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Master of Business (Accounting & Finance)

Minor Thesis (FB 723)

A Review Of Directors' & Officers' Liability Insurance
Policy Wordings In Light Of The Statewide Tobacco, National
Safety Council, AWA & East End Court Decisions.

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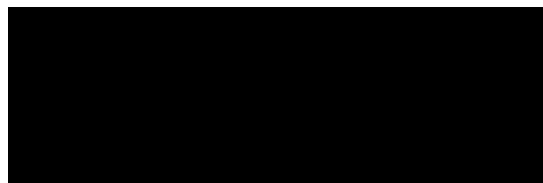
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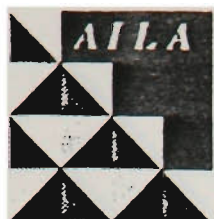
DECLARATION

I, David Abell, declare that this thesis is the work of me alone, except where due acknowledgment is made in the text, and does not include material for which any other university degree or diploma has been awarded.

Dated.....15..... day of.....APRIL....., 1993.



David I. Abell
(S/N 92 02460)



AUSTRALIAN

INSURANCE LAW

ASSOCIATION

PRESS RELEASE

A.I.L.A. TRAVELLING FELLOWSHIP

At the recent Annual Conference of the Australian Insurance Law Association (AILA) held in Canberra the National President, Andy Anderssen, presented the 1992 AILA Travelling Fellowship to David Abell.

David is the Manager, Risk Management Research in the ANZ's Group Risk Management section which has responsibility for placing the Group's global insurance programme. David's winning paper was entitled "A Review of Directors' and Officers' Liability Insurance Policy Wordings in the light of the Statewide Tobacco, National Safety Council, AWA and East End Court Decisions".

In his paper David looks at a number of recent court decisions that have confirmed the extensive personal liability exposure of directors and other persons involved in the management of a company. He also analyses a number of D & O policy wordings, reviews the indirect uninsured losses associated with a D & O insurance claim and suggests risk management procedures for minimising the likelihood of incurring a D & O insurance claim.

The Association also awarded a prize to the best paper submitted by a person aged 30 years and under. The winner of this award was Nigel Wilson who is presently undertaking post-graduate study at Oxford University and was previously a tutor in the Department of Law, University of Adelaide. Nigel's paper was entitled "Estoppel, Waiver & Election in Insurance Law - The Impact of Commonwealth v. Verywayen (1990) 95 A.L.R. 321 and the Insurance Contracts Act 1984".

The Association has resolved to invite applications for the 1993 Travelling Fellowship early in the New Year. The award of the Travelling Fellowship is to the value of A\$7500.00 and the additional prize for the best paper by a person aged 30 years and under is valued at A\$2500.00.

If the winner of the Travelling Fellowship is a person aged 30 years and under, then that person will win both awards.

The Association is committed to the objects of the Travelling Fellowship and the development of a scholarship in the field of insurance law and any enquiries can be directed to the National Secretary, Philip Rowell, on telephone (03) 6296621.

PHILIP ROWELL
National Secretary
19 October 1992

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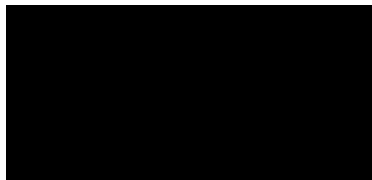
TO WHOM IT MAY CONCERN

This will serve to introduce David Abell who is the winner of the 1992 Australian Insurance Law Association Travelling Fellowship.

David's paper was entitled "A Review of Directors' and Officers' Liability Insurance Policy Wordings in light of the Statewide Tobacco, National Safety Council, AWA and East End Court Decisions". The award is in the nature of a travel and research fellowship.

David is carrying with him a copy of his paper and a copy of the Guidelines and Conditions for the 1993 Australian Insurance Law Association Travelling Fellowship which may be of interest to you.

I would be grateful for any assistance that you are able to extend to David during his travels.



Anders Anderssen
PRESIDENT

23 April 1993

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A U S T R A L I A N
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A S S O C I A T I O N

TRAVELLING FELLOWSHIP \$7,500

1993 UNDER 30 AWARD \$2,500

GUIDELINES AND CONDITIONS FOR THE 1993 AILA TRAVELLING FELLOWSHIP

As a result of the excellent response to the 1992 AILA Travelling Fellowship which resulted in David Abell of the ANZ Group's Risk Management Section winning the award for a paper entitled "A Review of Directors' and Liability Insurance Policy Wordings in the light of the Statewide Tobacco National Safety Council, AWA and Eastend Court Decisions", with Nigel Wilson, a former Tutor at the University of Adelaide now undertaking post-graduate study at Oxford University, winning the award for the best paper by a person aged 30 and under for a paper entitled "Estoppel, Waiver & Election in Insurance Law - The Impact of Commonwealth v Verwayen (1990) 95 A.L.J. R. 321 and The Insurance Contracts Act 1984", AILA has resolved to invite applications for the 1993 AILA Travelling Fellowship.

AILA invites the submission of original works of practical or academic importance in the field of Insurance Law and is anxious to stress that the submission of papers of practical significance is encouraged.

The major award is to the value of A\$7,500 and there is a further award to the value of A\$2,500 for the best paper by a person aged 30 years or under at the date of close of applications. The same entrant may be awarded both prizes.

The major award requires the successful applicant to undertake an overseas study tour to further his or her interest in Insurance Law.

The award is open to anyone with an interest in Insurance Law including but not limited to, members of AILA, the insurance industry, the academic fraternity and the legal profession.

GUIDELINES FOR APPLICATIONS

Applications for 1993 are to be in the form of an original paper on any aspect of Insurance or Insurance Law which will benefit from further study or consideration. The topic may be of practical or academic importance but should be related to Insurance Law generally.

The basic guidelines which should be strictly adhered to are as follows:

- (a) The paper must be the original unpublished work of the applicant.
- (b) The paper must be of approximately 10,000 but not exceeding 20,000 words and must be typed in double space and submitted on plain A4 paper.
- (c) The paper must be accompanied by a brief curriculum vitae giving details of qualifications and past and current employment.

Applications close on 25 June, 1993 in the expectation that the announcement of the awards will take place at the Annual Conference of AILA to be held on the Gold Coast between 15-17 September, 1993.

AWARD CONDITIONS

The award to the value of A\$7,500 is in the nature of a travel and Research Fellowship to be taken subject to the following conditions:

- (a) The award is to be taken within 12 months of presentation unless special circumstances in the decision of the Board of Directors dictate.
- (b) The itinerary and duration of travel is to be at the discretion of the recipient but is to allow for possible visits to up to three overseas chapters of the International Association for Insurance Law (AIDA) as the Board of Directors may determine.
- (c) The recipient should be prepared for the possibility of having to speak to his or her paper or on an Insurance Law related subject on one or more occasions whilst overseas.
- (d) The recipient should be prepared to speak to his or her paper and/or relate the benefit of his or her overseas experience to meetings of up to three branches of AILA in the twelve months following return to Australia on a travel expenses paid basis.
- (e) The recipient will be responsible for obtaining his or her own passport and any necessary visas and travel documents at his or her own expense.
- (f) The recipient may be required to take out travel insurance as nominated by the Board of Directors as part of the award.
- (g) The recipient will make his or her own travel and accommodation arrangements in accordance with the programme submitted to and approved by the Board of Directors.
- (h) The recipient will co-operate fully with the Board of Directors in its efforts to publicise the award of the fellowship through the media.
- (i) The recipient will not be reimbursed for salary loss, if any.
- (j) The award may be made in cash or in kind as the Board of Directors may determine.

The award to the value of A\$2,500 is to be taken subject to the following conditions (unless also awarded to the winner of the A\$7,500 award):

- (a) The recipient should be prepared to speak to his or her paper at meeting or seminars of up to three branches of AILA within 12 months of the award, on a travel expenses paid basis.
- (b) The recipient will co-operate fully with the Board of Directors in its efforts to publicise the award of the fellowship through the media.
- (c) The recipient will not be reimbursed for salary loss, if any.
- (d) The award may be made in cash or in kind as the Board of Directors may determine.

JUDGING

The successful applicant or applicants for the 1993 awards will be determined by a panel of four judges comprising the following:

- (a) The President for the time being of AILA.
- (b) The President for the time being of the Queensland Law Society Inc., or nominee.
- (c) The President for the time being of the Australian Insurance Institute, or nominee.
- (d) Professor Kenneth Sutton, Head of Department of Law, James Cook University of North Queensland and author of "Insurance Law in Australia".

All papers shall be anonymous to the judges. AILA reserves the right to decline to submit papers which in its absolute discretion may be regarded of insufficient merit to warrant submission to the judges. AILA reserves the right not to make any or either award if there is no paper of sufficient merit. The decision of the judges shall be final and no correspondence shall be entered into. In the event of the judges failing to reach a unanimous or majority decision, the award will be determined on the casting vote of the President for the time being of AILA.

COPYRIGHT

Copyright in respect of the winning paper or papers is or are to be vested in AILA and the Association reserves the right to publish such paper or papers in such form and at such time or times as AILA may determine.

AILA shall have first option to publish any other meritorious papers as it may deem fit on payment of a publicity fee of A\$250 to the applicant in each instance. Failing the exercise of such option or right to publication within 6 calendar months of the date of presentation of the award, the applicant or applicants shall be at liberty to make his or her own arrangements for publication.

TRAVELLING FELLOWSHIP CONTRACT

The successful applicant or applicants shall be required to enter into an agreement in the form of an exchange of letters setting out the conditions attaching to this award prior to presentation of the award.

ADDRESS

All papers must be submitted to the AILA Secretary at the following address no later than 5.00 p.m. Friday, 25 June, 1993.

Philip J. Rowell

Secretary

Australian Insurance Law Association Ltd

C/- Ebsworth & Ebsworth

10th Floor, 565 Bourke Street

MELBOURNE VIC 3000

Receipt of papers will be acknowledged but no other correspondence will be entered into.

