the months before February 2011, it would have been as obvious to Mr Gillfillan and Mr Koffel as to any other director, that the separation proposal was potentially controversial to a degree. The vital need to communicate to the public that the foundation would have insufficient funding to meet all the legitimate claims would have been equally obvious.'*³⁰

²⁸ Ibid [532].

²⁹ Ibid [536].

³⁰ Ibid [580].

Despite the fact that Mr Gillfillan and Mr Koffel gave evidence at the trial to the effect that if they had seen the ASX announcement they would have voted against it, it was argued by their counsel that in circumstances in which they had not been given the draft ASX announcement, they had not breached their obligations under s 180(1) of the Act. This was because (it was submitted) all that it required of them was to give ‘*careful attention*’ to what was before them, and if nothing was before them there was nothing more they could do and they had therefore complied with their obligations.

Heydon J did not accept this submission and held:

‘Mr Gillfillan and Mr Koffel appreciated that a significant announcement was to be made on the controversial subject of whether funding could be assured. The onus was on them to be cautious when voting on the making of the announcement – either by seeking further information or by explicitly abstaining. They gave evidence that if they had known the terms of the announcement approved, they would not have voted for it. This does not sit well with their conduct and leaving to other directors the task of devising the announcement. The submission must be rejected.’³¹

Following ASIC’s successful High Court appeal, the issue of the sentence to be imposed on the directors was remitted by the High Court to the Court of Appeal.

In the original judgment, each director was disqualified from being a director for five years and ordered to pay a penalty of \$30,000 each.

In a judgment delivered on 12 November 2012, the Court of Appeal reduced the period of disqualification of the Australian directors from five years to two years and three months (with one director having a slightly shorter period of disqualification imposed), and imposed fines of \$25,000 each.

It also reduced the penalties on the American directors to periods of disqualification from acting as directors of one year and 11 months and a lesser penalty of \$20,000 each.

Hellicar illustrates the commitment of ASIC in its pursuit of civil penalties and criminal proceedings against directors whom it considers to be derelict in their duties.



³¹ Ibid [581].

Fortescue

A further example of ASIC's commitment to the pursuit of directors is its prosecution of Andrew 'Twiggy' Forest in respect of his publication to the ASX that Fortescue Metals Group Limited (FMG) had entered into:

*'A binding contract with China Railway Engineering Corporation (CREC) to build and finance the railway component of the Pilbara Iron Ore and Infrastructure Project.'*³²

ASIC was successful before the Full Federal Court in securing a finding that Mr Forest did not have a genuine and/or reasonable basis for this announcement concerning the impact or effect of the 'framework agreements' and had therefore engaged in a course of conduct in the making of statements to the market which were 'false, unqualified and emphatic as to the significance and effect of the framework agreements.'³³

However, in a judgment delivered on 2 October 2012, the High Court dismissed the finding of the Full Federal Court and held that insofar as ASIC's case against Mr Forest depended on the proposition that the contentious statements conveyed to their intended audience a view about the legal enforceability of the 'framework agreements', the ASX announcement did no more than communicate matters of historical fact, namely that Mr Forest considered a binding agreement had been entered into which, it was ultimately held, was not a misleading or deceptive representation.

The High Court summarised the finding of the Full Federal Court in the following terms, namely that what had been found was:

*'Misleading or deceptive or likely to mislead or deceive to say that the parties to the framework agreements had made "binding contracts", unless the parties had made bargains that could be and would be enforced by action in an Australian court.'*³⁴

The High Court held that the construction of the impugned statements must be approached from the point of view of the intended audience for those statements and it was therefore essential to ask what *that* audience, when told that FMG had entered into binding contracts with the Chinese state-owned companies, would understand that to mean. The High Court posed the following question:

*'Would they, as the Full Court assumes, ask a lawyer's question and look not only to what the parties had said and done but also to what could or would happen in a court if the parties to the agreement fell out at some future time? Or would they take what was said as a statement of what the parties to the agreements understood that they had done and intended would happen in the future? The latter understanding is to be preferred.'*³⁵

It was held that the position favoured by the Full Court of the Federal Court, namely that 'the statement that the agreements being "binding agreements" necessarily conveyed the proposition that those agreements would be legally enforceable in an Australian court, was too broad a proposition to be sustained.'

³² Announcement made to the Australian Securities and Investment Commission by Fortescue Metals Group Limited on 23 August 2004 under a letter headed 'China signs to build railway'.

³³ *Australian Securities and Investments Commission (ASIC) v Fortescue Metals Group Ltd (No. 5)* (2009) 264 ALR 201.

³⁴ *Forrest v Australian Securities and Investments Commission (ASIC); Fortescue Metals Group Ltd v Australian Securities and Investment Commission* (2012) 291 ALR 399 [409].

³⁵ *Ibid* [410].

In this regard, the High Court observed:

*'The very words of the impugned statements made two points abundantly clear. First, there can be no doubt that the impugned statements conveyed to their intended audience that the parties had made agreements. Second, there can be no doubt that the impugned statements conveyed what the parties to the framework agreements had said in those agreements. And the provisions of the framework agreements showed (and ASIC expressly accepted at trial) that the parties intended their agreements to be legally binding.'*³⁶

The High Court held that the impugned statements were not capable of being properly construed to the effect that the agreements would be enforceable in Australian law and, rather, in circumstances in which ASIC could not establish that Mr Forest did not genuinely intend to enter into a legally binding agreement, the impugned statements did nothing more than convey to their intended audience:

*'... what the parties to the framework agreements had done and had said they had done. No further message was shown to have been conveyed to an "ordinary or reasonable" member of that audience.'*³⁷

The decisions in *Hellicar* and *Forest* provide a useful contrast with respect to the challenge of discharging directors' responsibilities in making and authorising announcements to the ASX. In *Hellicar*, the announcement concerning the adequacy of the compensation fund was not only wrong, but was found to have been misleading to the knowledge of the directors (at least those who had read the announcement) given that it did not provide a complete picture of the complexities attendant on the operation of the compensation scheme and provided false assurances to the effect that the scheme would be sufficient to meet 'all' future claims.

It was no defence for the absentee American directors to argue that they had not read the draft ASX announcement, or that their silence when the matter was put to the vote could be regarded as an abstention rather than as an approval. They had an obligation to read the material and, if they had not, or could not, they should have made that clear and abstained from the vote. As for the attempts of the Australian directors to distance themselves from the February 2001 board minutes, the fact that they subsequently approved those minutes in April 2001, and made no complaint about the announcement to the ASX when it was subsequently made, was fatal to their attempt to divorce themselves from the announcement.

However, in *Fortescue*, no dishonest intent was established by ASIC against Mr Forest and it was held that the announcement to the ASX, assessed by the standards of the tough, cynical and sceptical audience of intended recipients of that information, did no more than accurately communicate as a matter of historical fact that the parties had entered into what they considered to be, and intended to act upon, as binding agreements.

The key difference would seem to be that while *Hellicar* involved false promises about future matters which could not be kept, *Fortescue* involved an announcement of historical fact, namely the entry into certain agreements and the truly held opinions expressed by those who were parties to the agreements as to what they thought they were doing.

³⁶ Ibid [410].

³⁷ Ibid [411].

3 TRADING WHILST INSOLVENT

It is not only in making announcements to the ASX that directors need to be careful. A frequent source of claims against directors is when a company is in financial peril.

Pursuant to s 588G of the Act, a director is required to prevent the company from incurring further debt in circumstances where:

- the company is already insolvent, or becomes insolvent at the time the debt is incurred; or
- the director suspects the company is insolvent or will soon become insolvent.

Section 95A of the Act states that the test of insolvency is:

- (a) a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable;
- (b) a person who is not solvent is insolvent.³⁸

The issue of solvency must be considered over a period of time, not at one frozen point. The cases illustrate there is an emphasis on the analysis of cash flow, not balance sheets. In the renowned case of *Bank of Australia v Hall (trustee of the estate of Robertson) (in liquidation)*,³⁹ Griffith CJ held:

'The question is not whether the debtor would be able, if time were given him, to pay his debts out of his assets, but whether he is presently able to do so with moneys actually available. The most favourable construction that can be put on the words "his own moneys" is that they include any moneys which the debtor can obtain immediate command by sale or pledge of his assets.'

It has often proved difficult establishing whether a company was insolvent on the day a debt was incurred. This is at least in part attributable to the difficulties faced by a liquidator who may not have access to sufficient information to gain a complete understanding of the often complex financial arrangements and trading history of the company.

Given the difficulties of establishing at the date the debt was incurred whether the company was insolvent or not, and having regard to the necessity for an analysis of the conduct of the company over a period of time, the Act has created two rebuttable presumptions which reverse the onus of proof in proceedings dealing with corporate insolvency. Pursuant to s 588E(3) of the Act, a presumption of insolvency applies if it can be proved that a company was insolvent within a 12 month period prior to the *'relation back'* day. The *'relation back'* day is defined in s 9 of the Act as the day an administrator is appointed, or an application for winding up is filed.

The second presumption arises under s 588E(4) of the Act, in circumstances in which it can be shown that a company has failed to keep proper accounting records explaining the company's financial position, or has failed to retain financial records for a period of seven years, as required under s 286(2) of the Act.

Setting aside the rebuttable presumptions created by the Act, the question as to whether a company is able to pay its debts as and when they fall due is to be determined objectively as a question of fact, and ascertained from a consideration of the company's financial position taken as a whole.

³⁸ In this context, *'person'* is not a term restricted to a natural person.

³⁹ (1907) 4 CLR 1514.

Money which could be taken into account in considering liquidity is not limited to the resources immediately available to the company, but also includes moneys which the company could secure by realising its assets by sale or by mortgage or pledge within a relatively short time.⁴⁰

The principles with respect to an objective analysis of corporate solvency were usefully summarised in *White Constructions (ACT) Pty Ltd (in liquidation) v White*⁴¹ in which it was held that:

- (a) *Whether or not a company is insolvent for the purposes of the Act is a question of fact to be ascertained from a consideration of the company's financial position taken as a whole;*
- (b) *In considering the company's financial position as a whole, the court must have regard to the commercial realities, which include whether resources are available to the company to meet its liabilities as they fall due, whether resources other than cash are realisable by sale or borrowing upon security and when such realisations are achievable.*⁴²
- (c) *In assessing whether a company's position as a whole reveals surmountable temporary illiquidity or insurmountable endemic illiquidity resulting in insolvency, it is proper to have regard to the commercial reality that, in normal circumstances, creditors will not always insist on payment strictly in accordance with their terms of trade but that does not result in the company thereby having a cash or a credit resource which can be taken into account in determining solvency.*
- (d) *The commercial reality that creditors will normally allow some latitude and time for payment of their debts does not, in itself, warrant a conclusion that the debts are not payable at the times contractually stipulated and have become debts payable only on demand.*
- (e) *In assessing solvency, the courts act upon the basis that a contract debt is payable at the time stipulated for payment in the contract unless there is evidence, proving to the court's satisfaction, that there has been an agreed extension of time, conduct giving rise to an estoppel, a well established and recognised course of conduct by which debts are payable at a time other than stipulated in the creditor's terms of trade or are payable only on demand.*
- (f) *It is for the party asserting that a company's contract debts are not payable, at the times contractually stipulated, to make good that assertion by producing satisfactory evidence to that effect.'*

In applying s 588G, the question is whether a director was aware, or a reasonable person in the director's position should have been aware, that the company was trading whilst insolvent. In the explanatory memorandum to the *Corporate Law Reform Bill 1992* (Cth), it is stated that the test for liability in respect of the director's exposure for allowing a company to trade whilst insolvent does not require the higher threshold of there being an expectation held by the director that the company was insolvent, or would become insolvent as a result of entry into a particular transaction. Rather, all that is required is the existence of reasonable grounds for the director to suspect insolvency.

⁴⁰ See *Sandell v Porter* (1966) 115 CLR 666.

⁴¹ (2004) 49 ACSR 220, 221.

⁴² See also *Southern Cross Interiors Pty Ltd (in liquidation) v DCT* (2001) 53 NSWLR 213, 224; *Australian Securities and Investments Commission (ASIC) v Plymin (No 1)* (2003) 46 ACSR 126; *Emanuel Management Pty Ltd v Fosters Brewing Group Limited* (2003) 178 FLR 1; *Iso Lildow Aliphumeleli Pty Ltd (in liquidation) v Commissioner of Taxation* (2002) 42 ACSR 561.

In *Australian Securities and Investments Commission (ASIC) v Plymin (No 1)*⁴³ it was held that s 588G(2) requires proof of a subjective awareness by the director of grounds for suspecting that the company is insolvent, which must be objectively characterised as reasonable grounds for suspecting insolvency.

As to what is meant by the term ‘suspect’, that term was considered by Kitto J in *Queensland Bacon Pty Ltd v Rees*⁴⁴ in which it was held:

‘In the first place, the precise force of the word “suspect” needs to be noticed. A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to a “slight opinion, but without sufficient evidence” as Chambers Dictionary expresses it. Consequently, a reason to suspect that a fact exists is more than a reason to consider or look into the possibility of its existence. The notion which “reason to suspect” expresses in subsection 4 is, I think, of something which in all the circumstances would create in the mind of a reasonable person in the position of the payee an actual apprehension or fear that the situation of the payer is in actual fact that which the subsection describes – a mistrust of the payer’s ability to pay his debts as they become due and of the effect which acceptance of the payment would have as between the payee and the other creditors.’

Particularly in the context of insolvency, a number of these duties relate to the financial records and accounts of the company. A director of a company has a positive duty to prevent insolvent trading pursuant to s 588G of the Act. Given the current financial climate, it is important for directors to ensure they understand the balance sheet and profit and loss statement and to receive up-to-date financial information tracking the solvency of their company.