Any enquiries regarding guidelines or conditions contact the AILA Secretariat.

DAVID I. ABELL

David Abell is the Manager, Risk Management Research in the ANZ's Group Risk Management section. This section is responsible for placing the Group's global insurance programme which protects over 40,000 staff and about \$100 billion in assets in 40 countries. Before joining the Bank in 1987 David worked in the Insurance broking industry.

David has Bachelor of Business with majors in accounting and insurance as well Graduate Diplomas in Corporate Risk Management and Banking & Finance. He is completing a Master of Business (Accounting & Finance) at the Victoria University of Technology. David's minor thesis topic is on Directors' & Officers' Liability insurance.

David is also a Fellow of the Australian Insurance Institute, a Senior Associate of the Australian Institute of Bankers and an Associate of the Australian Society of Certified Practising Accountants.

SYNOPSIS

The Statewide Tobacco, National Safety Council & AWA decisions have generated a good deal of comment in business circles and in the media. References have been made in legal and business journals as to the importance of Directors' and Officers' Liability (D & O) insurance when discussing these court decisions. Unfortunately, for the purchasers of this class of insurance there is very little written material as to how to adequately evaluate the different D & O insurance policies offered by underwriters.

This paper examines the background of this class of insurance and suggests a way of comparing the various policies offered by the insurance market and a number of risk minimisation strategies. The policy wordings surveyed for this research paper were from the following insurance companies:-

- * American Home Assurance Company Limited. (A Member Insurance Company of American International Group)
- * C.E. Heath Underwriting and Agency Services Ltd
- * Chubb Insurance Company of Australia Limited
- * FAI General Insurance Company Limited (1991 & 1992 policy wordings)
- * Lloyd's of London (1991 & 1992 policy wordings - Australian contract - from the Reg Brown & Others Non-Marine Syndicate 702)
- * Pacific Indemnity Underwriting Agency Pty Ltd

- * State Insurance Office of Victoria (now owned by GIO of NSW)

Exhibit 5 is a questionnaire designed for purchasers of a D & O insurance policy in order that they may better understand the effects of policy coverage. The purchaser's professional insurance adviser should be requested to complete (and sign) the questionnaire and then fully explain the coverage restrictions of the recommended policy prior to the inception date of the insurance contract.

A brief review of the East End Real Estate decision has been undertaken when discussing the basis of the "claims made" D & O insurance policy wording. Indirect losses associated with D & O insurance claims are discussed together with risk management strategies for minimising the likelihood of incurring such claims. Appendices 1 and 2 have been included to deal with, respectively, the AWA apportionment of liability judgement and the proposed changes to the Corporations Law 1991 section relating to the indemnification of company officers and auditors.

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Review of Directors' & Officers' Liability Insurance
Policy Wordings In Light Of The Statewide Tobacco, National
Safety Council, AWA & East End Court Decisions.

An American insurance journal once reported:-

"To err is human; to forgive is not always economically feasible or legally required".¹

There have been several Court decisions² over the last 3 years that have confirmed the extensive personal liability exposure of directors and other persons involved in the management of a company. This paper looks at the following three decisions:-

- Statewide Tobacco Services Limited v Morley (1990) 8 ACLC 827
Statewide Tobacco Services Limited v Morley (1992) 10 ACLC 1233
- Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946
(which is commonly known as the "National Safety Council" decision)
- AWA Ltd v Daniels (1992) 10 ACLC 933
AWA Ltd v Daniels (No 2) (1992) 10 ACLC 1643

because not only are they the most recently decided but also it is considered that these decisions may explain the direction in which the law is moving regarding the assignment of personal liability in corporate governance or management of a company.

¹ Attributed to David S. Oppenheim, December 1979 issue of the American Insurance Law Journal. Quote found in a Risk Management presentation handout provided by the international insurance brokers Marsh & McLennan (Melbourne office, 360 Collins Street).

² Some recent cases involving the liability of directors resulting from insolvent companies incurring debts are as follows:-

- * Heide Pty Ltd T/A Farmhouse Smallgoods v Lester (1990) 8 ACLC 827
- * Group Four Industries Pty Ltd v Brosnan (1991) 9 ACLC 1
- * National Companies and Securities Commission v Sharp (1990) 1 ACLC 223
- * Hussein v Good (1990) 8 ACLC 390
- * Castrisios v McManus (1991) 9 ACLC 287

The first two decisions relate to actions taken under Section 556 of the Companies Code 1981 (now Section 592 of the Corporations Law 1991) which is titled "Offences relating to incurring of debts or fraudulent conduct." As the name suggests, this section is concerned with fixing joint and several personal liability on directors or persons concerned with the management of a company for the company's debts incurred when there were reasonable grounds to expect that the organisation would not be able to meet all its debts as and when they fell due for payment. It is a defence to such an action if the person concerned can establish that either:-

- a) the debt was incurred without his or her express or implied authority or consent; or
- b) at the time when the debt was incurred, the person did not have reasonable cause to expect that the company would not be able to pay all its debts as and when they became due.

The above section has become increasingly popular as a means of enabling creditors of a company to lift the corporate veil and to recover outstanding debts owed to them by insolvent companies by fixing liability on individuals.

The AWA case does not deal with the issue of lifting the corporate veil but with the intertwining responsibilities owed to a company by its executive and non-executive directors as well as those owed to the corporate body by the senior management and its auditors. Should the company suffer a loss due to the failure of these personal duties owed to it then the person(s) concerned could become personally liable to the organisation for such a loss.

The object of Directors' & Officers' Liability insurance is to offer protection to a person³ where they become personally liable for either a debt of or a loss (including opportunity loss of income) incurred by the organisation resulting from the commission of a wrongful act as defined in the policy. Before discussing this form of insurance it is considered advisable to first briefly review the facts and the reasons behind the decisions of the three cases being discussed.

³ Be they a director and/or an employee of the company.

Statewide Tobacco

On the 28 August, 1990 Mr Justice Ormiston in the Supreme Court of Victoria found Mrs Morley liable to a creditor (Statewide Tobacco) for the sum of \$165,290.⁴

Facts:- Mrs Morley had been the major shareholder in a small family company that was wound up by Court order in November, 1988. She had been a shareholder and a director of the company since 1959 yet had taken no part in its management. In 1978 Mrs Morley's son had taken over the responsibility of managing the company from Mrs Morley's husband who was the company's Governing Director. However, the son, Mr Ian Morley, was never appointed to the position of Managing Director but acted only as one of the board who had the functions of management delegated to him by his fellow directors. Mr Morley junior held no formal office under the company's Articles of Association and was dependent on the continuation of the authority informally given to him by the other two directors, his mother Mrs Morley and his sister Mrs Sloan. In addition to this, once Mr Ian Morley took over the business he discontinued his father's practice of providing regular reports to Mrs Morley.

The Court heard that Mrs Morley signed certificates for inclusion in the company's annual return as well as providing the required statement as a director with respect to the filed annual accounts as required by Section 269 of the Companies Code 1981.⁵ This Section deals with a director's obligations in relation to the issuing of a company's annual Profit & Loss Account and Balance Sheet.

When the family company went into liquidation⁶ in November, 1988 one of its suppliers (Statewide Tobacco) commenced action against Mrs Morley to recover the debt owed to it by the company.

⁴ Affirmed on appeal (1992) 10 ACLC 1233.

⁵ Now Sections 292 to 303 of the Corporations Law 1990.

⁶ With a net deficiency of liabilities over assets well in excess of \$300,000.

Held:- Mrs Morley was held personally liable to the pay \$165,250 debt owed to the supplier by the family company. The Court held that:-

1. A director cannot establish that a relevant debt was incurred without his express or implied authority or consent⁷ if the director participated as one of the board conferring authority to act on another person. Mr Justice Ormiston held that it is immaterial whether the authority related to a particular debt or was of a general nature.

On this issue his Honour said:-

"It is sufficient to repeat that she and her daughter agreed in 1979, albeit informally, with their co-director Mr Ian Morley that he should continue to manage the company on their and its behalf. The general authority so conferred was sufficient to authorise the incurring of the debts which the plaintiff now seeks to enforce against the defendant pursuant to sec. 556. It likewise follows that those debts were incurred with her implied authority within the meaning of the paragraph".⁸

2. In relation to the second defence under Section 556 the duties of directors now require the individual director to devote some attention to the affairs of the company. Consequently, the failure to make an enquiry regarding the company's financial affairs will not be regarded as reasonable in all the circumstances. On the question of "reasonable cause" Mr Justice Ormiston said:-

"...because the defendant must prove a negative and one related to the ability of the company generally to pay its debts as and when they become due, the question of the director's reasonable cause for expectation is not related to a specific debt but to the financial position of the company generally. Thus the issue is directed to what the director might reasonably know and understand of the company's general financial position at the relevant time. In the light of the various duties now imposed upon the directors, it would not appear unreasonable that they should apply their minds to the overall position of the company. In other words, a defendant is not entitled to say that he or she was told a minimal number of facts about the company's financial affairs but chose to ignore the possibility of other facts, or at least failed to enquire further as to other relevant facts".⁹

In reaching its decision the Court held that Mrs Morley had over a number

⁷ As required by the first defence under Section 556(2) of the Companies Code 1981 now Section 592 (2) of the Corporations Law 1991.

⁸ Statewide Tobacco Services Limited v Morely (1990) 8 ACLC 827 at 843.

⁹ Statewide Tobacco Services Limited v Morely (1990) 8 ACLC 827 at 843.

of years breached her directorial obligations¹⁰ in relation to the preparation of the company's accounts. This annual obligation required the signing director to declare that there were reasonable grounds to believe that the company was able to pay its debts as and when they fell due. This annual statement was required under Section 269(9) (a) (iii) of the Companies Code 1981.

In finding Mrs Morley liable for the company's debt Mr Justice Ormiston concluded:-

"I would repeat, however, that the present case concerned a director who paid no attention to the company's affairs at the relevant time, and to none of her relevant duties, and that it does not follow that those directors who do their best to attend to a company's financial affairs will be held not to have satisfied the defence available under para (b) if they have reasonably applied their talents, however modest they may be, to the running of the company".¹¹

Court of Appeal: On the 24 July, 1992 the Supreme Court of Victoria, Appeal Division dismissed Mrs Morley's appeal. The court concluded its decision with a fitting quote from Mr Justice Rogers decision in Naffai v Haines¹²:-

"As the judgement of Ormiston J in Statewide Tobacco v Morley has vividly reminded us, the days of the sleeping, or passive, director are well and truly over".¹³

¹⁰ Refer to Section 269 of the Companies Code 1981.

¹¹ Statewide Tobacco Services Limited v Morely (1990) 8 ACLC 827 at 849.

¹² Unreported, N.S.W. Court of Appeal, 26 November, 1991.

¹³ Statewide Tobacco Services Limited v Morely (1990) 10 ACLC 1233 at 1246.

National Safety Council ("NSC')

On the 3 July, 1991 Mr Justice Tadgell in the Supreme Court of Victoria found Mr Eise liable to a creditor of the NSC, the Commonwealth Bank of Australia (hereafter referred to as the CBA) for the sum of \$97 million.

Facts: Mr Eise was an honorary and part-time chairman of NSC, the principal activities of the NSC being the provision of safety and emergency rescue services. From May 1988 through to March 1989 the State Bank of Victoria (now the CBA) lent the NSC almost \$97m. Throughout this period the NSC was insolvent. At the time (April, 1989) the company was ordered to be wound up it had a deficiency of liabilities over assets amounting to \$258m. The primary cause of the NSC's loss was the fraudulent borrowings of its Chief Executive Mr J. Friedrich.

The annual reports produced by the NSC emphasised its modern equipment and successful operations. However, the reports provided little, if any, financial information. In fact, after the company went into liquidation it was established that over the years Friedrich was able to systematically overstate both income and assets of the NSC. The Court found that the extent of this overstatement was as follows:-

	Company's Accounts \$000	Liquidator's Estimate \$000	Estimated Overstatement \$000
1986			
Turnover	42,781	5,084	37,697
Profit (Loss)	2,449	(33,416)	35,865
1987			
Turnover	60,424	6,544	53,880
Profit (Loss)	783	(50,435)	51,218
1988			
Turnover	88,694	6,197	82,497
Profit (Loss)	544	(65,644)	66,188

	Company's Accounts \$m	Liquidator's Assessment \$m	Difference \$m
1986			
assets	99	47	52
liabilities	76	<u>91</u>	<u>15</u>
net assets (liabilities)	<u>23</u>	<u>(44)</u>	<u>67</u>
1987			
assets	155	51	104
liabilities	<u>131</u>	<u>145</u>	<u>14</u>
net assets (liabilities)	<u>24</u>	<u>(94)</u>	<u>118</u>
1988			
assets	296	113	183
liabilities	<u>269</u>	<u>273</u>	<u>4</u>
	<u>27</u>	<u>(160)</u>	<u>187</u>

The Court was informed that Mr Eise, who was 73 years old at the time of the company's winding up, played a reasonably active role in the day-to-day operations of the NSC. He was a former manufacturer of plumbing fittings who sold his successful business in 1964. He was a councillor for the City of Brighton for 13 years and its mayor for the years 1971 and 1972. Mr Eise had been a director of the NSC since 1968 and its president since 1972. He told the court that he only had a passing acquaintanceship with commercial principles. Furthermore, except for his plumber's licence he had no post-secondary qualifications. In relation to the financial affairs of the NSC Mr Justice Tadgell found:-

"By and large, he (Mr Eise) confined himself to the bottom line and was content with a balance sheet that showed an excess of assets over liabilities and a profit and loss statement that showed an excess of revenue over expenditure."¹³

¹³ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 at 963 (Emphasis added).

The Court was informed that in June, 1977 Mr Friedrich joined the NSC as a regional consultant and safety officer in the LaTrobe Valley. In 1982 the retiring Chief Executive of the NSC recommended that Mr Friedrich be his replacement. This was accepted by the Board and the Court found that:-

"According to Mr Eise, Friedrich claimed upon his appointment that he had a first-class knowledge of the company's operations. He requested a free hand in the conduct of those operations and the Board agreed."¹⁴

In January, 1988 Mr Friedrich was awarded the Medal of the Order of Australia in the Australia Day Honours list.

The Sydney Sun-Herald, in October, 1988, ran a long and unfavourable¹⁵ article on the NSC. Upon reading the article Mr Eise commenced to investigate Mr Friedrich's past. Mr Eise went so far as to raise the matter with the Victorian Chief Police Commissioner. However, his enquiries into Mr Friedrich's past proved inconclusive though he suspected that the NSC's Chief Executive might be an illegal immigrant. Unfortunately, for Mr Eise, he did not raise these concerns with his fellow board members. Consequently, Mr Friedrich was permitted to raise additional funds on the behalf of the NSC. Since the publication of the unfavourable article in early October, 1988 to January, 1989 the NSC's overdraft went from \$12 million to \$22 million. The Court was informed that on 26 January, 1989 the NSC's total liability to the State Bank of Victoria exceeded \$103 million.

The Court stated categorically that there was no question of fraud on the part of Mr Eise. However, his Honour found that the financing of the NSC's operations from 1985 onwards (at least) were left by the Board to Mr Friedrich and many of the arrangements he made were fraudulent. In addition to this, the court found that the directors of the NSC (like Mrs Morley in the Statewide Tobacco case) were errant in relation to their obligations under Section 269 of the Companies Code 1981. It was discovered in 1989 that the auditor's reports for 1986 and 1987, both of which had qualified the accounts, were not attached to the accounts which were presented at the annual general meeting.

¹⁴ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 at 963.

¹⁵ Especially in relation to some financial dealings involving the NSC.

Furthermore, neither of these reports were read by any of the directors of the NSC either before or after the meeting.

Held:- Mr Eise sought to rely on Section 556 (2) (b) (i) of the Companies Code 1981 which provides a defence where it can be established that the person concerned did not have reasonable cause to expect that the company would not be able to pay all its debts as and when they became due. However, this was rejected by the judge as the court found that the NSC's 1987 accounts disclosed numerous concerns which were sufficient to put a diligent director on notice. Mr Justice Tadgell said:-

"The company was not an elementary organisation operating in a backyard, but one with a stated annual turnover of \$60 million, having stated liabilities of at least \$131 million and the use of very substantial resources and some hundreds of employees, its affairs demanded an appreciable degree of diligent application by its directors if they were to attempt to do their duty. The deserved degree of application should have enabled an appreciation by a director of its 1987 accounts and the audit report thereon at least to the extent I have indicated."¹⁶

Counsel for Mr Eise also applied for statutory discretion from the Court under Section 535¹⁷ of the Companies Code 1981. This Section enables the court to relieve a person from liability on the basis that he had acted honestly in all the circumstances of the case and ought reasonably to be excused. His Honour rejected this argument Mr Justice Tadgell found that for at least the last two years, 1986 and 1987, there had been serious breaches of the Companies Code 1981 with respect to the preparation of the annual accounts and the reports provided by the directors of NSC. To further damage the case against Mr Eise it was found that for each of those years the accounts bore a statement signed by him which was purported to be made in accordance with a resolution of the directors pursuant to Section 269(9) (a) of the Companies Code 1981. This resolution related to the fact that the directors believed that the company was capable of paying its debts as and when they fell due and that they considered both the Profit & Loss Account and the Balance Sheet represented a "true and fair" view of the NSC's financial position.

¹⁶ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 at 1002.

¹⁷ Refer to Exhibit 1 which states Section 1318 of the Corporations Law 1991.

The Court found that Mr Eise's signing of these statements was in direct contravention of the Companies Code 1981. Mr Justice Tadgell said:-

"Central to Mr Eise's downfall was his signing on 26th February 1988 a statement of the directors and a directors' report. In doing so he represented that the directors had both considered the 1987 accounts and expressed an opinion on them conformably with S. 269(a) of the Code, when in truth they had done nothing of the kind. He thus falsely represented to those present at the annual general meeting, and to every member and every creditor who cared to refer to the accounts, that the Board had complied with its obligations under the Code in relation to the accounts. Worse than that, Mr Eise himself had not had any opportunity to look at the accounts and yet he represented that he had done so and that they were accounts on which members and creditors could rely."¹⁸

In refusing relief under Section 535 his Honour held:-

"Fraudulent though Friedrich's conduct was, it appears to me probable that he would not have been able to achieve his purpose in obtaining for the company the very large advances from the State Bank if Mr Eise had not compromised so seriously his performance of his own obligations. If, in the face of Mr Eise's conduct, I were to apply S. 535 in his favour, I should do a serious disservice to the administration of the Code and to the commercial community."¹⁹

Counsel for Mr Eise attempted to attribute the blame for the State Bank's loss on the financial institution's imprudent lending practices. The Court was informed that:-

"Mr Eise was said in particular to have been devoted to the company and was plainly as much a victim of Friedrich's fraud as was the State Bank of Victoria. It was said to be inequitable that the bank, having presumably far greater resources to investigate the financial position of the company than Eise had, and not having used them, should be allowed to recover the company's debts from an individual director."²⁰

¹⁸ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 at 1012.

¹⁹ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 at 1012.

²⁰ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 at 1011.

Mr Justice Tadgell in his conclusion responded to the above plea by saying:-

"The third reason is that there are or may be grounds to think that the State Bank of Victoria was imprudent in making advances to the company in the circumstances that it did. The fact remains that the company had the benefit of the advances and it thus incurred the debts. Section 556(1) does not draw a distinction between a wise and a foolish lender to whom the company incurs a debt in the circumstances it describes."²¹

His Honour concluded by stating that it was the responsibility of the Court to carry out the requirements of Section 556. If the Section seemed to be too severe then only the Parliament could remove or vary it.