Directors and officers face disqualification and civil penalties for any (and each)⁴⁵ breach of these provisions, in addition to liability for damages at common law and in equity, and in addition to criminal liability where dishonesty is involved and for failing to disclose a conflict of interest or for regulatory infringements relating to matters such as the registered office, prospectuses, issuing shares and complying with ASIC requirements.⁴⁶

Civil sanctions

The civil liability provision for insolvent trading falls under s 588G(2) of the Act. Both directors and officers may be held liable under this provision.

‘Civil penalty orders’ arise under s 9 of the Act, specifically:

- (a) A declaration of contravention under s 1317E, which can only be sought by ASIC. For such a declaration to be ordered, the Court must be satisfied that a director or officer has contravened the relevant civil penalty provision provided within s 1317E.
- (b) If the Court is satisfied the person has contravened the relevant penalty provision, ASIC may also seek a pecuniary penalty order, pursuant to s 1317G. A pecuniary penalty order under s 1317G may extend up to \$200,000 for an individual or \$1 million for a body corporate.

The purpose of a pecuniary penalty order was outlined by Santow J in *Re HIH Insurance Ltd (in prov liq) and HIH Casualty and General Insurance Ltd (in prov liq); Australian Securities and Investments Commission (ASIC) v Adler and Others*.⁴⁷

⁴³ (2003) 46 ACSR 126.

⁴⁴ (1996) 115 CLR 266, 303.

⁴⁵ Section 185 *Corporations Act 2001* (Cth) makes those remedies cumulative and not alternative.

⁴⁶ See *Australian Securities and Investments Commission (ASIC) v James Hardie* [2009] NSWSC 211.

⁴⁷ (2002) 42 ACSR 80.

It is well established that the principal purpose of a pecuniary penalty is to act as a personal deterrent and a deterrent to the general public against a repetition of like conduct.⁴⁸

- (c) A compensation order under ss 961M, 1317H, 1317HA or 1317HB. ASIC or the company may apply for a compensation order against a director, however, in practice it is generally the liquidator who will apply for a compensation order.

If a director has breached s 588G(2) of the Act, a compensation order may extend to include compensation equal to the amount of loss or damage caused. A compensation order under s 588J measures compensation according to the 'loss or damage' suffered.

- (d) An order under s 206C disqualifying a person from managing corporations. Such an order may be made by ASIC only once the Court has made a declaration of contravention.

Unlike a successful criminal action, civil actions will not include automatic disqualification.

Criminal sanctions

Criminal sanctions are outlined under s 588G(3) of the Act. Although dishonesty is not defined in the Act, the High Court has previously held '*dishonesty*' to '*likely mean an intentional, will or deliberate act*'.⁴⁹ A compensation order may be made, as well as a criminal conviction recorded.

If a person is convicted of an offence under s 588G(3), they are automatically disqualified from managing a corporation, pursuant to s 206B(1)(b)(i) or (ii) and face fines of up to \$220,000 on a preliminary basis and/or imprisonment for up to five years.

Liquidation

When an insolvent company is being liquidated, the liquidator has a duty to all the company's creditors and his/her role is to:

- Collect, protect and realise the company's assets.
- Investigate and report *to creditors* about the company's affairs, including any unfair preferences which may be recoverable, any uncommercial transactions which may be set aside, and any possible claims against the company directors and officers.
- Enquire into the reasons for the failure of the company and possible offences by the directors, and report *to ASIC*.
- Commence proceedings for insolvent trading (usually with the approval of creditors), in the name of the company pursuant to s 477(2)(a).
- After payment of the costs of the liquidation, and subject to the rights of any secured creditor, distribute the proceeds of realisation – with first priority to secured creditors and employees, and then to unsecured creditors.
- Apply for deregistration of the company on completion of the liquidation.

Except for lodging documents and reports required under the Act, a liquidator is not required to do any work unless there are enough assets to pay the costs.

The costs of proceedings brought by the liquidators are borne by the company, if there is any available cash or assets that can be sold.

⁴⁸ Ibid 115 (125).

⁴⁹ *Chew v The Queen* (1992) 173 CLR 626.

If the company is without sufficient assets, one or more creditors may agree to reimburse a liquidator's costs and expenses of taking action to recover further assets for the benefit of creditors. In this case, if additional assets are recovered, the liquidator or particular creditor can apply to the court for the creditor to be compensated for the risk involved in funding the liquidator's recovery action.

If a liquidator suspects that directors may have committed offences and reports this to ASIC, the liquidator may also be able to apply to ASIC for funding to carry out a further investigation into the allegations. Litigation funding is also available.

A liquidator will not usually commence proceedings unless there is a high prospect of success, because if the action is unsuccessful and the company is not capable of covering costs, the liquidator will be liable.

ASIC will monitor corporate governance and commonly intervene to bring proceedings against directors for breaches of the Act. In 2003, ASIC established the National Insolvent Trading Program, intended to specifically target directors participating in insolvent trading. The program focused on companies under financial strain. The National Insolvent Trading Program was completed in 2010, at which time a report was released detailing the outcomes of the program and the insolvency landscape. The report noted '*the greatest number of external administrations are director driven, creditor voluntary windings-up and voluntary administrations that together amount to 62% in total*'.

Voluntary administration is actively encouraged by ASIC. The process involves a voluntary administrator taking full control of the company to try to save it from insolvency. The focus of the voluntary administrator is to seek the most beneficial outcome for the creditors, instead of putting the company straight into liquidation. Conversely, putting a company into liquidation sees the balance of control shift from the directors to the liquidator.

Although the Courts⁵⁰ have tended not to impose on the company's auditors a liability to a bank as a creditor of the company, it would be a risky enterprise for directors and liquidators to ignore the interests of creditors⁵¹, particularly upon insolvency.⁵²

Although directors do not owe fiduciary duties to employees in Australia, Commonwealth legislation⁵³ does provide some protection for employees where a company collapses owing large sums to employees, particularly where huge bonuses have been paid to the directors – examples of one-off special arrangements being made include One.Tel, Ansett and James Hardie.

Claims

The plaintiff most likely to sue directors and officers is the company itself (the company that the director or officer represents) or the liquidators of the company, since (as we have seen) the directors' duties as fiduciaries are owed to the company.

In addition to the company, various regulators, in particular ASIC, but also the Australian Prudential Regulatory Authority (**APRA**) will monitor corporate governance and commonly intervene to bring proceedings against directors for breaches of the Act.

⁵⁰ *Stone & Rolls Ltd v Moore Stephens* [2009] UKHL 39.

⁵¹ See for example the comments of Mason J in *Walker v Wimborne* (1976) 3 ACLR 529.

⁵² *Kinsela & Anor v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722.

⁵³ *Corporations Law Amendment (Employee Entitlements) Act 2000* (Cth) and the *Corporations Amendment (Repayment of Directors' Bonuses) Act 2003* (Cth).

Although the duties owed by directors and officers are owed to the company itself (which in essence can be said to comprise the shareholders as a whole) and not its *individual* shareholders,⁵⁴ where the directors or officers who have caused the loss to the company also control the company (such that they would not elect to sue themselves), a class action (known as a *derivative action*) can be brought on behalf of shareholders, and these derivative actions are becoming increasingly common with the benefit of litigation funding.⁵⁵

There are other special circumstances where individual shareholders can bring a claim against the company.⁵⁶ In *Brunninghausen v Glavanics*,⁵⁷ the New South Wales Court of Appeal held that special circumstances existed where a director/shareholder owed a duty to disclose to another director/shareholder details of the transaction he had negotiated for the sale of the company, the duty arising because the second director was also a shareholder.

It is also theoretically possible for claims to be brought by employees, creditors and the general public.

Directors do not owe a duty to society at large, however this is a live issue in the context of the push for better corporate governance and social conscience and will continue to be closely monitored by the media, to the extent the risk of adverse publicity, the loss of investors or clients and staff becomes the incentive for directors to behave appropriately.

Increasing role of ASIC

As Australia's financial services regulator, ASIC has in recent years increased its focus by the pursuit of civil penalties and criminal proceedings, and has been particularly active in the courts. In its 2011/2012 annual report, ASIC is noted as having '*completed 133 civil litigation investigations, 118 investigations, 14 criminal proceedings, and secured 13 criminal convictions and 10 imprisonments.*'⁵⁸

In a media release following the High Court decision of *Shafron* (discussed above), ASIC Chairman Greg Medcraft made the following statements:

'... The case brought into sharp focus the fundamental responsibilities of both executive officers and non-executive directors who are ultimately responsible for significant public company decisions, and the release of information concerning those decisions, to the share market, employees, creditors and the public.

*... ASIC took this case to the highest court in the land and I am certain this case has and will be studied in boardrooms across Australia and in legal circles, and I know that it is already shaping corporate behaviour and is having a positive deterrent effect.'*⁵⁹

Directors can expect ASIC to continue to pursue its role as corporate watchdog, notwithstanding the company or its shareholders may not take legal action.

⁵⁴ *Percival v Wright* (1902) 2 Ch 421.

⁵⁵ See for example *Campbells Cash and Carry Pty Limited v Fostif Pty Limited* (2006) 229 CLR 386.

⁵⁶ See for example the comments of Chesterman J in *Southern Cross Mine Management v Ensham Resources Pty Ltd* (2003) QSC 486.

⁵⁷ (1999) 32 ACSR 294.

⁵⁸ Australian Securities and Investment Commission, 'Annual Report 2011–2012' (Annual Report, Australian Securities and Investment Commission, 10 October 2012) 4.

⁵⁹ Australian Securities and Investment Commission, 'Decision in ASIC's appeals in James Hardie matter' (Media Release, 12-85MR, 3 May 2012) < <http://www.asic.gov.au/asic/asic.nsf/byheadline/12-85MR+Decision+in+ASIC's+appeals+in+James+Hardie+matter?openDocument>>.

4 INSURANCE AND COMPANY INDEMNITY

Section 199A of the Act prescribes the way in which a company can indemnify or insure its directors and officers.

The Act does not permit a company to *exempt* a director from liability to the company, but subject to important limitations, does permit a company to *indemnify* its directors against liability they incur, including costs.

This is ordinarily achieved by a deed of indemnity by the company in favour of the director.

Important limitations placed on a company's ability to indemnify its directors include a prohibition against indemnifying a director for:

- a liability owed to the company itself or a related body corporate;
- a pecuniary penalty or compensation order under certain provisions of the Act;
- a liability owed to someone other than the company that did not arise out of conduct in good faith;
- the costs of defending criminal or regulatory proceedings in which the director is found guilty.

These limitations are significant. If the plaintiff is the company itself or the director's conduct is dishonest or lacks good faith, the company is unable to indemnify the director or officer, resulting in the director or officer being personally exposed for the loss, relevant pecuniary penalty or compensation order. A company will not usually indemnify directors and officers for loss of overtime, salaries, fees or fines and penalties.⁶⁰

However, the ability of the company to indemnify the directors for costs (subject to the obligation to repay costs that relate to criminal or regulatory proceedings in which the director is found guilty) do significantly improve the directors' position, including in particular the immediate need to fund the costs of investigatory proceedings undertaken by ASIC, APRA or a liquidator before court proceedings.

In addition to the ability of the company to indemnify its directors for legal costs before the outcome of the proceedings are known, a company can make a loan to a director or officer – again subject to reimbursement in the event of an adverse decision.

The Act also permits a company to obtain insurance cover for the purpose of providing indemnity to its directors, officers and auditors, although there are other important restrictions on the ability of a company to obtain insurance. Sections 199B and 199C of the Act prohibit a company (or related body corporate) from paying or agreeing to pay the premium for a director or officer (or auditor) against liability (other than for legal costs) arising out of willful conduct or the misuse of the director's position or information⁶¹ (a breach of which is a strict liability offence and renders the policy void).

Provided those matters are excluded by the policy (they usually are), there is no restriction on the company obtaining D&O insurance cover.

As we shall see in the next section and as is the case with company indemnity, the first and substantial benefit of D&O insurance is the cover provided for defence costs.

⁶⁰ *Power v Markel Capital Ltd* (2006) 14 ANZ Ins Cas 61-714.

⁶¹ *Corporations Act 2001* (Cth) ss 182 and 183.



5 D&O INSURANCE POLICIES

Scope of Cover

In the event of a claim by the company or its liquidators against a director for insolvent trading or other breaches of the Act, a potential source of protection comes in the form of the cover available under a D&O policy. Perhaps ironically, the increase in litigation against directors and officers has given rise to the increased need for D&O insurance, and the increased availability of D&O insurance has in turn encouraged litigation against directors and officers.

Without D&O insurance however, the situation would be problematic as directors would be unlikely to take up directorships. By the very nature of the problems that lead a company into receivership, voluntary receivership or liquidation for example, there is unlikely to be sufficient worth in the company to satisfy creditors, and the directors and officers who may have a liability for insolvent trading or other breaches of the Act are likely to have taken sufficient steps to protect their assets.

Cover is prima facie provided for liability and costs as a result of a claim in respect of directors' and officers' conduct, while acting in their capacity as directors and officers.

This coverage can extend to costs incurred participating in criminal and regulatory investigations in circumstances where there are often simultaneous civil and criminal actions brought against directors and officers, although the ultimate entitlement to cover is often dependent on the outcome of the underlying claim.

Like management liability and professional liability policies, D&O policies are claims made and notified policies, triggered by a third party claim unless the insured identifies and notifies circumstances likely to give rise to a claim before it is made.⁶² The same considerations with respect to the operation of s 54 *Insurance Contracts Act 1984* (Cth) (discussed below) apply as in the case of professional indemnity policies.

Sides A, B and C

Although a D&O policy is designed to benefit the directors and officers of a company, coverage also typically extends to the insured organisation itself, for example in respect of any deed of indemnity in place whereby the company first indemnifies the director or officer and then seeks reimbursement under its D&O insurance. The company also often has the benefit of cover under a D&O policy for claims against it (as a company/entity) by shareholders.