AWA v Daniels

Mr Chief Justice Rogers of the Supreme Court of New South Wales held that AWA's auditors Deloitte Haskins & Sells (hereafter referred to as Deloittes), had been negligent in their duties but that the company itself was contributorily negligent. The cross claims against the non-executive directors and AWA's banks, Westpac and Lloyds, were dismissed. The cross claim against the Chief Executive Officer and Chairman of AWA was allowed.

Facts:- AWA took action against its former auditors, Deloittes for negligence in relation to the conduct of the audits for the year ended 30 June 1986 and the period ended 31 December 1986. AWA alleged that the auditors were negligent in not bringing to the attention of the company to:-

- (1) the full extent of the activities of Mr Andrew Koval, the foreign exchange manager of AWA. Mr Koval's foreign exchange hedging activities resulted in the company suffering a \$43 million loss; and
- (2) the deficiencies in AWA's accounting structure and internal control procedures.

The auditors denied liability. They also claimed submitted that if they were found to be liable, then AWA was contributorily negligent. Deloittes also cross claimed against the directors of AWA and against two of AWA's banks, Westpac and Lloyds, on the basis that these banks had:-

- (1) extended unauthorised loans to AWA at Koval's request, and they had
- (2) failed to disclose the existence of large borrowings by Koval, in the name of AWA, in responses to circular letters written to them by the company's Auditors.

The Court found that AWA was run by a Board consisting of Mr Hooke, who was Chairman and the company's Chief Executive Officer, and 4 non-executive directors. Mr Hooke was also a director of several other major Australian

²¹ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 at 1031-1014. Also refer to page 1012 column 1 paragraph 2.

companies including BHP and the National Australia Bank. The non-executive directors were, with the exception of Mr Lewis, considered by the Court to be "as close to professional directors as Australia has them." At the time of the audits his Honour found AWA to be a company:-

"...of some considerable substance. It carried on business throughout Australia and New Zealand and had factories, or offices, in the UK, the USA, Thailand and Hong Kong. Its activities extended as well to China, India, Nepal, Malaysia, Singapore, Indonesia, Papua New Guinea, Fiji, the Middle East, South America, Spain and Italy. It had 6,600 employees with an annual turnover over \$500 million and total tangible assets of \$397 million. Its activities extended over a very wide spectrum of manufacturing and trade."²²

In December, 1983 the Australian dollar was floated. Because AWA had a large exposure to foreign currency fluctuations in relation to the purchase of imported material the senior management of the company appointed, unbeknown to the Board, AMP Acceptances Ltd to prepare a report for AWA covering all aspects of its currency exposure position and make recommendations as to "action required to achieve optimum management." A very detailed report was received in February, 1985. Some of the report's recommendations were as follows:-

- * a selective hedging and future foreign exchange exposure management strategy.
- * recruitment of an experienced foreign exchange dealer manager (who would be at least 25 years old) with 3-5 years dealing experience in foreign exchange management and systems with either a trading or merchant bank.
- * a warning to AWA's senior management that managing foreign exchange risks was a highly technical and specialist area, and
- * the introduction of a supporting computer system so that whatever contracts were entered into or closed out, would be recorded thereby providing a facility to assess cash flows and foreign exchange exposures.

²² AWA Ltd v Daniels (1992) 10 ACLC 933 to 988.

His Honour said:-

"Neither Koval, nor the system, if it can be called that, put in place by him (Mr Mileham the then Chief Accountant), satisfied the AMP specifications".²³

The first foreign currency contract was entered into by Koval, on behalf of the company, in about September, 1985. Mr Koval had come to AWA as a trainee accountant and although he had managed the company's money market desk he had no experience in foreign currency dealings. Mr Hooke did not inform the other Board members of the fact that the company was entering into foreign exchange contracts nor that Mr Koval had been appointed to manage the AWA foreign exchange exposure.

In March, 1986 the non executive directors of AWA first became aware that the company was dealing in foreign exchange. Although "no formal resolution of any kind relating to foreign exchange transactions was proposed or passed by the directors at any time" his Honour accepted that at the March, 1986 meeting the

"...directors' view, as it emerged in the discussion was, first, that no risk was to be taken, and second that stop loss orders were to be in place."²⁴

Within the above frame work the company could, with the concurrence of its Board of Directors, manage or trade foreign currency hedge contracts. In August, 1986 the company adopted a budget which set a limit on open foreign exchange contracts that amounted to 2 year's exposed purchases. At the time this translated to a foreign exchange exposure of between \$200m and \$250m. Unbeknown to both to the non-executive directors and AWA's senior management, the unsupervised speculative trading of Mr Koval exceeded the Board's limits by a factor of between 7 and 12.

Initially the new foreign currency strategy adopted by Mr Koval appeared spectacularly successful for AWA. In the 8 months to February, 1987 the company's foreign exchange earnings went 400% over forecast to \$26m and equalling all profits from within the company's other operating divisions. However, the Court found that Mr Koval's activities had in fact led AWA to suffer a loss of \$49.8m. Investigations revealed that only profitable contracts had been disclosed whereas the ones which were in a loss situation were either rolled over or paid for by foreign currency loans.²⁵

²³ AWA Ltd v Daniels (1992) 10 ACLC 933 at 947.

²⁴ AWA Ltd v Daniels (1992) 10 ACLC 933 at 949.

²⁵ At 31 December, 1986 these foreign currency Loans amounted to the equivalent of \$38.8 million.

The Court heard that AWA's auditors discovered that the company's foreign currency operation had no proper system of books and records nor were there effective dealing limits in place or an adequate system of internal control. Furthermore, there was not an adequate segregation of duties and responsibilities. Mr Koval was responsible for the foreign currency dealing, the settlement and accounting functions of the company's foreign exchange department. Although the auditors drew these concerns to the attention of AWA's senior management nothing was done about it. Moreover, when the non-executive directors expressed concern as to the level of profits being made in the foreign currency area they requested the auditors to comment on the authenticity of these profit figures. The auditors failed to alert them to any problems relating to internal control and segregation of duties within the company's foreign currency department. On this issue Mr Justice Rogers said:-

"On two occasions the Board had Daniels attend meetings to speak on foreign exchange results. Although on both occasions Daniels was fully aware of the deplorable state of books and records and the absence of any internal controls worthy of the name in the foreign exchange operations he gave no hint of this to the Board. That in itself served to reassure the Board that all was well."²⁶

In addition to the above his Honour found that during mid to late 1986 a representative of Lloyds bank, with which AWA had foreign currency dealings, contacted the senior management of the company a number of times to express concerns about the size and nature of its foreign currency transactions with the company. This information was not passed onto the Board nor to the company's Chief Executive. Furthermore, Lloyds were informed that AWA was "happy to rely"²⁷ on Koval's expertise and that they had "the greatest confidence in him."²⁸ On other occasions when banks expressed concern about the company's foreign currency operation the senior management of AWA told them to refer the matter to Mr Koval as he handled all of the company's foreign currency work. Finally, his Honour noted that:-

"On a number of occasions from mid March 1987 onwards, Parkes and Binsted of Lloyds Corporate Advisory told Hooke that the profits being made by AWA were too large to come from hedging and he ought to find out what was going on."²⁹

The above concerns were not passed on by Mr Hooke, AWA's Chairman and Chief Executive, to the company's non-executive directors. This was not done even though these same directors had expressed their concern over the company's foreign exchange profits on a number of occasions.

²⁶ AWA Ltd v Daniels (1992) 10 ACLC 933 at 943.

²⁷ AWA Ltd v Daniels (1992) 10 ACLC 933 at 960.

²⁸ AWA Ltd v Daniels (1992) 10 ACLC 933 at 960.

²⁹ AWA Ltd v Daniels (1992) 10 ACLC 933 at 986.

The position the non-executive directors of AWA found themselves in is best summarised by the following words of his Honour when he said:-

"It is fair to say that, throughout 1986-7, the non-executive directors displayed anxiety and concern about the foreign currency activities of the plaintiff, but were reassured by senior management that there was no substantial risk involved in the way the operations were conducted. The fact of the matter is that from beginning to end, senior management, in whom the non-executive directors were entitled to have confidence did not suggest that there were any problems whatsoever with the foreign exchange operation. On the contrary foreign exchange was the jewel in the crown. Senior management, in whose number I include Hooke as Chief Executive, did not share with the non-executive directors disturbing information which came to hand. A principal source of reassurance lay in the assertion by senior management that there were stop loss orders in place to ensure that, in the event of any unforeseen fluctuation in the currency market, the necessary steps would be taken to avoid any major loss taking place. In fact, at various relevant times there were no stop loss orders in place."³⁰

Held:- Chief Justice Rogers found that the auditors had been negligent in not informing the Board of AWA of their concerns (having already raised the problem with the company's senior management on several occasions) regarding the company's lack of internal controls in the foreign currency department. However, the Court held that the obligation to limit and supervise employees and to ensure a proper system of internal control lay on the management of AWA and not its auditors. The judge found that the senior management of AWA and its internal auditor not only did not fully understand the operation of the company's foreign currency department but they also failed to adequately supervise Mr Koval's dealing activities. In addition to this, having been alerted by the company's external auditors and its bankers to the potential problems that could arise as a result of Mr Koval's uncontrolled trading, his Honour found that the senior management of AWA did not take any immediate steps to rectify the problem.

³⁰ AWA Ltd v Daniels (1992) 10 ACLC 933 at 943 (Bolding added).

The key implications of the judgement in relation to the duties of auditors are as follows:-

1. There was a legal duty placed on the auditor to assess and comment on the adequacy of the client's internal control system. Failure to provide such a commentary when the system proved inadequate could not be expected to be successfully defended on the grounds that such commentary was a mere "matter of grace." Mr Justice Rogers held it to be a discharge of a legal duty.
2. The auditors, having detected a deficiency in the client's system of internal control, owe a duty to the company to raise the issue at the appropriate level of management. Having regard to the seriousness and urgency of the matter, the auditors have a duty to raise the issue with the Board if senior management do not rectify the problem within a reasonable time frame.
3. The technical capability of the audit team must be at a level which will enable it to adequately undertake the task at hand. For example, where an audit involves technical business activities such as foreign exchange trading, the auditor must ensure that there is an appropriate level of technical expertise within the audit team in order that it will be able to report accurately on the true position of the client's business.
4. The growing legal importance of published (for example Statement of Auditing standards AUS1 and AUP12) accounting and auditing standards and statements of practice was emphasised. His Honour held:-

"...while it is true that professional practice is not always determinative of the breach of legal duty, in a matter such as this it is not a bad indicator."³¹

In addition to this the Court found that the auditors disregarded their own Audit Manual which stated:-

"The report should be addressed to the managing director, finance director or chairman or to the board of directors (depending on the circumstances and the client's wishes)... It should not normally be addressed to someone below board level, unless the matters dealt with in the report are of relatively minor importance."³²

³¹ AWA Ltd v Daniels (1992) 10 ACLC 933 at 965.

³² AWA Ltd v Daniels (1992) 10 ACLC 933 at 963 (Bolding added).

His Honour found that the auditors had been negligent in relation to the signing of the profit statement of 9 March, 1987 as well as failing to inform the Board of the state of internal controls, the lack of proper accounting records and the absence of segregation of duties in AWA's foreign currency department. However, as it was the company's responsibility to adequately supervise its employees in addition to instigating an appropriate system of internal control, the Court found that contributory negligence will reduce the amount of damages that AWA will be able to recover from its auditors. His Honour said:-

"The negligence of the auditors on 22 September, was followed by and its consequences refreshed by further acts of negligence each step of the way up to 30 March, 1987. These acts of negligence ran in tandem with those on the part of Hooke and management."³³

Chief Justice Rogers stated that if he was wrong in his view that the Auditors were able to use the defence of contributory negligence then he believed they would gain relief from Section 1318 of the Corporations Law, 1990 (refer Appendix 1). This section allows the Court to excuse the liability of any person (including auditors) where it thinks:-

"...having regard to all the circumstances of the case...the person ought fairly to be excused for the negligence..."³⁴

The Court dismissed the **cross claims against the banks**. These allegations were based on a claim that Mr Koval lacked the authority to borrow, on behalf of AWA, in foreign currency. His Honour found that Mr Koval had been impliedly authorised by AWA to do what was a normal part of an foreign exchange manager's business. Part of such a business included borrowing in a foreign currency to manage the company's foreign exchange position. Furthermore, the fact that AWA paid the principal and interest on these loans added weight to the impression that Mr Koval had authority to undertake such borrowings.

³³ AWA Ltd v Daniels (1992) 10 ACLC 943.

³⁴ Refer to Appendix 1, Section 1318 of the Corporations Law 1991.

Although the senior management (including the Chief Executive and Chairman) of AWA were found to have acted negligently the company's non-executive directors managed to escape liability because it was established that the Board of Directors had put in place a set of broad principles which, so far as they knew, were being followed. Consequently, the non-executive directors were entitled to rely upon the senior management of AWA to establish appropriate systems of internal control and accounting which would give effect to these principles. Having become concerned at the level of profits being generated by the company's foreign currency department the non-executive directors of AWA, on a number of occasions, requested assurance from the organisation's senior management and its auditors that their policy of "no risk" and "stop loss orders" was being implemented. His Honour found:-

"...no information came their way to suggest anything untoward was taking place. It was in this respect that they (the non executive directors) were in a completely different position from Hooke (the company's Chief Executive and Chairman)... It is only if they had in truth had a knowledge of the true facts that their in action could have been described as negligent. As matters stood it was not negligence."³⁵

Mr Hooke, the Chief Executive Officer of the company, was found to have acted negligently. It was established that he had adopted a policy of "kid gloves" treatment of Mr Koval because he was apparently producing spectacular profits for the company and he did not want to lose him. Moreover, in view of the possibility of a takeover from the Skase group it was essential that the stream of profits emanating from the company's foreign currency department be continued. The Court found Mr Hooke, as Chief Executive, should have responded to the cautionary statements received from senior management, the auditors and outside advisers by making enquiries and taking remedial action. His Honour said:-

"Hooke was the chief executive, not the auditors. It was for Hooke to decide on the appropriate action. One course that was certainly not appropriate was to fail to share with the non-executive directors, the information both from the auditors and from others."³⁶

The Chairman of the Board, the Court held, had primary responsibility for selecting matters and documents to be brought to the attention of the Board, for formulating its policy and promoting the position of the company. Consequently, the Chairman owes a higher duty to the company to inform himself of its business activities and to scrutinise them than do the non-executive directors of the same organisation. Finally, Mr Justice Rogers found that where the positions of Chairman and Chief Executive are combined, there must be co-operation with the company's senior management and the role is a "very sensitive"³⁷ one.

³⁵ AWA Ltd v Daniels (1992) 10 ACLC 933 at 1020 (Emphasis added).

³⁶ AWA Ltd v Daniels (1992) 10 ACLC 933 at 1021.

³⁷ AWA Ltd v Daniels (1992) 10 ACLC 933 at 1015.

Chief Justice Rogers has handed down an "interim" judgement in that he has found AWA's auditors were negligent in the preparation of the two audits in 1986 while at the same time recognising that the company's senior management also contributed to the organisation's loss by failing to properly supervise staff and implementing an inadequate system of internal control.

Apportionment

Although his Honour is yet to determine quantum, on the 18 November, 1992 he presented a further judgement regarding the apportionment of liability. Chief Justice Rogers has allocated liability on the following basis:-

AWA (Contributory Negligence)	20%
Deloittes (Negligence)	<u>80%</u>
	<u>100%</u>

AWA's then Chief Executive, Mr Hooke, was required to contribute (as a concurrent tortfeasor) to 10% of the amount awarded against the Auditors. Therefore, the effective apportionment between the parties is 20%, 72% and 8% respectively. His Honour held that Mr Hooke was not entitled to relief under Section 535 of the Companies Code 1981 (now Section 1318 of the Corporations Law 1991) stating that:-

"Honest bungling is no appropriate basis for relief from liability"³⁸

In his judgement on quantification, which was issued on 7 April, 1993 Mr. Justice Rogers determined³⁹ that the auditors liability towards AWA's \$38m loss amounted to \$12.25m plus interest.

Analysis and Implications of the Decisions

Two of the three cases studied involve statutory liability to creditors arising from incurring debts through insolvent trading whereas the other concerns a common law action for breach of contract and negligence. However, a common theme in these decisions is the responsibilities owed by directors and those persons concerned in the management of a company. Failure to adequately discharge such responsibilities may result in the person incurring personal liability to either the company or a creditor of the company.

In the Statewide Tobacco⁴⁰ decision Mrs Morley, a non executive director, who for a number of years received a substantial income from a small family company yet took no part in its management; was found personally liable for the debts of that company. Mr Justice Ormiston, in this case, did not follow the Court of Appeal decision in Metal Manufactures v Lewis (1988) 6 ACLC 725 which dismissed the case against a non-executive director who took no part in the governance of the company.

³⁸ AWA Ltd v Daniels (No 2) (1992) 10 ACLC 1643 at 1658.

³⁹ Refer to Appendix 1 for further details on Chief Justice Rogers' judgements determining apportionment and quantification between the parties.

⁴⁰ Statewide Tobacco Services Limited v Morely (1990) 8 ACLC 827.

Mr Justice Tadgell, in utilising the reasoning of the Statewide Tobacco decision, held Mr Eise liable for the debts of the National Safety Council.⁴¹ Mr Eise (also a non-executive director, who unlike Mrs Morley in Statewide) took a reasonably active role in the day-to-day activities of the company yet received no remuneration for his services.

Both Mrs Morley and Mr Eise were found to have breached Section 556 of the Companies Code 1981. Consequently, they were held to be liable for the payment of their respective company's debts which were incurred when there were reasonable grounds to expect that the companies would not be able to pay all the debts as and when they fell due for payment. However, in dismissing the argument that the directors were able to rely on the secondary defence, both Justices took into account not only the breach of Section 556 but also the contravention of Section 269 of the Companies Code 1981. This latter section deals with a director's statutory obligations in relation to the preparation⁴² of the yearly Profit & Loss Account and Balance Sheet and the annual statement indicating that the company could pay its debts as and when they fell due. As a result of these failures both non-executive directors were held liable for not taking an active interest in the financial affairs of their respective companies.

In the AWA v Daniels⁴³ case the auditors cross claimed against the three former non-executive directors of the company. Because the Court found that these directors repeatedly requested assurance from the company's senior management and its auditors that risks were not being taken in relation to its foreign exchange operation and more specifically that stop-loss orders were in place, Chief Justice Rogers held that these directors had not been negligent and had discharged their duties properly. His Honour concluded:-

"the opportunity for non-executive directors to exercise meaningful control over management is as slight as the ability of ministers to control a vast bureaucracy."⁴⁴

The lesson, emanating from the AWA decision, for the executive directors and senior managers of a company is important. The senior management of a corporation has primary responsibility for staff supervision and the installation of an adequate system of internal control. Consequently, a company which suffered a loss because its senior management failed in meeting these responsibilities, cannot look to its auditors (even where they have acted negligently) to recover 100% of the loss.

⁴¹ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 (which is commonly known as the "National Safety Council" decision).

⁴² As well as the submission of the accounts to the annual general meetings of the company.

⁴³ AWA Ltd v Daniels (1992) 10 ACLC 933.

⁴⁴ AWA Ltd v Daniels (1992) 10 ACLC 933 at 1023.