If more than one insured party (for example, separate directors or a combination of one or more directors and the company itself) has an entitlement to cover, the total amount of coverage under the policy can often apply to all the insured parties as an aggregate and will not be a separate amount of coverage available to each insured party.

In that context, one of the most contentious and highly publicised aspects of D&O insurance has been the so called '*Side C issue*'.

⁶² By virtue of a deeming provision in the policy or s 40(3) *Insurance Contracts Act 1984* (Cth).

The three⁶³ insuring clauses typically available in the market are often (but not necessarily always) found within one D&O policy:

- Cover for directors and officers in the event of a claim against them, where they are unable to be indemnified by the company for their costs and any liability they may have (for example if the company is insolvent, or if the company is the plaintiff). This is known as Side A cover, whereby the relevant insured (person) will be the director.

As noted, claims under Side A cover by directors arise in circumstances in which the company is insolvent, or if the company is the plaintiff or liquidator suing the director.

- Cover for the company where it indemnifies/reimburses the directors and officers for their liability, pursuant to its deed of indemnity. This is known as Company Reimbursement or Side B cover, whereby the relevant insured will be the company.

It is important to note however that the company is not insured under Side B against any liability claimed against the company itself (for example, in proceedings against the company, not its directors)⁶⁴ or for any liability it voluntarily assumes even if that liability is assumed on behalf of the company's directors.

In *Integrgraph Best (Vic) Pty Ltd v QBE Insurance Ltd*,⁶⁵ in seeking Side B cover the company had chosen to meet the defence costs incurred by its directors, rather than requiring its directors to incur those costs themselves and then reimbursing them. Although the distinction is technical and the company was attempting to assist its directors, it was fatal to the claim under Side B since the company was seeking to recover its *own* legal costs and not those incurred by the directors. Side B would likely have responded if the company had required its directors to bear the costs and then reimbursed them.

In *Vero v Baycorp Advantage*,⁶⁶ a claim was made against both the company and its directors. In drafting the settlement terms, the document provided for settlement by the company on behalf of itself and each of the directors for an amount that exceeded the directors' potential liability. The Court found that by entering into the settlement on the directors' behalf, the directors did not have the personal liability necessary to trigger Side B.

Care must therefore be taken at the commencement and conclusion of proceedings, to ensure steps taken by the company in the perceived best interests of its directors do not unwittingly disentitle the company to claim under Side B. The distinction between a company that *indemnifies* its director and one which *assumes liability* for them is critical.

- Coverage for the company itself for its own liability, for securities claims brought against it by shareholders. This is Side C cover.

Side C cover was not traditionally provided within D&O cover, however a trend to include it as a 'free' addition commenced in the 1990's. Clearly it is beneficial for the company to receive additional cover for itself for no extra premium, in circumstances where securities class action claims against companies have gained momentum over the last ten years.

⁶³ A fourth insuring clause is sometimes added (Side D cover) to cover investigative costs (subject to a sub-limit) relating to a shareholder derivative demand.

⁶⁴ *Medical Mutual Insurance Co of Maine v Indian Harbor Insurance Co* (2009) BL219379 (1st Cir, 8 October, 2009).

⁶⁵ (2005) 11 VR 548.

⁶⁶ (2005) 23 ACLC 199.

The different cover clauses often attract different excess payments and deductibles which usually apply to each and every claim and defence costs, with different aggregate limits and options for reinstatement when the primary amount of cover has been eroded.

An interesting issue arises as to whether the company directors, being the controlling mind of the company, and the brokers who advise them, have a conflict of interests in deciding whether to only obtain Side A and B cover to ensure the directors' personal exposure is protected, when the company could benefit from additional cover under Side C for no or little extra premium.

The D&O market has evolved to meet this challenge in recent years, with some insurers removing Side C cover from D&O policies and offering it in a separate '*companion*' or stand alone policy. The result is a director focused policy unaffected by corporate entity liability, which should provide more adequate coverage for directors' liability and a separate and additional specialised policy to cover the entity's exposure to securities claims.

Directors should be mindful of the levels of cover afforded under their current D&O policy and the potential exposure to uninsured risk that may arise in the event of significant Side C claims.

Directors are entitled to obtain their own private insurance if they have concerns about the adequacy of the D&O coverage provided by the company, although they are usually entitled to expect the company will obtain sufficient cover for them.

The significance of Side C cover was highlighted by the decision of the High Court in *Sons of Gwalia Limited v Margaretic*.⁶⁷

That case involved the construction of s 563A of the Act, which provides:

'Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise and as members of the company have been satisfied.'

A disappointed shareholder sought to pursue a claim against a gold mining company, alleging that he had been misled by the company as to its ability to meet its gold delivery contracts and that as a result of being misled he had purchased shares in the company which were worthless. The receivers of the company contended that the shareholder's action must rank behind the actions pursued against the company by its other creditors, having regard to the fact that the shareholder should properly be regarded as a member of the company.

The High Court did not agree, and concluded that the nature of the claim pursued by the disappointed shareholder was not founded upon his position as a member of the company. Gleeson CJ held:

'What determines the present case is that the claim made by the respondent (the disappointed shareholder) is not founded upon any rights he obtained or any obligations he incurred by virtue of his membership of the first appellant (the company). He does not seek to recover any paid up capital, or to avoid any liability to make a contribution to the company's capital. His claim would be no different if he had ceased to be a member at the time it was made, or if his name had never been entered on the register of members. The respondent's membership of the company was not definitive of the capacity in which he made his claim. The obligations he sought to enforce arose, by virtue of the first appellant's conduct, under one or more of the statutes mentioned in the earlier description of the respondent's claim (namely section 52 of the TPA, section 1041H of the Act, section 12(d)A of the Australian Securities and Investments Commission Act 2001).'

⁶⁷ (2007) 231 CLR 160.

The disappointed shareholder was therefore at liberty to pursue his claim and was not required to rank behind the other company creditors.

As a direct result of that decision, the *Corporations Amendment (Sons of Gwalia) Act 2010* (Cth) was enacted, which provides in respect of shareholder actions arising after 18 September 2010, that any claim that arises from 'buying, holding, selling or otherwise dealing in shares in the company' will be a 'subordinate claim' and must be postponed until all other debts payable by, and claims against, the company are satisfied.⁶⁸

The costs involved in these types of shareholder claims (before even turning to the losses claimed) have the potential to quickly erode and often exhaust the limit of indemnity available under the policy, leaving the directors and officers with an uninsured exposure to any further claims that may subsequently arise during the policy period under Sides A or B.



⁶⁸ See s 563A of the *Corporations Amendment (Sons of Gwalia) Act 2010* (Cth).

Bridgecorp

When canvassing the issue of competing claims on the indemnity available under a D&O policy, it is important to consider the 2013 New Zealand Supreme Court judgment in *Bridgecorp*.⁶⁹

The receivers of various Bridgecorp companies pursued claims against their directors for alleged breaches of their duties as directors, with the damages estimated to be in excess of NZ\$450 million. To compound their troubles, the directors were also prosecuted by the New Zealand equivalent of ASIC for various alleged regulatory violations.

Faced with the costs of preparing for lengthy and expensive litigation, the directors sought access to their D&O policies (which had an NZ\$20 million indemnity limit) to fund their costs of defending the regulatory proceedings.

At first instance the receivers successfully blocked that claim on the policy, on the basis a ‘charge’ arose over the proceeds of the policies having regard to the operation of s 9 *Law Reform Act 1936* (NZ). That section provides:

‘If any person (hereinafter in this Part of the Act referred to as the Insured) has, whether before or after the pricing of this Act, entered into a contract of insurance by which he is indemnified against liability to pay any damages or compensation, the amount of his liability shall, on the happening of the event giving rise to the claim for damages for compensation, and notwithstanding that the amount of such liability may not then have been determined, be a charge on all insurance money that is, or may become, attainable in respect of that liability.

. . .

- (3) *Every charge created by this section shall have priority over all other charges effecting the said insurance money, and where the same insurance money is subject to two or more charges by virtue of this Part of this Act first charges shall have priority between themselves in the order of the dates of the events out of which the liability arose, or, if such charges arise out of events happening on the same date, they shall rank equally between themselves.’*

Acknowledging the significantly adverse impact of the outcome for the directors, the Court at first instance found the directors could not access the benefits of their D&O policy because a charge did indeed arise under the applicable legislation.

In a judgment delivered shortly before Christmas 2012, the New Zealand Court of Appeal overturned the trial judgment and held that s 9 *Law Reform Act 1936* (NZ) did not preclude the directors’ contractual entitlement to cover for defence costs by giving rise to a charge over that contractual entitlement.

The New Zealand Court of Appeal noted that the policy in question provided two distinct aspects of cover for the insured directors, being cover for defence costs incurred by the directors and cover for liability to a third party. It reasoned that whilst the component of cover for third party liability remained contingent on that liability being established, the component of the policy for payment of defence costs had already been triggered.

It was therefore held the receivers were not entitled to a statutory charge over the proceeds of the policy that were due and payable in respect of the existing liability of the directors to pay defence costs, as opposed to any liability to pay compensation that had not yet crystallised.

⁶⁹ *BFSL 2007 Limited v Steigrad* [2013] NZSC 156.

Section 9 *Law Reform Act 1936* (NZ) is similar to other statutory provisions which create charges over insurance policies in Australia, in particular:

- *Law Reform (Miscellaneous Provisions) Act 1946* (NSW) s 6;
- *Law Reform (Miscellaneous Provisions) Act 1956* (NT) ss 26 to 28;
- *Civil Law (Wrongs) Act 2002* (ACT) s 206;
- *Insurance Contracts Act 1984* (Cth) s 51;
- *Corporations Act 2001* (Cth) s 601 AG.

At the same time directors were taking comfort from the New Zealand Court of Appeal decision in *Bridgecorp*, a significant measure of comfort was also achieved in Australia from the New South Wales Court of Appeal judgment in the *Great Southern* case.⁷⁰ In essence the New South Wales Court of Appeal agreed with the New Zealand Court of Appeal, with the result that insurers in Australia can continue to provide cover for defence costs without eroding any third party rights and later having to pay out twice.

To give the judgment in *Great Southern* its proper context, the insurers successfully argued New South Wales law should not apply because the shareholder class actions were being run in Victoria and Western Australia, and Western Australia was where the company was headquartered and mostly did business, and was where its executives worked. The New South Wales Court of Appeal agreed the insured company had no special connection with New South Wales and s 6 should only apply to claims brought in that jurisdiction.

However, the New South Wales Court of Appeal said that even if the New South Wales legislation did apply and there was a charge, that charge would not extend to the insurance payable for defence costs before there was any judgment or settlement of the shareholders' claims.

The *Great Southern* judgment acknowledges the indemnity limit could be exhausted by defence costs, noting if the insured directors are found liable they will have to pay the claimants out of their own funds. Rather than leaving the insured directors out of pocket with respect to funding their defence costs, the position in Australia potentially leaves claimants out of pocket, where they may successfully sue an insured but be unable to recover any money.

However, the *Bridgecorp* Court of Appeal decision was itself overturned a year later (in December 2013) by the Supreme Court of New Zealand. The Supreme Court of New Zealand held (by a majority 3:2) that defence costs should not erode the limit of cover available to a successful third party claimant, on the basis the wording of the legislation does cause a charge to arise at the time the event giving rise to the liability occurs, and thereby secures the amount of any liability to the third party claimant.

In other words, in a situation where there is insufficient cover to meet both an insured's liability to a third party claimant and the insured's own defence costs, an insurer should be very cautious about paying defence costs with the accompanying risk of breaching the statutory charge and having to pay twice.

Although sympathetic to the directors, the Supreme Court of New Zealand observed the directors had 'made a poor bargain' by overlooking the effect of the statutory charge and entering into that particular policy (albeit on conventional terms).

⁷⁰ *Chubb Insurance Company of Australia Limited v Moore* [2013] NSWCA 12. However, subject to a potential appeal to the High Court.

Importantly however, the Supreme Court did not determine whether the insurer or insured should bear the cost burden of that oversight, seemingly leaving open the possibility the insurer may ultimately be required to pay both the limit of policy cover to the insured and the insured's defence costs.

This decision is not subject to further appeal in New Zealand and unless and until there is any legislative change it is important for insured directors to purchase stand alone defence costs cover, at least in New Zealand. The Great Southern position in Australia is subject to an application for special leave to the High Court.

This leaves a significant difference between the position in New Zealand and the law as it currently stands in Australia, as to whether the statutory charge provisions override directors' and officers' contractual entitlement to defence costs. The position in Australia currently remains the charge does not interfere with the insured's contractual entitlement to defence costs.

It is an issue of concern that if the *Bridgecorp* decision was to be followed in Australia on appeal, where a D&O policy extends cover for an insured's liability to pay defence costs, a charge may arise and preclude access to the benefit of the policy.

Where there are a number of claims for compensation or damages (for example by receivers, shareholders and a regulator) and the response of the policy to each remains contingent, entitlement to cover under the policy for any such potential liability may remain problematic under the applicable legislation in New South Wales.

It is not yet clear whether the sum insured would be reduced by application of a charge and whether, if a charge exists, any payments made by the insurer towards the insured's defence costs would be paid on an ex-gratia basis rather than reduce the sum insured.⁷¹

It should be noted that the *Bridgecorp* decision in New Zealand (should it be followed at some point in Australia), may only apply to policies where the combined sum of the monies claimed against the directors and the anticipated defence costs of the directors exceed the sum insured. There is also strong judicial support for legislative reform.

The prospect that third party creditors and litigants may have access to a D&O policy in priority to the directors, at a time when the directors are desperately seeking to access the policy for the payment of their defence costs, understandably created a great deal of concern for directors, and their brokers and insurers, in New Zealand and Australia. The fact that there is currently a disparity of legal interpretation means that the High Court's decision in the Great Southern case will be anxiously awaited by insurers and directors.