Finally, as indicated in the AWA segment of this paper, Chief Justice Rogers found that the position of Company Chairman held greater responsibility than any other director for formulation of company policy as well as the performance of the Board as a whole and each member on it. Furthermore, where the Chairman also holds the position of Chief Executive then the role is a "very sensitive" one. This is because the dual officeholder is not only the channel of communication between the Board but also between management and the Board. In the AWA case Mr Hooke's negligence⁴⁵ came not from his position as an executive director but as Chief Executive, a management position.

The implications of these decisions is clear. Failure to adequately address the duties owed to a company or its creditors could well result in incurring personal liability. One method for minimising the costs of such an exposure is to consider the merits of Directors' & Officers' Liability insurance. However, those people taking out this form of insurance should not assume that it is a panacea for the elimination of such a liability.

⁴⁵ Mr Hooke's negligence resulted from his failure to act upon or communicate information received by him to AWA's Board of Directors.

Purpose of this Paper

As indicated earlier, the judgements in the previous section have forced company office-holders, management and employees to review the importance of Directors' & Officers' Liability insurance policies.

The purpose of this paper is to:-

- a) briefly explain the difference between a Professional Indemnity and a Directors' and Officers' Liability (D & O) insurance policy,
- b) discuss the D & O insurance policy's major enhancements/restrictions, exclusions, extensions, and excesses,
- c) review the indirect uninsured losses associated with a D & O insurance claim, and to
- d) suggest risk management procedures for minimising the likelihood of incurring a D & O insurance claim.

The categories of persons responsible for conducting the affairs of a company are as follows:-

- (i) directors - those persons appointed to the office of director so as to be responsible for the direction of the company;
- (ii) officers - senior employees (ie company secretary and executives) responsible for managing the company; and
- (iii) employees - those other employees not responsible for either the direction or management of the company.

Directors, officers and employees owe not only a common law duty and contractual obligation to their organisation, but they may also be subject to either civil and/or criminal liability arising from offences due to breaches of any of the following statutes:

- * Anti-discrimination Act 1984
- * Corporations Law 1991
- * Crimes Act 1972
- * Environmental Protection Act 1978
- * Equal Opportunity Act 1987
- * Fair Trading Act 1985
- * Income Tax Assessment Act 1936
- * Industrial Relations Act 1988
- * Life Insurance Act 1945
- * Occupational Health & Safety Act 1991
- * Occupational Superannuation Standards Act 1987
- * Stamp Duties Act 1942
- * Trade Practices Act 1974
- * Various trustees acts and other relevant legislation

This list is not exhaustive, but gives an indication of the plethora of legislation which may fix such liabilities.

A Directors' & Officers' Liability Insurance Policy usually covers all past, present and future directors, officers and employees of the insured corporation. However, for the purposes of this paper, only the liabilities of directors and officers (ie those people concerned in the management of the company) will be discussed, as the implications of the Corporations Law⁴⁶ 1991 will be the focus of this paper.

⁴⁶ On 1 January, 1991 the Corporations Law came into force throughout Australia. This legislation replaced the existing Companies Code 1981 Companies (Acquisition of Shares) Code 1980, Securities Industries Code 1980 and the Futures Industry Code 1980. The predecessor legislation remains in force and applies where there is no coverage under the Corporations Law. Also, on the same date, the Australian Securities Commission (hereafter referred to as the "ASC") took national responsibility for the administration and compliance with the Corporations Law and the Corporations Regulation.

Professional Indemnity Insurance

The Professional Indemnity Insurance Policy is purchased to protect the employer against liability arising out of breach of professional duty. The policy indemnifies the employer (and in some instances, the employees where they are a "named insured" under the contract) for its legal liability to third parties due to the negligent acts, negligent errors or negligent omission of its employees in the conduct of the employer's business. Although the policy is called Professional Indemnity insurance there is no mention of any skill, judgement or the practicing of any profession in any sense by the insured business or its employees.⁴⁷ Furthermore, there is a generally held view that Professional Indemnity insurance policies do not cover the consequences of deliberate actions.⁴⁸

Typical claims or allegations which would fall within the ambit of the operative clause of a Professional Indemnity policy are as follows:-

- * wrongful or inadequate advice to a client
- * undue delay in dealings
- * acting without proper instructions from a client
- * failure to act in accordance with a client's instruction
- * failure to advise a client.

The Professional Indemnity policy reimburses the insured against liability owed to third parties which it may have incurred as a result of the vicarious liability due to the wrong doings of its employees, the premium is paid by the employer. Directors, who are not also employees of the insured, are not normally covered by this form of insurance. This is because they are considered to be involved with the direction of the insured's business and not its revenue gaining activities.

⁴⁷ "Some aspects of Professional Indemnity Insurance", Page 2, Unpublished Seminar Paper, E. Fick, Partner, Norton Smith & Co. Solicitors.

⁴⁸ Unless these acts are specifically incorporated into the policy as for example in the case of fraud cover. For further details refer to E. Fick paper titled "Some aspects of Professional Indemnity insurance".

Director's & Officer's Liability Insurance

D & O insurance is normally arranged by a company on behalf of its directors, officers and employees to cover them for claims for which they may be personally liable. The policy indemnifies the insured for the legal liability arising out of the commission of a wrongful act or the omission to act, in the course of his or her duties to the company. This is ordinarily reflected in the definition of wrongful act which includes both acts and omissions. A Wrongful Act could be defined as:-

Any actual or alleged, breach of duty, breach of trust, neglect, error, mis-statement, misleading statement, omission, breach of warranty of authority or any other act done or wrongfully attempted by any director or officer or employee or any of them wherever or whenever while acting in their individual or collective capacities as directors, and/or officers of the company named in the policy schedule.⁴⁹

Directors and officers owe a fiduciary duty to the company. Common law requires that they must act honestly, in good faith, and, to the best of their ability, in the interests of the company as a whole. In addition to a Director's fiduciary duty to act honestly and in good faith, they must act with reasonable skill, care and diligence in the exercise of their powers and the discharge of their duties owed to the company.

It is generally considered that a director's or officer's primary responsibility lies with the duties owed to the company. This poses a major problem for directors of public companies who may have allegations brought against them, ranging from mismanagement of the company funds to negligent advice or actions in the face of a takeover threat and commonly today, incurring liabilities when the company is unable to repay its debt. It should not be considered that directors and officers of private companies cannot be sued. In fact the Wyatt report⁵⁰ of 1989 indicates that more than 60% of all D & O insurance claims come from parties other than shareholders. For example, the Australian Statewide Tobacco⁵¹ action involved a creditor successfully suing a director personally for the debts incurred by the company.

Examples of some of the claimants who can initiate action against individual directors and officers are as follows:-

- * Employees - hiring and firing practices, wrongful dismissal, unlawful discrimination, mismanagement of superannuation funds.

⁴⁹ Definition of a wrongful act has been adapted from the Pacific Indemnity Underwriting Agency Pty Ltd policy wording (Draft No. 5 PACD 091), page 3.

⁵⁰ This report provides statistics regarding the genesis of Directors' & Officers' Liability insurance claims in the United States of America.

⁵¹ Statewide Tobacco Services Limited v Morely (1990) 8 ACLC 827.

- regulatory bodies - Australian Securities Commission, Trade Practices Commission, Australian Taxation Office, etc.
- * Competitors - alleging restrictive trade practices.
- * Other Third Parties - Customers, Creditors, Public interest groups and other individuals.

Today's legal environment is one in which the directors' and officers' function becomes increasingly onerous through greater community awareness of rights, greater demand for accountability and information, and a greater willingness of shareholders and other interested parties to bring actions. Consequently, it is essential that directors and officers be familiar with their respective duties and responsibilities, and the civil and criminal liabilities to which they may be exposed in relation to the management of the corporation. In the event that legal action is instituted against a director or officer, his/her personal assets can be at risk. Civil actions may involve the payment of damages, awards of claimants' costs against the director or officer, together with the costs of personal legal representation. Criminal actions, at a minimum, would involve substantial legal expenses even where the defendant is successful.

Joint and Several Liability

Ordinarily, the Board of Directors is vested with the power to manage the company's affairs in accordance with the law and the company's constituent documents. Modern commercial opinion now considers the Board of Directors to be the primary management organ of the company. The Board of Directors are liable jointly and severally and duties are imposed on the directors acting collectively as a board charged with directing the company's affairs. That is, if they are found legally liable, then each director is responsible for the total debts of the company⁵² as well as being liable jointly to do so with others who also share this responsibility. Furthermore, the party bringing the action may sue at his or her option one or more of the persons involved jointly or severally.

Responsibility rests with the individual directors to ensure that they act with propriety and in accordance with the law and the company's constituent documents.

⁵² As was the case with the Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 and Statewide Tobacco Services Limited v Morely (1990) 8 ACLC 827.

Indemnification of Company Officers

Section 232 of the Corporations Law 1991 codifies the Common Law duties of good faith and the exercise of reasonable care which is owed by directors and officers to the company. Although employees who are not executive officers or the company secretary are not covered by the relevant clauses of this section, there is at Common Law an implied term in their contract of service which requires them to exercise reasonable skill up to the standard applicable to their calling.⁵³

If one accepts the broad interpretation⁵⁴ of Section 241⁵⁵ of the Corporations Law 1991, then directors and officers cannot transfer by contract or otherwise their personal responsibilities to the company, nor can they obtain a contract for indemnity⁵⁶ other than a contract of insurance which has not been paid for by their company or a related corporation. The section was intended to accommodate the notion that directors should accept full personal responsibility for their improper conduct, and thus personally compensate those who suffer loss arising from that conduct. The second purpose of Section 241(1) was to reflect the view that unlimited liability acts as an incentive for directors and officers to properly discharge their duties, particularly those of care and skill.

The origin of Section 241(1) is derived from United Kingdom legislation which was passed after the Greene Committee in 1926 expressed⁵⁷ disquiet about provisions in company articles of association under which a director would be relieved from liability⁵⁸ for all but dishonesty. The Greene Committee said:-

"We consider that this type of article gives a quite unjustifiable protection to directors. Under it a director may with impunity be guilty of gross negligence provided that he does not consciously do any thing which he recognises to be improper...

⁵³ Lister v Romford Ice and Cold Storage Co Ltd 1957 AC 55.

⁵⁴ For further details refer to an article titled "Indemnification of company officers" by P Critchfield of Mallesons Stephen Jacques which appeared in the October, 1991 issue of the Law Institute Journal.

⁵⁵ Refer Exhibit 2 for details on Section 241.

⁵⁶ Refer Exhibit 3 for examples of indemnities which are either valid or invalid under Section 241.

⁵⁷ Paragraph 14 of the Companies and Securities Law Review Committee Report No. 10 dated May, 1990 titled "Company Directors and Officers: Indemnification, Relief and Insurance".

⁵⁸ Ibid paragraph 14.

To attempt to define by statute the duties of directors would be a hopeless task and the proper course in our view is to prohibit articles and contracts directed to relieving directors and other officers of a company from their liability under the general law for negligence and breach of duty or breach of trust. We are satisfied that such an enactment would not cause any hardship to a conscientious director or make his position more onerous and, in our view, there is no foundation whatever for the suggestion that it would discourage many otherwise desirable persons from accepting office. A director who accepts office does not do so upon the footing that he may be as negligent as he pleases without incurring liability. It is only when he has been negligent and the company has suffered a loss, that he is content to take shelter behind the article.

It is, moreover in our opinion fallacious to say that the shareholders must be taken to have agreed that their directors should be placed in this remarkable position."⁵⁹

As a result of its finding the Greene Committee recommended:-

"...that any contract or provision (whether contained in the company's articles or otherwise) whereby a director, manager or other officer is to be excused from or indemnified against his liability under the general law for negligence or breach of duty or breach of trust should be declared void. This should extend to contracts or provisions existing at the date when the amending Act comes into force, but as regards such contracts or provisions it should not take effect until (say) six months from that date."⁶⁰

It is interesting to note that the Greene Committee made its recommendation without any reference to insurance against liability⁶¹ arising from the suggested change in legislation. The reason for this was probably due to the fact at that point in time the United Kingdom insurance market did not offer insurance to cover such contingencies as directors personal liability. It was not until the early 1930's that the first Directors' & Officers' Liability insurance policies were issued by Lloyds of London.⁶²

⁵⁹ Paragraph 14 of the Companies and Securities Law Review Committee Report No. 10 dated May, 1990 titled "Company Directors and Officers: Indemnification, Relief and Insurance".

⁶⁰ Ibid paragraph 14.

⁶¹ Ibid paragraph 14.

⁶² Refer page 1 of the Advanced Study Group 226 of The Insurance Institute of London (dated October, 1986) titled "Directors' and Officers' Liability Insurance".

Power of Court to Grant Relief

Section 1318⁶³ of the Corporations Law 1991 provides the court with the discretion to grant relief to the directors, officers and employees whom it considers have acted honestly and reasonably, and with regard to all the circumstances of the case, ought fairly to be excused for the negligence or breach of trust. Section 1318(2) permits a person to apply to the court for relief if he or she "has reason to apprehend that any claim will or might be made against" them "in respect of any negligence, default, breach of trust or breach of duty."

The origin⁶⁴ of Section 1318 pre-dates the Greene Committee recommendations of 1926 and results from a recommendation made in 1906 by the Company Law Amendment Committee which was chaired by Sir Robert Reid (later Lord Loreburn). The Reid Committee's report stated:

"We have already expressed an opinion that the number of companies into the formation or management of which fraud enters is small in comparison with the number of sound undertakings registered and working, under the Acts, and this being so the dishonest director is the exception. We think that nothing could be more unfortunate than that provisions designed for checking or punishing dishonesty or gross negligence should be turned into an engine of oppression for honest and prudent men. Now there are a variety of sections in the Companies Acts which impose upon directors and other persons connected with a company the duty of doing certain acts, making certain disclosures and returns, and furnishing certain information at the risk of incurring a penalty or liability to damages. It would not in our opinion be either safe or wise to diminish these obligations otherwise than, as in this Report suggested, but we do think that it would be both safe and wise to make some amendment in the law which shall prevent such penal provisions from operating unfairly. We therefore recommend that the law be amended:

⁶³ Refer to Exhibit 1 for the operative clause of Section 1318.

⁶⁴ Paragraph 95 of the Companies and Securities Law Review Committee Discussion Paper No. 9 dated April 1989 and titled "Company Directors and Officers: Indemnification, Relief and Insurance".

- (1) By giving power to the Court to relieve any director or promoter from liability for breach of any duty imposed on him by the Companies Acts, 1862 to 1900, provided that the breach has been occasioned by honest oversight, inadvertence, or error of judgment on his part.
- (2) By giving the Court power, in an action for negligence or breach of trust against a director, to relieve him from his liability on such terms as the Court may consider proper, where the Court is satisfied that he has acted honestly and reasonably.

An analogous power, we may point out, has been already given to the Court in the case of trustees by Section 3(1)(a), of the Judicial Trustees Act, 1896."⁶⁵

Only the civil liability recommendation was enacted into Section 32 of the Companies Act 1907 (UK). This section states:

"32. If in any proceedings against a director of a company for negligence or breach of trust it appears to a court that the director is or may be liable in respect of the negligence or breach of trust, but has acted honestly and reasonably, and ought fairly to be excused for the negligence or breach of trust, the court may relieve him, either wholly or partly, from his liability on such terms as the court may think proper."⁶⁶

The fact that Sections 241 and 1318 are related was recognised by the 1926 Greene Committee when it recommended the addition to the provision for relief of words which require the Court to take into account the circumstances of the appointment of a director for a special purpose. That provided "some amelioration"⁶⁷ for the loss of protection under a company's article of association or otherwise that the Greene Committee was recommending⁶⁸ in relation to a company indemnifying a director, manager or officer for negligence or breach of trust.

⁶⁵ Paragraph 95 of the Companies and Securities Law Review Committee Discussion Paper No. 9 dated April 1989 and titled "Company Directors and Officers: Indemnification, Relief and Insurance".

⁶⁶ Ibid paragraph 95.

⁶⁷ Lawson v Mitchell (1975) VR 579 at 589.

⁶⁸ Paragraph 98 of the Companies and Securities Law Review Committee Discussion Paper No. 9 dated April 1989 and titled "Company Directors and Officers: Indemnification, Relief and Insurance".

This is because Section 1318 applies to relieve someone who is first judged to be liable or to be prospectively liable. But both provisions rest on the same basic idea which was seen as the original rationale behind the section as envisaged by the Reid Committee. This idea being that there was a need to avoid imposing liability on those who acted honestly and reasonably.⁶⁹

- **Qualifications to Section 241**

The prohibition contained in Section 241(1) is subject to two exceptions. Firstly, Section 241(2) permits the company to indemnify (subject to its articles) directors, officers and employees for liability incurred in successfully defending civil or criminal proceeding. Secondly, Section 241(3) allows the same class of persons to take out insurance as long as the premium is not paid by the company or a related corporation. Consequently, insurance market practice is to issue two separate policies:

- a directors' and officers' liability policy which protects the directors, officers and employees if their defence of any action brought against them is unsuccessful. However, the loss must fall within the ambit of the D & O insurance policy. Furthermore, the insurance premium must not be paid by the company or a related corporation;
- a company reimbursement policy which protects the company's liability to reimburse directors, officers and employees who **successfully** defend any action brought against them or who have been permitted by the Court to seek indemnity from their company under Section 1318 of the Corporations Law 1991. In this instance the company is entitled to pay the premium.

Directors' & Officers' insurance is intended to provide cover for **honest** mistakes made by directors, company secretaries and other officers concerned in the management of the affairs of the company as well as its employees. Indemnity is provided for "loss" as a result of a "claim" arising out of an insured's "wrongful act". Cover is for damages and legal costs incurred in defending a civil action brought against the insured. In addition the policy will provide cover for legal costs incurred in the successful defence of criminal proceedings.

The definition of "wrongful act" in the policy is very broad and extends to include any error, misstatement or misleading statement, act or omission, or neglect or breach of duty of an insured director or officer in the conduct of his or her duties - in short, everything an insured individual does or fails to do. This definition is drafted to cater for the wide range of employment and directorial activities and the variety of industries in which these people operate.

⁶⁹ Paragraph 109 of the Companies and Securities Law Review Committee Discussion Paper No. 9 dated April 1989 and titled "Company Directors and Officers: Indemnification, Relief and Insurance".

It must be emphasised that a D & O insurance policy does not cover any loss suffered by the company. For example, assume a situation where both the company and an officer are found legally liable under Section 52 and Section 75B of the Commonwealth's Trade Practices Act 1974. The court might make a civil damages award of \$1,000,000 against the company and also hold the officer concerned personally liable for damages of \$100,000 which will be required to be paid to the applicant. In this instance, the D & O insurance policy will pay the \$100,000 plus the associated legal costs of the officer. However, the company will have to find the \$1,000,000 award plus its own legal costs from other sources.

Corporate Law Reform

The Corporate Law Reform Bill (No 2) 1992 was introduced into the Federal Parliament on 26 November, 1992. Although this legislation is yet to become law it is considered sufficiently important⁷⁰ to warrant comment in relation to the proposed changes to Section 241 of the Corporations Law 1991. Appendix 2 contains details on the proposed amendments.

Claims-Made Insurance Policy

The D & O policy is a "claims-made" rather than an "occurrence" insurance contract. "Claims-made" insurance policies limit the risk to claims made or arising from circumstances notified during the period of insurance. In some cases the policy also requires that the claim be notified to insurers during the same policy period in which it is made. Occurrence coverage, on the other hand, provides cover for events occurring during the policy period. It thus exposes the insurer to the future cost of the insured's present risky conduct. Succinctly put:-

"Insurers are risk spreaders, not risk takers. Forcing them to write occurrence coverage would place them in the latter role."⁷¹

Policy holders should be fully aware that a "claims made" insurance policy only covers those claims first discovered or made against them during the period of insurance. Unless the policy contains a specified retroactive date, this cover is irrespective of when the "wrongful act" giving rise to the claim occurred.