This is another example of the unfortunate situation that can arise from standard D&O policies affording cover for a range of exposures – here, defence costs and damages – in one policy with a single policy limit. Insurers have moved to address the issue with the provision of separate cover for defence costs and third party liability, including 'stand alone' defence costs policies, to quarantine that cover from any other claim for compensation that may be on foot in the event a charge arises.

⁷¹ See Mark Radford, 'Steigrad v Bridgecorp: NZ case with potential to impact rights of Australian insurers and insureds under liability policy' (2012) 10 No 7 *Financial Services Newsletter* 148, 150.



Acting in the capacity as a director

A D&O policy will usually be expressed to only afford cover to circumstances where a director is acting in his or her capacity as such and/or exclude cover for directors acting in some other capacity, such as liability arising from the provision of professional services.

Professor Robert Merkin has suggested⁷² that this standard requirement of D&O policies – for the claim to arise in relation to conduct undertaken by the insured person in his/her *capacity as a director* – is an issue that requires careful attention.

As we have seen, the duties owed by directors are generally duties owed to the company rather than shareholders or other third parties, and the common law therefore generally does not recognise that a director can incur a personal liability directly to a third party while acting in the capacity as a director.

As mentioned above, in *Williams v Natural Life Health Foods Ltd*,⁷³ a director presented a favourable account of the company to a potential franchisee, who purchased the franchise on the strength of the director's representations regarding future income. The director's representations proved inaccurate and the franchisee suffered a loss. The franchisee's claim against the director was dismissed on the basis the director was acting on behalf of the company and had not undertaken any personal responsibility towards the franchisee. The franchisee's action therefore lay against the company, which had become insolvent.

Professor Merkin's observation is that the director could have only incurred a personal liability to the franchisee if he had been acting outside his capacity as a director (on his own behalf), but in which case his D&O policy would likely not respond. His point is therefore essentially that, to this extent, a D&O policy does not afford any cover, because there is no liability that the director could incur to which the policy would respond.

Professor Merkin argues any liability of a director is in fact more likely to be incurred in his/her capacity as an employee. In *Tosich v Tasman Investment Management Ltd*⁷⁴ for example, the Court held that coverage for liability imposed on a director acting in the capacity as a director does not extend to employment duties. If, for example, a D&O policy includes cover for discrimination and it is a requirement of the policy that any liability is to be incurred by a director in his or her capacity as such, the policy will be unlikely to respond because it is difficult to see how any discrimination would be attributable to the acts of a director in his/her capacity as a director rather than an employee.

It may be possible (depending on the appetite of the underwriter) to have this issue clarified in the policy. If a policy makes clear a liability to a third party may be covered by the policy even if there is some confusion about the capacity in which the director was acting, then the director will be considered to be acting in his capacity as a director of the company.

Composite Cover and Non-Imputation

A composite policy of insurance is one where each individual insured in a class, is an insured in its own right. In the context of D&O, the company is typically the named insured however the directors are parties to the insurance contract in their own right, as co-insureds (insured persons).

⁷² Robert Merkin, 'Directors' and Officers' Insurance and the Global Financial Crisis' (Speech delivered at the Australian Insurance Law Association Geoff Masel Lecture & Annual General Meeting, 4 November 2009).

⁷³ [1998] 2 All ER 577.

⁷⁴ (2008) 250 ALR 274.

The position at common law is that conduct of one director that falls outside the scope of cover will not usually affect the entitlements of the company or other directors. In *Arab Bank v Zurich Insurance Company*,⁷⁵ it was held that the conduct of any one director, which takes him outside the protection of the policy, will not necessarily affect the rights of the others under the policy.

That position is usually enshrined by the policy wording itself by use of a non-imputation clause, making it clear that conduct by one insured director will not be imputed to another.

Shareholders' and Insolvency Practitioners' access to the D&O policy

Section 247A of the Act allows a shareholder to apply to the court for an order allowing it to inspect the company's books, if the court is satisfied the shareholder is acting in good faith and for a proper purpose.

By extension, disgruntled shareholders will also be granted access to the company's directors' and officers' policies for the purpose of considering the utility of the pursuit of an action against the company and its officers. In this regard, see *Merim Pty Ltd v Style Limited*,⁷⁶ *London Equities Limited v Penrice Soda Holdings Pty Ltd*⁷⁷ and *BOS International (Australia) Limited v Babcock & Brown International Pty Ltd*,⁷⁸ where such applications were granted.

The justification for permitting access to the directors' and officers' policies was discussed by Le Miere J in *Snelgrove v Great Southern Managers Australia Limited (in liquidation) (receivers and managers appointed)*⁷⁹ in the following terms:

'The disclosure of the existence and extent of the relevant insurance cover is likely to assist the plaintiffs in determining whether or not to commence or proceed with the proposed action. If the company does not have insurance which covers the plaintiffs' claims or the quantum of the cover is such that it is likely to be substantially exhausted in legal costs, then the plaintiffs may well not proceed with the proposed action. That will prevent the resources of the parties and public resources being wasted.'

In addition to the right of shareholders to demand access to the company's insurance policies, a liquidator, administrator or receiver appointed by ASIC is empowered to conduct public examinations,⁸⁰ and issue summonses for directors, officers and other persons to be examined about the company's 'examinable affairs'.

That term has been interpreted to include matters occurring prior to, and during, the winding up, administration or receivership, including the brokering of insurance arrangements for the company and its directors and gathering information regarding the company's prospects of success in litigation. Further, an inquiry into the company's prospects of success in litigation has been defined to encompass the ability to successfully enforce any judgment against the company.⁸¹

⁷⁵ (1999) 1 Lloyd's Rep 262.

⁷⁶ (2009) FCA 394.

⁷⁷ (2011) 281 ALR 519.

⁷⁸ (2011) NSWSC 1382.

⁷⁹ (2010) WASC 51.

⁸⁰ See s 596B of the Act.

⁸¹ See *Gerah Imports Pty Ltd v Duke Group Limited (in liquidation)* (1993) 611 SASR 557; *Meteyard v Love* (2005) 224 ALR 558 and *Grosvenor Hill (Qld) Pty Ltd v Barber* (1994) 48 FCR 301.

The powers conferred on ASIC and liquidators under s 596B of the Act in respect of the public examination of directors and others were justified in *Hamilton v Oades*⁸² on the basis that:

'The very purpose of [public examination] is to create a system of discovery (which) gives to the liquidator rights not possessed by an ordinary litigant.'

In line with the comments of Le Miere J in *Snelgrove* (above), access to insurance documents allows a liquidator to identify the availability of insurance before embarking on potentially costly litigation.

Although the examinee is entitled to claim legal professional privilege, this advantage bestowed on insolvency practitioners to some extent recognises the disadvantage faced on their appointment:⁸³

- Company records are often missing or incomplete.
- Directors and officers often abscond, are uncooperative or cannot be relied on to provide accurate information about their involvement in the affairs of the company, especially about suspicious transactions.

In *Meteyard v Love*,⁸⁴ the New South Wales Court of Appeal upheld the receiver's right to proceed with a public examination of employees of an insolvent company's insurer to determine why indemnity for a claim had been declined. The case arose out of a spontaneous gas explosion at a coal mine, which caused in excess of \$40 million in damage. The insurer of the mine declined the mine's claim for indemnity on the basis that the mine had failed in its duty of disclosure and misrepresented its safety protocols.

When the summonses were served on its employees, the insurer attempted to avoid disclosure and the public examination by arguing that an examination directed to a particular policy document could not be justified by an examination into *'the affairs of the company'*.

However, the Court held that the policy was owned by, and was an asset of the company, and that its terms and conditions were directly relevant to the availability of cover for civil proceedings against the insurer and the prospects of success of any such claim. The Court held that:

'Returning to the scope of the power conferred by s 596B, (which permits a summons to be issued for the examination of a person who may be able to give information about the examinable affairs of a company) the aspect of the examinable affairs of the company of primary relevance in the present circumstances is sufficiently encapsulated in the concepts of management and administration identified in paragraph (a) of the definition of 'examinable affairs'. Part of the management and administration of Southland Coal will be deciding whether to institute proceedings against QBE in relation to a denial of liability under the insurance policy. Information relevant to that decision forms part of the examinable affairs of Southland Coal. Such information will, consistently with the authorities, include:

- (a) *information necessary to assess the justification or otherwise of the denial, and*
- (b) *in an appropriate case (of which this is not one) information as to the worth of the potential defendant in such proceedings.'*

⁸² (1989) 166 CLR 486, 497-498.

⁸³ See *Adler Group v Qintex Group Management Services (in liq)* [1997] 2 Qd R 91, 94-95.

⁸⁴ (2005) 65 NSWLR 36.

Such material falls within the proper field of examinable affairs described by Street J in *Hugh J Roberts Pty Ltd & Companies Act, Re* (1971-73) CLC 40-048, quoted with approval by the Full Court of the Federal Court in *Grosvenor Hill (Qld) Pty Ltd v Barber* (1994) 48 FCR 301 at 309:

'The liquidator is given by the statute this special authority to proceed by way of private examination to obtain information which he needs for the due winding up of the company, the affairs of which he has the responsibility of administering.'

The insurer then argued that any right of access to the policy should be subject to its claims for legal professional privilege which, it asserted, would render the conduct of the examination 'pointless'.

However, whilst the Court accepted that a valid claim for legal professional privilege could be asserted by the insurer, it also found that the insurer had not demonstrated its need to protect that privilege which would render the conduct of the public examination oppressive or pointless. Santow JA held:

'... given the wide scope of an enquiry over a company's examinable affairs, a priori observations seeking to limit that scope should be made with caution and the a priori exclusion of information from such an enquiry because the information is already known is dangerous.'

Exclusions

To some extent, exclusions found in D&O policies are in respect of conduct for which the availability of indemnity is already precluded by the Act (for example, breaches of ss 182 and 183, wilful breaches of duty and deliberate or dishonest conduct), and a number of the exclusions therefore simply repeat the position at law (and are strictly speaking unnecessary, save as to avoid any doubt as to the intention of the policy or to ensure the policy is not void), whilst other exclusions (for example, prior known claims/circumstances) go further.

Some of the standard exclusions commonly found in D&O liability policies include:

- prior known claims and prior known circumstances likely to give rise to a claim. (The most commonly invoked exclusion clauses in professional liability policies are the standard exclusions for claims or knowledge of circumstances that the insured knows or ought to know may give rise to a claim, before inception of the policy. These exclusions are equally important in D&O and management liability policies and are discussed below.);
- insured versus insured, discussed below;
- conduct, discussed below;
- fines and penalties, discussed below;
- dishonesty, discussed below; and
- insolvency, discussed below.

Prior known circumstances and claims

As with other claims made and notified insurance policies, D&O policies typically exclude prior known claims or prior circumstances likely to give rise to a claim.

In isolation, these exclusions simply entitle an insurer to decline cover whether the insured knew or ought to have known of a claim or circumstances that might give rise to a claim prior to inception of the policy.

In practice, a number of complications can arise, for example, in relation to the question, what constitutes a ‘*circumstance*’?

In *FAI General Insurance Co Ltd v McSweeney*,⁸⁵ the court said the test was objective ‘*requiring notice when a reasonable person in the insured’s position would consider there was a reasonable possibility of a claim. Notice is not required if the possibility of a claim is remote or unlikely. However, providing there is a real or definite risk of a claim, notice is required even if the claim is not probable.*’

*CGU Insurance Limited v Porthouse*⁸⁶ concerned a barrister’s failure to notify his insurer of circumstances that may give rise to a claim against him and the insurers’ consequent declinature of coverage under a professional liability policy. The court applied an objective test to the question whether the insured was aware of circumstances that may lead to a claim, being whether a reasonable person in the insured’s professional position and ignoring his personal idiosyncrasies would have thought a claim may arise.

The factual issues that have to be considered are often technical and complex, making it sometimes difficult to say with certainty whether a prior known *circumstances*⁸⁷ exclusion will apply.

Similarly, an insured owes its insurer a duty of disclosure as defined in s 21 *Insurance Contracts Act 1984* (Cth) which states:

- (a) ‘*Subject to this Act, an insured has a duty to disclose to the insurer, before the relevant contract of insurance is entered into, every matter that is known to the insured, being a matter that:*
 - (i) *the insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or*
 - (ii) *a reasonable person in the circumstances could be expected to know to be a matter so relevant.*’

Similar difficulties can arise in assessing whether the insured has breached that duty, sufficient to entitle the insurer to avoid payment under the policy.⁸⁸

The indemnity consequences of a failure to provide either notification of the claim or a circumstance which might give rise to a claim also needs to be considered in the context of the relationship between ss 40 and 54 of the *Insurance Contracts Act 1984* (Cth).

Section 40

Section 40 is directed to a situation in which an insurer might otherwise be entitled to decline or limit indemnity, if the insured should fail during the currency of the policy to give notice of a claim.

⁸⁵ (1999) 73 FCR 379.

⁸⁶ (2008) 235 CLR 103.

⁸⁷ The application of such an exclusion to a prior known *claim* are less problematic.

⁸⁸ Pursuant to s 28 *Insurance Contracts Act 1984* (Cth).

The contractual right of an insurer to decline indemnity in such circumstances is ameliorated by s 40(3). Section 40(3) provides that if the insured gives notice to the insurer of *circumstances that might give rise to a claim* as soon as reasonably practicable after he or she became aware of them during the currency of the policy, the insurer is not relieved of liability to indemnify the insured *only* by reason of the fact that any subsequent *claim* arising from those circumstances is made after the expiry of the policy.

Section 40(3) has the effect of a statutory ‘*deeming*’ provision, deeming the claim to have been made and notified during the policy period, provided notification of the claim (after the policy expires) is given as soon as reasonably practicable after the insured learns of the claim.

Like professional indemnity policies, D&O policies now seldom provide a contractual provision which mirrors the effect of s 40(3), in light of the High Court decision in *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd*,⁸⁹ discussed below.

Section 54

Section 54 of the *Insurance Contracts Act 1984* (Cth) is concerned with the position where the insured knows about circumstances which might give rise to a claim, or a claim, and fails to comply with its contractual obligations under the policy by failing to provide timely notification of the claim or circumstances to the insurer.

Whilst the history and development of the law in relation to s 54 is an interesting topic in its own right worthy of another paper, the current position now seems well settled under Australian law and can be briefly stated as follows.

Section 54 operates to ‘forgive’ a failure by an insured to notify a *claim* within the policy period (if cover would otherwise have been available had it done so), provided there is no prejudice to the insurer.⁹⁰ The effect is that the insurer who is on risk at the time the claim is made against the insured (and at the time the claim ought to have been notified) remains obliged to respond to the claim, subject to the absence of any discernible prejudice and the policy’s other terms and conditions.

What then is the position if an insured’s failure to notify within the policy period is in relation to a *circumstance* that may give rise to a claim, rather than an actual claim?

In the well known but sometimes misunderstood decision of *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd*,⁹¹ it was held that s 54 also excuses the insured’s failure to provide notification to the insurer of a circumstance if (but only if) there is a deeming provision in the policy, and provided there is no prejudice to insurers. Prior to *Australian Hospital Care*,⁹² s 54 of the *Insurance Contracts Act 1984* (Cth) was argued by insurers to be more limited in its application (in the context of the notification requirement) to an omission to notify *claims*.

Pausing there, the effect of the decision in *Australian Hospital Care* is not to enable s 54 to forgive an insured for failing to notify a *circumstance* until after the policy has lapsed where the policy (that is, the contract of insurance) does not contain a deeming provision. Such deeming provisions have been removed by insurers as a result of the *Australian Hospital Care*⁹³ decision, to ameliorate its effect.

⁸⁹ (2001) 204 CLR 641.

⁹⁰ See in particular *East End Real Estate v CE Heath Casualty & General Insurance Ltd* (1991) NSWLR 400; *FAI General Insurance Co Ltd v Perry* (1993) 30 NSWLR 89 and *Antico v CE Heath Casualty & General Insurance Ltd* (1996) 38 NSWLR 681.

⁹¹ (2001) 204 CLR 641.

⁹² *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd* (2001) 204 CLR 641.

⁹³ *Ibid.*

In the Supreme Court of Queensland, Chesterman J considered the interrelationship between ss 40 and 54 in *CA & MEC McInally Nominees Pty Ltd v HTW Valuers (Brisbane) Pty Ltd*⁹⁴ with regard to whether, in the absence of a deeming provision in the policy, the statutory deeming provision in s 40(3) could be used together with s 54 to forgive a failure to notify circumstances.

That case concerned, amongst other things,⁹⁵ the failure of the insured to give notice of a claim under a professional indemnity insurance policy held by a firm of valuers during the currency of the policy period. The valuers held a professional indemnity insurance policy with CUA for the period 15 September 1998 to 15 September 1999. However, proceedings by the disappointed borrowers against the valuers were not issued until December 1999 (after the termination of the policy) and indemnity was not sought by the valuers from their insurer until 16 March 2000.

The insurer argued that it was not liable to indemnify the valuers as no notification had been given to it whilst the policy was in force.

Encouraged by *Australian Hospital Care*, the valuers submitted an entitlement to indemnity on the basis ss 40 and 54 operated in combination. That is, the valuers' failure to notify a circumstance that may give rise to a claim within the policy period under s 40(3) (there was no deeming provision in the policy), was an 'omission' for the purpose of s 54, and having regard to the application of s 54 as applied by *Australian Hospital Care*, the insurer could not therefore rely on that omission to justify its declining indemnity.

Chesterman J did not accept that argument. Chesterman J quoted a passage from the joint judgment of McHugh, Gummow and Hayne JJ from *Australian Hospital Care* to the effect that:

'The claim which the insured made on FAI was for indemnity against liability for an occurrence of which the insured first became aware during the period of cover. The effect of the contract of insurance is that FAI could refuse to pay that claim by reason only of the fact that the insured did not give notice of the occurrence to it. Section 54, therefore, requires the conclusion that FAI may not refuse to pay the insured's claim. The effect of the contract of insurance, but for section 54, would be that the insurer may refuse to pay the insured's claim by reason only of the omission of the insured to notify the occurrence.'

Chesterman J concluded that s 40(3) could not be relied upon in combination with s 54 to cure the failure of the insured to provide notification of the claim to the insured during the currency of the policy period because:

*'Section 40(3) would have obliged CUA (the valuer's insurer) to grant indemnity, but that indemnity **would have flowed from the intervention of the statute, not the effect of the policy.** In this regard, the phrase, 'but for this section', which appears in section 54(1) cannot be overlooked. The effect of CUA's policy, if one ignores HTW's omission to give notice of its negligent valuation, would not have been that HTW was entitled to indemnity. An insurer may not refuse to pay a claim by reason only of the fact that an insured omitted to give notice of an occurrence, but, had HTW given notice, the insurer would still not have been obliged to indemnify. To get to that result, section 40(3) must also operate. But section 54 is concerned with the situation where, if an omission is disregarded, a policy of insurance would provide cover. To assist HTW here, section 54 has to be understood as though it read:*

⁹⁴ [2009] 2 QdR 1.

⁹⁵ Namely a finding of the negligence of a firm of private mortgage lenders – which was so bad that it was found to have rendered the valuers' negligent valuation otiose.

Where the effect of a contract of insurance would, but for this section and section 40(3).⁹⁶

Chesterman J held that s 40(3) does **not** imply a term into policies of insurance to the effect of the subsection. Rather, it confers a statutory right on an insured, and obligations on an insurer, but only in circumstances in which the insured has complied with its contractual terms by giving notice. Chesterman J concluded:

'HTW's submissions would require a modification to the subsection and provide relief in circumstances other than those specified by the legislation. If it were Parliament's intention that section 54 should modify the operation of section 40(3), one would expect to find some indication of the intention in the provision. There is nothing in section 40(3) which makes the requirement that notice be given during the currency of the policy "subject to section 54".⁹⁷

Chesterman J also referred to the observations made by McHugh, Gummow and Hayne JJ in *Australian Hospital Care*, in which they held:

'Sections 40 and 54 deal with different problems. Section 40 is concerned with certain contracts of liability insurance and, among other things, with the insured giving notice of a potential claim during the period of insurance cover, when the claim is not made until after the expiration of that period. Section 54, by contrast, deals with a much more general subject of an insurer refusing to pay claims.'⁹⁸

Summary – sections 40(3) and 54 Insurance Contracts Act 1984 (Cth)

In summary, an insured's failure to notify (within the current policy period):

- a claim is cured by s 54, subject to any prejudice;
- a circumstance that may give rise to a claim:
 - is cured by s 54 if there is a deeming provision in the insurance policy, subject to any prejudice;
 - is not cured by s 54 in the absence of a deeming provision in the insurance policy.

As noted above, in practical terms due to the effect of *Australian Hospital Care*, most deeming provisions have been removed from insurance policies with the result that whilst an insured who fails to notify a claim received during a policy period may still have a prima facie entitlement to cover under that policy, an insured who fails to notify a circumstance that may give rise to a claim received during a policy period will not enjoy that protection.

It is in that situation that an insured (who changed insurers) would potentially find itself without insurance cover. The earlier insurer being entitled to decline cover due to the absence of a notification, and the later insurer being able to rely on the policy exclusion for a prior known circumstance that might give rise to a claim.

Alone and in combination, the high occurrence of coverage problems arising from the failure to promptly notify pre-existing circumstances; the fact that in the absence of a deeming provision in the prior policy neither the current nor prior insurer may be obliged to respond to a claim; and the uncertainty and resultant cost in determining whether something constitutes a notifiable circumstance; highlight the importance for insureds of good internal risk management and insurance reporting/notification protocols, and the value of continuity of cover. These issues can be avoided if insureds notify promptly.

⁹⁶ Ibid [11].

⁹⁷ Ibid [12].

⁹⁸ Ibid [12].

Insured versus Insured

These are typically claims made against a director by another director or officer or the company itself, or a shareholder of the company who holds at least 15% of the shareholding or voting rights.

This exclusion typically provides there is no cover for claims where the director would stand to benefit from the claim in his/her capacity as a shareholder.⁹⁹ This protects insurers against 'collusion' but unless the exclusion is expressly limited to so called 'consensual' claims, it may arguably also apply to claims brought by ASIC on behalf of shareholders (in addition to claims by shareholders who hold at least a 15% shareholding).

As the directors' duties are owed to the company itself and the company is therefore a significant potential source of claims, this exclusion is important. Unless the Insured versus Insured exclusion is expressly subject to an exception for claims brought in the name of the company as a shareholder derivative action, by ASIC or at the instigation of a receiver, administrator or liquidator, any such claim could be the cause of some anxiety for directors.

However, the Insured versus Insured exclusion does not seem to apply where the director is sued in his/her capacity as an employee.¹⁰⁰ But is the director then acting in his/her capacity as such, to trigger the insuring clause?¹⁰¹ Also, once a company is in liquidation, there is some suggestion the exclusion may no longer apply to remove protection for the directors who are sued by liquidators,¹⁰² unless subject to another express exclusion designed to specifically exclude cover for claims arising from insolvency or brought by a receiver, administrator or liquidator.

The potential for ambiguity whether this type of exclusion will apply to proceedings by a liquidator is one best addressed in the policy wording before inception.

Conduct

Another contentious exclusion clause is where the *conduct exclusion* is stated to exclude criminal or unlawful conduct.

As Professor Merkin has observed,¹⁰³ just as an arsonist cannot recover under a building insurance policy if he deliberately burns down his own property, similarly a director cannot recover under a D&O policy if he has acted in a way designed to cause loss to the company. The principle is that an insured cannot claim under a contract of insurance if he has to rely on his own illegality, or seeks to profit from that illegality (the doctrine of *ex turpi causa*).

However, the question often arises whether a breach of certain legislation (see for example occupational/workplace health and safety legislation) constitutes criminal or unlawful conduct, where it satisfies some of the key indicia of being criminal or unlawful (such as involving a *prosecution* of an *offence* under *summons* involving the potential for *imprisonment*), whilst not falling under the criminal code or being specifically identified as criminal.

Particularly in the context of management liability policies (discussed below), this has become an important negotiation point when seeking insurance to ensure the policy wording does not exclude occupational/workplace health and safety activities or environmental offences where directors and officers may be exposed under the relevant legislation. It has often given rise to disputes between insurers and the insured/broker where the issue first arises after a claim is made and the insurer seeks to rely on the exclusion.

⁹⁹ *Kohanski v St Paul Guarantee Insurance Co* (2006) 78 OR (3d) 684.

¹⁰⁰ *Conklin Co Inc v National Union Fire Insurance Co* (1987) WL 108957.

¹⁰¹ As discussed above under the heading 'Acting in the capacity as a director'.

¹⁰² *Re People's Department Stores Limited* (1992) Inc (1998) 23 CBR (4th) 200.

¹⁰³ Robert Merkin, 'Directors' and Officers' Insurance and the Global Financial Crisis' (Speech delivered at the Australian Insurance Law Association Geoff Masel Lecture & Annual General Meeting, 4 November 2009).

It is also important to note that if a director's conduct gives rise to a criminal liability, then the policy cannot respond whether or not it purports to provide cover. This is an area that is still evolving and is a topic of considerable academic interest pending clear judicial guidance on the extent to which the Courts will be asked and be prepared to intervene to preclude cover offered in a policy for certain fines and penalties.

For example, it is unclear the extent to which insurance cover is being provided for claims for conduct which is apt to be described as uninsurable, without judicial knowledge or intervention. Even though a company is prohibited from indemnifying its directors in respect of a liability for a pecuniary penalty or compensation order under certain provisions of the Act, it is arguable insurance may be available if the liability solely arises from negligence and no criminal sanction is involved. (This seems to be the interpretation applicable under s 199B of the Act).

It is likely to be the case a civil penalty fine against a director is insured where the court acknowledges the insured person acted innocently or honestly, for example, where the insured person fails to exercise care and diligence in discharging duties¹⁰⁴ or allows the company to trade while insolvent.¹⁰⁵

In *Green v CGU Insurance Limited*,¹⁰⁶ the directors were sued in respect of insolvent trading contrary to s 588G of the Act. The directors were alleged to have had reasonable grounds for suspecting the company was insolvent and faced (pursuant to s 588G(3)) criminal liability in the event they acted dishonestly. It is arguable the directors' conduct was insurable if they acted negligently, but would be uninsurable if they were dishonest. The point was not tested in this case, because the insurers were able to decline indemnity on grounds of non-disclosure¹⁰⁷ of the parlous financial state of the company.

Although claims of this nature may have been paid by insurers, for this reason many policies now specifically exclude any liability arising out of or relating to the company's ability to pay its debts as and when they fall due, discussed below.



¹⁰⁴ *Corporations Act 2001* (Cth) s 180.

¹⁰⁵ *Corporations Act 2001* (Cth) s 180, s 886.

¹⁰⁶ (2008) 67 ASCR 390.

¹⁰⁷ *Insurance Contracts Act 1984* (Cth) s 28.

In any event, the performance of the acts or omissions prohibited by the conduct exclusion must usually be determined by judicial finding, or by formal admission of the insured. Where a dispute arises in relation to defence costs, insurers cannot usually decline to pay merely because relevant conduct (such as fraud) is alleged; it is necessary for the relevant conduct to be proved before the right to decline arises.¹⁰⁸

Fines and penalties

As discussed above, the law does not permit a person to be indemnified for their own criminal conduct. However, policies are available to cover fines and penalties arising from, for example, occupational/workplace health and safety legislation, environmental offences and directors' civil penalties.

A public policy dilemma that is often raised is:

- on the one hand, will directors make the types of decision that are not free from risk necessary for innovation and commercial enterprise; and will companies be able to attract the best business people to act as directors without being able to provide such cover?
- on the other hand, what incentive is there for company officers to undertake adequate due diligence and corporate governance to avoid prosecutions if they have insurance for any fines and penalties?

As part of that public policy debate, it should be remembered that in addition to the sanction of a fine or penalty there are often also reputational issues, and a company's and director's solvency could be impacted depending on the extent to which cover is available.

There is currently no Australian case law on the extent to which civil fines and penalties can be insured against, and remains to be tested here. To some extent, the distinction between civil and criminal law is less helpful than an analysis of the ingredients of an offence.

In *Strongman v Sincock*,¹⁰⁹ in the English Court of Appeal Lord Denning said:

'It is a settled principle that [someone] cannot recover for the consequences of [their] own unlawful act, but this has always been confined to cases where the doer of the act knows it to be unlawful or is himself in some way morally culpable.'

More recently, the Court of Appeal in the UK decision in *Safeway Stores Ltd v Twigger*¹¹⁰ confirmed that where an offence had been committed by a company 'intentionally or negligently', it was contrary to public policy to allow the company to have an entitlement to cover itself for the penalty (from former officers of the company (and accordingly, their D&O insurers) whose behaviour had led to the imposition of the penalty).

Applying this approach, the best guidance seems to be the distinction between:

- on the one hand, intentional or fault based crimes involving at least an element of reckless behaviour or such as wilful blindness or indifference to the consequences of one's actions;
- on the other hand, unintentional or inadvertent offences, such as those involving strict liability offences or arising from vicarious liability that have no *mens rea* (the necessary element of intent) or moral turpitude.

This second category would not seem to offend public policy and would not fall foul of the requirements for wilful or intentional conduct exclusions.

¹⁰⁸ *Silbermann v CGU Insurance Limited* (2003) 57 NSWLR 469.

¹⁰⁹ [1955] 2 QB 525.

¹¹⁰ [2010] All ER (D) 245.

In the absence of any clear judicial guidance or legislation as to what might be contrary to public policy, in a free market economy, insurers will continue to be apt to issue policies which cover fines and penalties with the proviso that they do so to the extent legally permissible (see s 199B of the Act). That being the case, the question then arises as to who would challenge a payment by an insurer to indemnify a director for a civil penalty – certainly it would not be expected the insurer,¹¹¹ insured director and broker would mount a challenge; and it is difficult to see a claimant doing so if the result might be an uninsured and impecunious director unable to pay the fine, unless ASIC wishes to take a hard stance on the issue.

Insuring for dishonesty

As mentioned above, it may seem axiomatic that a director or officer will not be able to insure against his or her own deliberate or reckless breaches of their obligations under the Act, such as:

- obtaining a personal profit, advantage, or remuneration from the discharge of their duties; or
- engaging in any conduct which is dishonest, fraudulent, or criminal, such as insider trading.¹¹²

If an insurer's decision to decline indemnity can be justified by a proper analysis of the evidence and construction of the policy, then it is likely that a decision to decline indemnity in circumstances of *actual* dishonesty or fraud will be upheld.

If the policy requires an admission, determination or finding in respect of *unproved allegations* of fraud or dishonesty, then the insurer will usually be obliged to indemnify until that requirement is met. There is an obligation on insurers to continue to advance defence costs (discussed below) even though there is an allegation of fraud, as in *Wilkie v Gordian Runoff Limited*¹¹³ and cases like it.

If the policy does not have that requirement and affords the insurer an opportunity to refuse to indemnify, simply on an allegation of fraud or dishonesty being made (which is becoming increasingly unlikely in the current market), then the insurer will be entitled to decline to indemnify in respect of the claim including defence costs. In *Silbermann v CGU Insurance Limited*¹¹⁴ the insurers were entitled to refuse to advance defence costs on the basis that, on the construction of the policy, the insurers had a *discretion* to decline indemnity for certain allegations of fraud, even if unproven.

Although an insured cannot claim under a policy if it must rely upon its own illegality, or seeks to profit from that illegality, this is not to say that conduct falling short of illegality, amounting to gross negligence, will not be indemnified as in *Green v CGU Insurance Limited*.¹¹⁵

Insolvency

It is understandable that with the increasing frequency of corporate insolvencies and the corresponding exposure of directors to litigation arising from allowing the companies to trade whilst insolvent (whether as a result of negligence or dishonesty), insurers will be keen to limit their exposure to such risks by excluding any liability referable to claims arising out of a company's inability to pay its debts as and when they fall due.

¹¹¹ Assuming the policy otherwise responds.

¹¹² *Rich v CGU Insurance Limited* (2005) 214 ALR 370.

¹¹³ (2005) 221 CLR 522.

¹¹⁴ (2003) 57 NSWLR 419.

¹¹⁵ (2005) 215 ALR 612.

D&O policies are often drafted to exclude either insolvency generally, or liability arising out of a failure to pay its debts as and when they fall due.

In the context of the large number of D&O claims that arise in the context of financial distress (particularly in the recent economic climate) this is obviously a potentially significant impediment to cover, and a good way for insurers to limit their potential exposure.

One issue that has yet to be determined by the courts is the ambiguity attributable to the phrase *liability arising out of [or caused by] a failure to pay its debts as and when they fall due*.

Although the words in bold type are to be widely construed, this is less so in the context of construing an *exclusion* clause if it is considered to be ambiguous (given the courts' likely application of the *contra proferentum* rule against insurers in light of any ambiguity).

Consider the following scenario:

A director represents the company is able to repay a loan it has applied for.

On the strength of that application, the lender advances the loan.

The company defaults on repayment.

It transpires the company was never in a position to meet the repayment obligations and the director knew or ought to have known that.

The lender sues the director, for the misrepresentation.

Does the claim truly arise from the misrepresentation, or can it fairly be said to arise from failure of the company to pay its debts as and when they fell due, such as to trigger an insolvency exclusion? Put differently, must the claim be directly based on the insolvency for an exclusion to apply, or is some nexus between the claim and the insolvency sufficient?

There is currently no judicial answer to this debate, but it may yet be tested in the courts and is an issue to be considered when the policy is being drafted and underwritten.

Other exclusions

Other common exclusions include:

- Economic loss arising from personal injury or property damage.

This is the province of a public liability policy.

- Breach of professional duty, other than that of a director or officer acting in their capacity as such.

This is the province of a professional liability policy.

- Defamation.

Cover for defamation is often found in public liability policies, but if that is not the case, directors should ensure that cover is provided elsewhere.

- If a director or officer improperly uses his or her position.

- Geographical limitations specified in the policy.

This is usually in respect of overseas directors or Australian based directors involved in overseas entities, particularly those in the US.

- Availability of indemnity from the company.

As we have seen, a director can be provided with indemnity against certain liabilities by the company. Some policies with Side A cover will exclude indemnity if the company is *permitted* to indemnify the director, which can have the effect of significantly limiting the operation of the Side A cover. The result will be a need for the director to pursue the company itself for indemnity, if the claim is for a liability in respect of which the company is *permitted* to provide indemnity.

The exclusion to cover has the potential to operate such that Side A cover is unavailable simply where the company is permitted to indemnify the director, even if the company is insolvent, or has refused to provide or honour an indemnity (leaving the director with the unattractive prospect of pursuing litigation against the company at his or her own expense, when already faced with the costs of defending the action being brought).

- If a personal profit, advantage or remuneration is illegally obtained by a director or officer.

Even though a company may not have suffered a loss, its director will have breached the fiduciary duty owed to the company if the director makes an undisclosed profit. A director is also unable to seek cover under a D&O policy where he has illegitimately profited from his position and the company seeks to recover that profit.

- If a director or officer provides a political group, public official, or the company's directors, officers, employees, shareholders or customers a payment, benefit or favour.
- Conduct carried out by the director or officer that is a deliberate statutory breach or insider trading.

Pre-conditions of cover

In *Australian Securities and Investments Commission (ASIC) v Healy* (the Centro case),¹¹⁶ the directors were pursued in respect of their endorsement of financial statements which contained errors regarding the financial health of the company. The directors attempted to abdicate responsibility for their errors, arguing that it was a matter which should have been picked up by the company's auditors. The court did not agree, and held that the proper assessment of the company's financial statements was a task which fell within the capacities and responsibilities of the members of its board. The court held:

*'Directors cannot substitute reliance upon the advice of management for their own attention and examination of an important matter that falls specifically within the board's responsibilities as with the reporting obligations. The Act places upon the board and each director the specific task of approving the financial statements. Consequently, each member of the board was charged with the responsibility of attending to, and focusing on these accounts and, under these circumstances, could not delegate or "abdicate" that responsibility to others.'*¹¹⁷

¹¹⁶ (2011) 278 ALR 618.

¹¹⁷ Ibid [621].

That statement echoes the High Court's observations in *Hellicar* concerning the responsibilities of the absentee American directors, discussed above.

In light of such statements concerning the high standards expected of directors, insurers may be more inclined to insist, before offering cover, that they are satisfied that the directors and officers are appropriately qualified and capable of discharging their responsibilities. This may involve considering the professional and other qualifications held by directors, enquiring into the number of boards upon which those directors sit in order to be satisfied that they are able to devote sufficient time to discharging their obligations, or seeking warranties from directors who sit on multiple boards, that their capacity to discharge their obligations in respect of one company will not be hampered by other competing obligations.

Defence and Investigation Costs

D&O policies provide cover for both third party legal liability and for defence and investigation costs.

Defence and investigation costs may or may not attract the policy excess/deductible, and may form part of the overall limit of indemnity or have an additional limit.

In respect of the entitlement to costs, a policy will usually either entitle the insurer to take over conduct of the defence at its own cost, or indemnify the director for the costs incurred in the investigation or defence of a claim by its own lawyers. More so than professional indemnity policies, D&O policies accommodate the appointment of separate *defence counsel* for the insured and *indemnity counsel* for the insurers, rather than combining that function in the same firm of lawyers.

Defence costs are often defined to comprise the reasonable legal fees and associated disbursements incurred by solicitors, barristers and experts for the purposes of defending the claim, sometimes together with any related investigation costs (usually incurred before proceedings are commenced), and can extend to extradition costs, bail bond and civil bond premiums, public relation costs and travelling expenses; but will not ordinarily cover claim preparation costs and the time and lost business opportunity incurred by the insured providing instructions and assisting in the conduct of the defence.

A defence or investigation costs clause will be triggered by a claim being made against an insured within the policy period, or upon operation of a contractual or the statutory¹¹⁸ deeming provision in respect of an earlier notification of a circumstance. The policy will not therefore respond to costs incurred by an insured in anticipation of a claim or investigation unless it has notified circumstances that may give rise to a claim/investigation and received prior consent to incur those costs under the terms of the policy, although failure to obtain prior consent can be cured by s 54 *Insurance Contracts Act 1984* (Cth), absent prejudice.

As one might expect, an insured is entitled to coverage for the costs of defending claims to which the policy does respond even if the underlying claim is wholly without merit, or even fraudulent.¹¹⁹ If the policy does not respond to the underlying claim, there will usually be no coverage for costs.

¹¹⁸ *Insurance Contracts Act 1984* (Cth) s 40(3).

¹¹⁹ *Cooper v Farmers' Mutual Insurance Society* [2001] OTC 652.



The advancement of defence costs

One benefit typically (but not always) found in D&O policies is the requirement for the advance payment of defence costs, entitling directors and officers to indemnity for their costs of defending a claim under the policy even where their entitlement to coverage under the policy may involve complex issues of law and/or fact that cannot be resolved quickly, in respect of which the insurer may have reserved its rights in relation to coverage.

It is commonly said this is the major benefit of D&O policies: the access they afford directors to funding for investigation and defence costs, notwithstanding allegations have been made that may fall within a policy exclusion (often dishonesty), until such time as indemnity is declined by proper reference to the evidence or a finding or admission is made against the director to that effect.

Limitations on the prohibition for the advancement of defence costs to directors in certain circumstances are usually predicated on the basis there must be a *'finding or conclusion'* that the director engaged in conduct which otherwise would be excluded from cover, for example, because he/she is dishonest.

The wording of the policy's exclusion clauses will be critical to any dispute over an entitlement to coverage for costs where cover is not available for the legal liability itself.

For example, in *Wilkie v Gordian Runoff Ltd*¹²⁰ and *Silbermann v CGU Insurance Limited*¹²¹, insurers had the right to withdraw coverage once fraud was proved but could not refuse to defend or indemnify defence costs merely because fraud was alleged.

Without an advancement of defence costs provision, the directors would be required to fund the often substantial costs of defending a claim (or costs arising from the preceding investigation process) themselves until such time as the insurer had the opportunity to determine whether the policy responded – a process that can often take many months or even years while the litigation proceeds to trial. With advance payment of defence costs, insurers can only decline payment of defence costs where they have determined the policy does not respond to the claim. If the insurer is still investigating cover under a reservation of rights and has neither confirmed nor denied cover, it is in the meantime obliged to make payment of reasonable defence costs, subject to the entitlement to seek reimbursement of any defence costs paid under the policy if coverage is ultimately declined (to the extent that is possible).

The amount of defence costs necessary to defend claims against directors can often be financially disastrous for the directors if they are not indemnified by the company or the D&O policy.

This is particularly important given the increasing trend towards Royal Commissions of inquiry (for example, HIH, James Hardie and AWB) and the more widespread use by ASIC and APRA of their investigatory powers, where the (often substantial) costs of these types of inquiry are usually covered.

In a situation where there is an entitlement to an advancement of defence costs, but it is unclear whether all or only part of the claim against the director will be covered, it appears the insured is similarly entitled to the benefit of defence costs unless and until it is established coverage is not available for the claim. Pending any judicial determination in respect of the claim itself, it is incumbent on the insurer to establish that part of the claim falls outside the scope of cover, such that there is no entitlement to an advancement of defence costs for that part of the claim.

¹²⁰ (2005) 221 CLR 522.

¹²¹ (2003) 57 NSWLR 469.

What if cover has been eroded by a claim or combination of claims, so that the insurer is then entitled to seek reimbursement of defence costs advanced under the policy such that recovery would replenish the cover available to other directors – is the insurer obliged to pursue recovery for the benefit of the remaining directors? Some policies appear to entitle directors to the benefit of cover as if an advancement of defence costs for which a director has a liability to reimburse, had been recovered even if that is not so.

Otherwise, it remains to be seen whether a court would imply such a term into the policy or oblige the insurer to pursue recovery, bearing in mind the costs of doing so and the potential for the beneficiary of the advancement of the defence costs to be unable to make good any repayment due.

It is possible a Court would not impose an obligation on an insurer to pursue such a costly and potentially fruitless recovery, but may in those circumstances be more willing to imply a requirement for the insurer to indemnify the remaining directors for the amount the insurer could recover were it inclined and able to do so.

The present Australian position with respect to the obligation of advancing defence costs was summarised by Professor Merkin based on the judgment in *Nichols v American Home Assurance Company Limited*¹²² with regard to the following principles:

1. The insurer's duty to defend arises where there is a 'mere possibility' that a claim against the insured is covered by the policy. It is the insured who bears the obligation to establish that it is possible that the allegations made by the third party, if proved at trial, would bring the claim within the policy.¹²³
2. If the pleadings in the claim against the insured allege facts, which if true could require the insurer to indemnify the insured, then the insurer must provide a defence.¹²⁴ In construing the nature of the claim, the pleadings must be read realistically, not by reference to the labels and terminology employed by the pleading, but by reference to 'the true nature of the claim'.¹²⁵
3. Once these threshold requirements have been met, the insurer then assumes the obligation of establishing that the claim falls outside the coverage afforded by the policy, or that the insured is otherwise in breach of a policy condition which precludes entitlement to recovery under the policy.¹²⁶ In this regard, Professor Merkin observed:

¹²² (1990) 1 SCR 801.

¹²³ See also *Kerr v Lawyers Professional Indemnity Company* (1995) 25 OR (3D) 804.

¹²⁴ See also *Bacon v McBride* (1984) 5 CCLI 146.

¹²⁵ In this regard, see *Rothschild & Sons v St Paul International Insurance Company* (2004) 13 ANZ Ins cas 61-602 in which McDougall J held, determining whether a claim fell within the definition of a policy of insurance in respect of a 'wrongful employment practice' required an examination of the 'true nature of (the claimant's) claims, and that the question whether they were claims which gave rise to a legal liability arising out of an "employment practice" required a consideration of their true nature and not just of the way they were pleaded.'

¹²⁶ See *Laughlin v Sharron High Voltage Incorporated* (1993) 12 OR (3D) 101.

*'Where it is clear that the allegations in the pleadings against the assured fall outside the insuring agreement or are excluded by an applicable exclusion, the duty to defend does not arise. Importantly, if the insurers assert that they are not liable under the policy so that they are not liable for defence costs, and they lose at the hearing on defence costs, they are not estopped from relying on their substantive defence to liability under the policy at a later stage. It would seem that there is nothing to prevent the insurers from seeking at this stage a final order that it is not under any obligation to indemnify the assured, by reason of a coverage or other defence for substantive claim: this was so held in Silbermann v CGU Insurance Limited.'*¹²⁷

In this regard, it is instructive to read the judgment of Jackson J in *Bank of Queensland Ltd v Chartis Australia Insurance Ltd*,¹²⁸ where the insured's application for declaratory relief in respect of the extension of defence costs was refused on the basis that the facts upon which such a determination was to be based were not established.

4. If some allegations in the pleading are covered but a dispute arises as to whether others are covered, then there is a duty to defend in full with the court to allocate the costs after the trial between the insured and the uninsured portions of the loss, subject to the following caveat. If the facts in relation to the insured and uninsured components of the claim are separate and discrete, then no obligation arises to defend the uninsured claim. The test is *'whether the two claims arise from the same actions and have caused the same harm so that the uninsured claim can be said to be derivative.'*¹²⁹ Further, as was seen in *McCarthy & Ors v St Paul Insurance Company Limited*,¹³⁰ the obligation to indemnify in respect of defence costs, where there are multiple causes of loss, including the dishonesty exclusion, will not arise if that obligation to indemnify might tend to result in *'inconvenient and obviously unintended results.'*

The proper construction of D&O policies in this context was given detailed consideration by Jackson J in the Supreme Court of Queensland in the *Chartis* decision.¹³¹

That case arose out of proceedings instituted against the Bank of Queensland by ASIC and Barry and Deanna Doyle, in which it was alleged that the Bank had engaged in unconscionable conduct, in contravention of the *Australian Securities and Investments Commission Act 2001* (Cth) and the *Fair Trading Act 1999* (Qld), by entering into home loan contracts, a mortgage, and making certain credit advances to the Doyles.

These allegations arose out of the fact that the Doyles were sold investment schemes promoted by the infamous Storm Financial Limited in Townsville.

The Doyles incurred significant liabilities to the Bank as a result of the investment advice provided to them by Storm, and as Storm was insolvent and its directors impecunious, the Doyles and ASIC sought to implicate the Bank in the multitude of allegations of nefarious conduct advanced against Storm.

The Bank sought indemnity from its insurer in respect of the claim. The insurer denied the claim for indemnity on the basis of an exclusion in cl 3.9 of the policy, which provided that:

¹²⁷ See pages 23–24 of Professor Merkin's article. Robert Merkin, 'Directors' and Officers' Insurance and the Global Financial Crisis' (speech delivered at the Australian Insurance Law Association Geoff Masel Memorial Lectures, November 2009).

¹²⁸ [2012] QSC 319.

¹²⁹ See *JAS v Gross* (1998) 231 AR 228.

¹³⁰ 2007 FCAFC 28.

¹³¹ [2012] QSC 319.

'The insurer shall not be liable to make any payment for Loss:

Lender's liability

Arising out of, based upon or attributable to any actual or alleged:

- (i) Loan, lease or extension of credit except to the extent that such Claim arises out of a Wrongful Act in the administration of such loan, lease or extension of credit; or*
- (ii) Collection, foreclosure or repossession in connection with any actual or alleged loan, lease or extension of credit.'*

With respect to the advancement of defence costs, clause 6.6 of policy provided:

'Except to the extent that the Insurer has denied indemnity for any Claim, the Insurer shall advance Defence Costs in excess of the retention, if applicable, promptly after sufficiently detailed invoices for those costs are received by the Insurer.

The Insurer may not refuse to advance Defence Costs by reason only that the Insurer considers that conduct referred to in the 'wrongdoing' exclusion has occurred, until such time as there is an admission by the Insured, or, a judgment, award or other finding by a court, tribunal or other trader with jurisdiction to finally determine the matter (including the outcome of any appeal in relation to such judgment, award or other finding) which establishes the foregoing.'

The indemnity obligation on the insurer was expressed in cl 1 of the policy in the following terms:

'The Insurer shall pay on behalf of each Insured all Loss and Defence Costs resulting from any Claim first made during the Policy Period for any Wrongful Act.'

Clause 2.20 of the policy defined 'Wrongful Act' as including:

'Act or error or breach of duty or omission or conduct (including misleading or deceptive conduct) committed or attempted or allegedly committed or attempted by or of the Insured . . .

Without limiting its scope, Wrongful Act includes:

- (a) Breach of contract for the provision of Professional Services (notwithstanding exclusion clause 3.2);*
- (b) Breach of any state or territory fair trading legislation;*
- (c) Breach of the Trade Practices Act 1975 (Cth) (as amended)*
- . . .*
- (j) Breach of the Australian Securities and Investments Commission Act 2001 (Cth) (as amended).'*

In justifying its denial of indemnity, in particular with respect to its refusal to advance defence costs, the insurer argued that the 'Loss' the subject of the claim arose out of, was based upon or attributable to the actual or alleged loans made by the Bank to the Doyles, and therefore fell within exclusion cl 3.9.

The Bank argued that the exclusion clause lacked sufficient precision insofar as it failed to identify **what** was required by the words *'arising out of, based upon or attributable to'*. It argued that what was required was a *'non-coincidental nexus between the proscribed conduct and the loss'*, which, it submitted, could not be established in this case. In the alternative, the Bank argued that the loss in fact arose out of the administration of the loans, not the making of the loans themselves, and so the *'carve out'* in exclusion cl 3.9 was triggered.

The insurer successfully resisted a declaratory determination with respect to its obligation to indemnify the Bank on the basis that to do so would involve proceeding on the basis of allegations made in the pleadings which had not been proven or accepted by either party as facts which were true or binding on them.

In this regard, the insurer relied on *Bass v Perpetual Trustee Company Limited*,¹³² in which it was held that it was central to the purpose of a judicial determination that *'it includes a conclusive or final decision based on a concrete and established or agreed situation which aims to quell a controversy.'*¹³³

In that case, the High Court stated that if a declaration is made not based on the facts either as found or agreed between the parties, it will be purely hypothetical and:

*'... at best ... do no more than declare that the law dictates a particular result when certain facts in the material pleadings are established. Also, if "the relevant facts" are not identified and the existence of some of them is apparently in dispute, the answers ... may be of no use at all to the parties and may even mislead them as to their rights.'*¹³⁴

Jackson J agreed with that statement of principle and held that the:

*'... proper application of the principles in Bass leads to the conclusion in the present case that a declaration as to the operation and application of clause 3.9 to the claim in the Doyle proceedings for Loss under the policy should not be made because the declaration would be hypothetical.'*¹³⁵

With respect to whether there was any obligation on the insurer to advance defence costs in circumstances in which it had declined indemnity on the grounds that the loss was not covered, the insured argued that the obligation to advance defence costs crystallised upon the lodgement of a qualifying claim. The insured also argued that the insurer's reliance on exclusion 3.9 did not excuse it from its obligation to extend defence costs in circumstances in which the exclusion clause only made reference to the insurer not being liable to make payment for *'Loss'* in certain circumstances, and did not make reference to and exclude a separate obligation to provide *'Defence Costs'*.

Jackson J undertook a comprehensive analysis of the state of the law with respect to the obligation to advance defence costs in circumstances in which indemnity was denied. Jackson J made reference to *Wilkie v Gordian Runoff Limited*¹³⁶ in which (as noted above) the insurer denied indemnity in respect of both the claim and defence costs, predicated on the fraud exclusion in the policy. He noted that the High Court had held in that case that to permit the insurer to avoid the obligation of advancing defence costs in circumstances in which it relied on the fraud exclusion, there was a requirement that the fraud *be established* before the exclusion might be invoked, and so it was held that there was an obligation to advance defence costs *pending a determination of the fraud claim*.

¹³² (1999) 198 CLR 334.

¹³³ *Ibid* [355].

¹³⁴ *Ibid* [357].

¹³⁵ *Bank of Queensland Ltd v Chartis Australia Insurance Ltd* [2012] QSC 319 [40].

¹³⁶ (2005) 221 CLR 522.

Whilst indemnity in the *Chartis* case was not declined on the basis of fraud, the insured similarly contended that the obligation to advance the defence costs could not be curtailed by the insurer's decision, particularly in circumstances in which the exclusion clause was not expressly framed as excusing the insurer from an obligation to extend defence costs.

Jackson J observed that the '*high point*' of cases in which it was held that it would be '*incongruous for an insurer to be liable to indemnify the defence costs of a claim to which liability for the loss claim was excluded*' was *McCarthy & Ors v St Paul International Insurance Company Limited*.¹³⁷ That case concerned an obligation to indemnify in respect of a liability which was excluded in respect of liability arising from '*eight enumerated factors set out in the policy, including a dishonesty or fraudulent act or omission of the insured.*' That is, the question in that case was whether the insurer declining the extension of defence costs could be justified in circumstances in which the dishonesty exclusion was but one of the causes of the liability.

In upholding the insurer's declinature of indemnity in respect of both the loss and the extension of defence costs, the Full Federal Court held in *McCarthy* that a construction of the policy which '*restricted the operation of the exclusions to liability to the claimant for loss, so that there was no exclusion of liability for defence costs*' would lead to '*inconvenient and obviously unintended results*' . . . and that '*unlikely commercial results enforced the otherwise available construction, . . . which gives a commercial coherence and businesslike meaning to the relationship between the insuring clause and the exclusion clause.*'¹³⁸

Jackson J also referred to the Court of Appeal of Victoria's endorsement of the question put by the insurer in *Major Engineering Pty Ltd v CGU Insurance Limited*,¹³⁹ '*Why should we have to pay for costs when there is no cover under the Policy?*' and observed that ultimately the determination of the effect of the policy is a finely balanced matter which turns upon a '*businesslike and commonsensical*' construction of the policy as a whole.

In dealing with the argument as to whether the fact that there was no reference in the preamble to the exclusion section of the policy to an exclusion in respect of the obligation to advance defence costs, Jackson J therefore preferred the construction of the policy that if the insurer denied indemnity for the claim, the insurer was not obliged to pay defence costs, because:

- (a) *The language of the insuring clause is that the insurer will pay "Loss and Defence Costs" resulting from any qualifying Claim;*
- (b) *It seems to be an unlikely commercial result that the insurer would be ultimately liable (not just by way of advances to Defence Costs) to pay Defence Costs in respect of the claim which is not otherwise covered because of an exclusion under cl 3;*
- (c) *Neither the subject matter of the policy nor the text supports the construction that it is intended that the policy deal with liability for Loss and Defence Costs differently, except for the opening words of cl 3 (which omits reference to "Defence Costs"); and*
- (d) *The second sentence of cl 6.6 is clearly inconsistent with that construction in respect of cl 3.8.*¹⁴⁰

¹³⁷ (2007) 157 FCR 402.

¹³⁸ *Bank of Queensland Ltd v Chartis Australia Insurance Ltd* [2012] QSC 319 [70].

¹³⁹ (2011) 282 ALR 363.

¹⁴⁰ *Bank of Queensland Ltd v Chartis Australia Insurance Ltd* [2012] QSC 319 [74].

Accordingly, Jackson J concluded:

*'Once that point is reached, it seems to me that the proper construction of clause 3.9 and clause 6.6 are resolved in a consistent or harmonious manner, and the insurer will be entitled in a proper case to deny indemnity for a Claim including liability for Defence Costs in reliance on clause 3.9 of the policy. In those circumstances, the insurer is not obliged to advance Defence Costs under clause 6.6, or to pay Defence Costs under clause 1, until the insurer's denial of indemnity is determined to be wrong as between the insurer and insured.'*¹⁴¹

On appeal, the Queensland Court of Appeal¹⁴² agreed with Jackson J's conclusions, emphasising in their judgment the principles to be applied when construing insurance policies. The Court of Appeal was prepared to stray from a literal interpretation of the relevant exclusion clause to give them a commercial and businesslike meaning by construing the policy as a whole, and agreed an entitlement to be indemnified the costs of defending an excluded claim would have the unintended outcome of creating two policies from one policy document.



¹⁴¹ Ibid [75].

¹⁴² *Bank of Queensland Ltd v Chartis Australia Insurance Ltd* [2013] QCA 183.

Allocation of Loss

Allocation of Loss clauses emphasise the insurer is only liable to indemnify loss covered by the policy.

If a claim comprises various losses and costs only some of which are covered by the policy, the policy typically requires the insured and insurer to act in good faith to attempt to agree a fair allocation of insured and uninsured loss and costs, to be determined by a QC or senior counsel in the absence of agreement.

The assessment should be based on each party's relative legal and financial exposure to the claim, and the benefits obtained by the parties from the defence of the claim.

For example, a director will often be alleged to have been both negligent and fraudulent. As we have seen, an advancement of defence costs may be available even though fraudulent conduct is excluded, until such time as there is a finding or admission of fraud. If an adverse finding on the issue of fraud is made, an allocation will be necessary unless the insured can prove the defence costs were attributable to defending the allegations of negligence (to which the policy did respond) and were not increased by reason of the allegations of fraud.¹⁴³

In *McCarthy v St Paul International Insurance Co Ltd*,¹⁴⁴ the claim against the insured comprised both insured and uninsured (fraud) components. Relying on the well known *Wayne Tank*¹⁴⁵ principle, the insurer argued that as there were two proximate causes of the loss, one of which was covered by the insuring clause but the other being expressly excluded, there was no liability at all for defence costs. On the particular wording of the policy in question however, the court considered the claims to be separable, with the result defence costs were payable in respect of the insured aspects of the claim (and where the costs were attributable to both the insured and uninsured components).

In *Vero Insurance Ltd v Baycorp Advantage Ltd*,¹⁴⁶ this principle was considered in the context of there being an insured and an uninsured defendant. In that case defence costs were incurred on behalf of the insured directors and uninsured company. The court noted that where an insured would have incurred the same costs (for example, in preparing pleadings, statements and obtaining expert evidence) whether or not there was an additional uninsured party, the insurer is required to pay the entirety of the costs without contribution from the uninsured party, adopting the 'reasonably related' test applied in the UK.

Where there is more than one insurer with the duty to defend, ordinary contribution principles apply, whereby if one insurer pays the defence costs it is entitled to an appropriate contribution from the other insurer.

Dual insurance

Dual insurance arises if there are two (or more) insurance policies, and the same interest, subject matter and risk are covered by those policies. The same insured, or person acting on the insured's behalf, must affect the two insurance policies for dual insurance to exist.

¹⁴³ *John Wyeth v Cigna* [2001] Lloyd's Rep IR 420.

¹⁴⁴ (2007) 157 FCR 402.

¹⁴⁵ *Wayne Tank & Pump Co Ltd v Employers Liability Assurance Corp Ltd* [1974] QB 57.

¹⁴⁶ (2005) 23 AGLC 199.

Dual insurance does not arise if two different insureds obtain coverage with two different insurers for the same subject matter on the basis that each insured's interests in the same subject matter are different, for example, a property is insured by a mortgagee and a mortgagor or a vendor and a purchaser.¹⁴⁷

Dual insurance similarly does not arise if there has been a lapse in one of the insurance policies, or the risk is not covered or excluded by one policy.

Where there is dual insurance, the insured is entitled to claim under either policy. It is able to choose the most favourable policy (for example, by reference to the excess/deductible, the limit of cover or the policy exclusions) and is under no obligation to notify under the other policy.

When an insurer pays out a claim however, equity entitles that insurer to obtain a proportionate contribution of the total claim amount from other insurers. Therefore if a claim is made:

*'namely by one insurer against the other for full indemnity, [the claim] must fail on the simple ground that the right to contribution between co-insurers recognised and confirmed by the decision in Albion Insurance Co Ltd v Government Insurance Office of New South Wales,¹⁴⁸ can never amount to a complete indemnity but must always be confined to rateable contribution.'*¹⁴⁹

The issue of dual insurance and the contribution principle arose in *Australian Eagle Insurance Co Ltd v Mutual Acceptance (Insurance) Pty Ltd*.¹⁵⁰ Priestly JA proposed two questions be asked when determining whether contribution can be claimed by an insurer based on the existence of dual insurance. The first question was whether a common burden was shared by the two insurers, and the second question was whether an insured would be paid twice for the same loss if both policies paid out the claim.

In order for the Court to order in favour of contribution, the responses to these two questions must be 'yes', because an insured can only be indemnified once.

Policies often contain what is known as 'other insurance' provisions, which purport to exclude cover where the insured is also covered under another insurance policy for the same risk.

Section 45(1) *Insurance Contracts Act 1984* (Cth) states:

*'Where a provision included in a contract of general insurance has the effect of limiting or excluding the liability of the insurer under the contract by reason that **the insured has entered into** some other contract of insurance . . . the provision is void'*

Section 45 therefore renders such clauses void unless they specifically identify the other policy, for example, where an excess layer policy is specifically noted to be in excess of the primary layer policy.

¹⁴⁷ *GIO General Ltd v Insurance Australia Ltd (t/as NRMA Insurance)* (2008) 15 ANZ Insurance Cases 61-761.

¹⁴⁸ *Albion Insurance Co Ltd v Government Insurance Office of New South Wales* (1969) 121 CLR 342.

¹⁴⁹ *Commercial & General Insurance Co Ltd v Government Insurance Office (NSW)* (1973) 129 CLR 374, 381.

¹⁵⁰ *Australian Eagle Insurance Co Ltd v Mutual Acceptance (Insurance) Pty Ltd* [1983] 3 NSWLR 59.

In *Zurich Australia Insurance Limited v Metals & Minerals Insurance Pty Limited*,¹⁵¹ the High Court confirmed that the wording of s 45 is confined to actual insureds named in the policy, and does not extend to beneficial third parties named in that policy. However, the Supreme Court of Queensland¹⁵² has subsequently clarified that the section will extend to named insureds where the other policy was effected by an agent or parent company on its behalf.

If an insured enters into a contract where the work performed by the insured is to be covered by an insurance policy provided by the other party, the insured's existing insurance policy will often provide coverage where the other policy does not.

Management liability

D&O insurance has close similarities to aspects of broader form management liability insurance, covering certain liabilities of the company as well as the personal liabilities of its directors and officers. Management liability insurance is also known as a form of statutory liability insurance because coverage extends to non deliberate breaches of legislation.

As with some of the D&O exposures discussed above, management liability insurance is designed to cover claims arising from the management of the company.

A management liability insurance policy will typically provide coverage to:

- Directors, officers and the company where a claim is made against them that alleges the occurrence of a wrongful act, whether the wrongful act is a breach of duty, misrepresentation or negligence, in similar form to a D&O policy.
- The company where a claim is made against the company, alleging a breach of employment practices, whether the breach is associated with dismissal of an employee or an employee suffers from discrimination, harassment or loss of opportunity.
- The company where an employee steals from the company (fidelity cover).
- Persons or entities who are the trustees of the superannuation funds of staff.

A management liability insurance policy will usually provide coverage for:

- Representation costs incurred when a director or officer attends an inquiry or investigation, if it is a legal obligation of the director or officer to attend.
- Legal costs and expenses incurred when defending or investigating a claim made against the director or officer.
- Compensation that the insured or insured person must pay to the claimant.
- Direct financial loss suffered by the company.
- Representation costs incurred by a company involved in an occupational health and safety investigation.
- Claims regarding employment practices liability.

These types of policy are most commonly used by smaller private companies, as distinct to larger or publicly listed companies who tend to seek specialised D&O cover and any additional coverage required for employment practices liability or fidelity separately.

As with the D&O, Side C issue discussed above, there is a risk one type of claim covered by a policy may erode or exhaust the policy limit, potentially leaving an uninsured exposure for other intended beneficiaries of the policy during the balance of the policy period.

¹⁵¹ *Zurich Australia Insurance Limited v Metals & Minerals Insurance Pty Limited* (2009) 240 CLR 391.

¹⁵² *Nicholas v Wesfarmers Curragh Pty Limited* [2010] QSC 447.

It should also be noted that the different cover clauses under a management liability policy usually attract different deductibles, and can be subject to lower sub-limits of cover.

There are standard exclusions in a management liability policy which apply to the policy as a whole, and additional exclusions which apply to the different types of coverage provided by the various insuring clauses (for directors and officers, the company itself and claims involving employment liability and fidelity).

The following standard exclusions can be found in management liability policies:

- Loss caused by the insured's conduct being improper, fraudulent or dishonest, or being unlawful or criminal.
- The insured's knowledge of a claim or circumstance that may result in a claim.
- Loss caused by bodily injury or damage to property.
- If the claim involves law relating to occupational health or safety (although often offered as an extension).
- Loss of employment benefit.
- Loss caused by raising capital.
- Insured versus insured issues and loss caused by a claim made by a shareholder of the company who holds at least 15% of the company.
- Loss arising from a professional service or advice.

If the company itself is liable, the following exclusions are often found:

- Any breach of an express or implied term in a contract.
- A breach of intellectual property rights held by a third party or a trade secret being infringed or violated.
- A breach of privacy rights held by a third party.
- Product liability or product recall.
- Restrictive trade practices.
- A wrongful act which relates to superannuation funds.

The same controversy arises in the context of exclusions for criminal and unlawful conduct discussed above in relation to D&O.

Insureds should also be mindful to ensure claims that can be made against both the insured entity and insured persons are covered, as the drafting of some management liability policies can leave in doubt whether both the insured and the insured persons are entitled to cover, particularly in relation to statutory liability.

Global D&O policies versus local D&O policies

A consideration for multinational companies is whether to apply for a global D&O policy or local policies.

Global D&O policies by their nature are general in application and do not discriminate between jurisdictions, whereas local D&O policies will only cover directors operating within the particular jurisdiction in question.

It is recommended companies identify the jurisdictions in which they face exposure and the legal intricacies of each. The reality is that a combination of both a global D&O policy and select local policies may be the most sensible option depending on the analysis of coverage and jurisdictional issues.

Global policies may potentially only operate as an excess layer where a local policy is also in force, but will often have a drop down clause that will entitle the insured to use the global policy as a primary layer policy where the local/primary layer policy has been eroded.

D&O Group Policy

In a corporate group structure, it is common for the parent company to take out D&O cover for itself, its controlled subsidiaries, and directors and officers of the entire group.

Key indicia

In his article, *D&O Insurance and the Global Financial Crisis*,¹⁵³ Professor Robert Merkin helpfully summarised six key features of directors' and officers' policies:

1. The cover is predicated on the liability arising from the **status of the insured**, regarding his or her role as a director.
2. The cover is written on the basis of **'claims made' during the currency of the policy**, not the events or losses which occurred during the currency of the policy.
3. Even though the policy is held in the name of the company, **the directors are parties to the insurance in their own right, as co-insureds**. The policies are **composite**, insofar as each individual director is an insured in his or her own right.
4. D&O policies have (like policies of professional indemnity insurance) **per claim deductibles and aggregate cover limits**. Whilst a policy may provide for an *'automatic reinstatement'*, in circumstances in which the policy limit has been exhausted, policies will differ as to whether the reinstatement will be effected as soon as the limit has been exhausted, or will not fall into place until a prescribed renewal date.
5. It is necessary to consider the **interrelationship between local policies and global policies**, as global policies may operate as an excess only cover if there is a local policy in force, subject to there being any *'drop down'* clause in the excess policy, which prescribes that it will be treated as a primary layer policy, but on the terms of the local policy, if the local limits have been exhausted.
6. Policies provide for both substantive cover for **legal liability and defence costs**.

¹⁵³ Published as part of the *Australian Insurance Law Association Geoff Masel Memorial Lectures Series*.

Conclusion

The cover afforded by D&O policies has contractual, statutory and common law constraints and caveats as to what directors may be able to seek to be indemnified against.

The law in this area is complex and quickly evolving as a consequence of the increasing focus on corporate governance.

The greatest benefit of D&O policies may ultimately be their ability to provide funds to directors to defend certain claims, including allegations of dishonesty or other regulatory infractions, an entitlement that will arise until such time as there is a determination as to the nature of the conduct engaged in by the directors, subject always to the threshold issue that the loss the subject of the claim is properly regarded as indemnified by the policy and the policy provides that the insurer is not able to decline until such time as the proscribed conduct is proved.

As a final comment, as with other forms of insurance, there is a circuitous irony that the essential nature of D&O insurance for the protection of directors and officers and its availability is often the incentive for plaintiffs to bring those claims for which the cover is sought.

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