East End Real Estate Case

On 17 December, 1991 the N.S.W. Court of Appeal delivered a judgement which could effect the future of insurance policies written on a "claims made against the insured and notified during the period of insurance" basis.

⁷⁰ Refer to an article titled "Directors' and Officers' insurance" by Geoff Masel (Phillips Fox, Melbourne) which commenced on page 41 of the February/March 1993 issue of the Australian Insurance Law Bulletin.

⁷¹ A quotation taken from an ANZ Bank Risk Management presentation. Case Unknown.

In East End Real Estate Pty Ltd (trading as City Living) v C.E. Heath Casualty and General Insurance Ltd (1991) 25 NSWLR 400 the Court held that Section 54 of The Insurance Contracts Act 1984 could provide relief to an insured where a claim was first made during the period of insurance but notified to the insurer after the policy had expired. The pertinent words of Section 54 are as follows:-

- (1) Subject to this section, where the effect of a contract of insurance would, but for this section, be that the insurer may refuse to pay a claim, either in whole or in part, by reason of some act of the insured or of some other person, being an act that occurred after the contract was entered into ... the insurer may not refuse to pay the claim by reason only of that act but his liability in respect of the claim is reduced by the amount that fairly represents the extent to which the insurers' interests were prejudiced as a result of that act.

The Court looked for reference to the Explanatory memorandum relating to The Insurance Contracts Act 1984 when it was introduced into Parliament. In relation to Section 54, it said:-

"The existing law is unsatisfactory in that the parties' rights are determined by the form in which the contract is drafted rather than by reference to the harm caused. The present law can also operate inequitably in that breach of the term may lead to termination of the contract regardless of whether or not the insurer suffered any prejudice as a result of the insured's breach. The proposed law will concentrate on the substance and effect of the term and ensure that a more equitable result is achieved between the insurer and the insured."⁷²

⁷² East End Real Estate Pty Ltd T/A City Living v C.E. Heath Casual & General Insurance Ltd (1991) 25 NSWLR 400 at 404.

Consequently, the Court held that on the facts of the case Section 54 could act to give relief to the insured. Mahoney J A said:-

"Section 54(1) looks, in its terms, not to the provisions of the contract of insurance but to "the effect" of it. This, in my opinion, means the effect which the contract of insurance would, apart from the section, have in the relevant factual context. In the present case, a claim has been made on the insurer and it has refused to pay that claim. It has, for present purposes, refused to pay "by reason of" the fact that, within the terms of the policy, the claim is for a loss which is not within the cover. But the reason why the loss is not within the cover is that the claim upon the insured was not "notified" to the insurer within the period of insurance. In my opinion, upon the construction of the words "by reason of", the effect of the policy in the factual context would, apart from s.54(1), have been that the insured might refuse to pay the claim by reason of the fact that the claim upon the insured had not been "notified" to the insurer ...(The) claim was not within the cover ... by reason of an (omission) of the insured. Therefore the entitlement to refuse arose by reason of that omission".⁷³

As a result of this judgement,⁷⁴ which is very much in the policyholder's interest, any provision in an insurance contract that defines the extent of the cover in terms which involve some act or omission by the insured (or another person) which occurred after the policy was entered into, will be read subject to Section 54.

The respondent's leave to appeal the decision to the High Court of Australia was refused. However, in a judgement⁷⁵ handed down 1 December, 1992 C.E. Heath successfully denied East End Real Estate's claim. The insurer was able to rely on an exclusion clause relating to any claim brought about or contributed to by any dishonest, fraudulent, criminal or malicious act or omission of the insured or a director of the insured.

Major Policy Enhancements/Restrictions in a D & O Insurance Contract

In order to provide an adequate research basis for this thesis, the standard insurance policy wordings for six of Australia's major D & O

⁷³ East End Real Estate Pty Ltd T/A City Living v C.E. Heath Casual & General Insurance Ltd (1991) 25 NSWLR 400 at 407.

⁷⁴ This N.S.W. Court of Appeal judgement has caused a good deal of debate within legal circles with judges in two states disagreeing with the decision. For further information refer to an article by Geoff Masel (Phillips fox, Melbourne) titled "Claims Made Professional Indemnity Insurance" which appears on page 49 of the April, 1993 issue of the Australian Insurance Law Bulletin.

⁷⁵ East End Real Estate Pty Ltd T/A City Living v C.E. Heath Casual & General Insurance Ltd. (Unreported Rolfe J, 1 December, 1992).

insurance underwriters were surveyed. This survey provided the material for the following policy enhancements/restrictions which policy holders should look for when reading their insurance contracts. The relevant points are as follows:-

- **Action Against Underwriter**

This rather obscure policy condition states:-

No action shall lie against the Underwriter unless, as a condition precedent thereto, there shall have been full compliance with all of the terms of this policy, nor until the amount of the Insured's obligation to pay shall have been finally determined either by judgement against the Insured after actual trial or by written agreement of the Insured, the claimant and the Underwriter. No person or organisation shall have any right under this policy to join the Underwriter as a party to any action against the Insured to determine the Insured's liability, nor shall the Underwriter be impleaded by the Insured or their legal representatives."⁶

There seems to be three objects of this condition. Namely,

1. The policyholder is not permitted to take action against the underwriter unless,
 - a) there has been full compliance with all the terms⁷⁷ of the insurance contract, and
 - b) a Court has determined the insured's liability or the matter has been settled with the insurer's concurrence, and
2. Where a third party has instigated an action against a policyholder and becomes aware of the existence of an insurance policy then the third party is not permitted to also join the underwriter to the same action in order to access the policy, and
3. Where a policyholder is being sued and there is possibly a dispute with the underwriter over whether liability will be admitted or not, then the insured (or their legal representatives) is not permitted to join the underwriter to the action to determine whether the third party action is covered by the insurance policy.

⁷⁶ Page 6 of the FAI Directors & Officers Liability Insurance contract dated July, 1991.

⁷⁷ For example, correct notification of a potential claim.

In relation to the first objective, Section 54 titled "Insurer may not refuse to pay claims in certain circumstances" of The Insurance Contracts Act 1984 will operate to restrict the failure to meet the "full compliance" requirement.⁷⁸

In an action against a policyholder Section 51 titled "Right of third party to recover against insurer" of the above act provides a third party in some circumstances with the right to look directly to the insurer. The section only applies where the insured person has died or cannot, after reasonable enquiry, be located. However, the provisions of the Corporations Law 1991 and the Bankruptcy Act can also act to quarantine the claim proceeds for the benefit of the injured third party.

Finally, although it is possible to join an underwriter in a third party action against an insured, it may not be tactically advisable. It may be more appropriate to run a concurrent action against the insurer. Consequently, the third objective is perhaps of little real importance to the policyholder.

• **Advancement of defence costs**

An employer is not entitled under Section 241 of the Corporations Law 1991 to provide funds for legal investigation or representation of a director, officer or employee in relation to the successful defence of an allegation that falls within the ambit of the Section. In order to have a situation where the accused person does not have to incur his or her own legal costs it is essential that the D & O insurance policy provides advance defence costs. An example of such a provision could be along the following lines:-

Where indemnity has been confirmed under the policy the underwriter agrees to **advance** such reasonable defence costs. Under all other circumstances the underwriter may, at its **absolute discretion**, agree to advance such reasonable defence costs, provided that, should it be subsequently established by judgement, settlement, or other final adjudication, the insured is not entitled to indemnity then the underwriter may recover from the insured the total amount of the defence costs which have been advanced.⁷⁹

If the policy holder's insurance contract does not contain a provision similar to the above then it would be prudent to approach the underwriters prior to acceptance requesting them to confirm in writing whether they intend to provide advance defence costs.

⁷⁸ Details on Section 54 can be found in the segment on the East End Real Estate case.

⁷⁹ Clause 8.1 of the Chubb Insurance Company of Australia Limited 1991 Directors' & Officers' Liability Insurance Policy wording.

Where the policy does provide "Advance defence costs" it would be prudent to establish whether the insurer is entitled to charge interest on funds which might have to be repaid should a claim either not eventuate or liability be denied. It is possible that the policy may contain the following interest charge proviso:-

If, after final disposition of the Claim, the Underwriter elects to deny indemnity under this policy, the Insured shall forthwith repay to the Underwriter the amount of such advances together with interest (calculated at daily rates) at the rate stipulated by the Underwriter when making each advance and the total of such advances together with the interest shall be a debt due and owing to the Underwriter.⁸⁰

It would be advisable to ascertain whether the advancement of legal fees extends to legal costs incurred in investigating a claim or is the policy extension restricted purely to the advancement of legal costs in relation solely to defending a claim.

• Automatic Indemnification

A company's Articles of Association may provide⁸¹ that a director, officer or employee shall be entitled to be indemnified by the company against all costs, charges, losses, expenses and liabilities incurred in the execution and discharge of his/her duties to the company. It is debatable whether such a provision provides a person with an automatic and absolute right to indemnification. That is, the company could, because of the adverse publicity resulting from the litigation; decide not to indemnify a director even though the allegation was successfully defended.

⁸⁰ Page 5, Condition (1) of the FAI Directors & Officers Liability Insurance Policy wording dated July, 1991.

⁸¹ As long as it is permitted by Company law. i.e It does not breach section 241 of the Corporations Law 1991.

The Companies and Securities Law Review Committee¹² recognised this and made the following recommendation:-

"The Committee recommends that directors, officers and employees of a company be given a statutory right to indemnity for the costs of a successful defence in terms similar to section 124(3) of the Canada Business Corporations Act. The duty to indemnify should extend to the case where a director, officer or employee has incurred costs in being represented in criminal or civil proceedings to which he or she is made a party by reason of being or having been a director, officer or employee of the company.

The duty to indemnify should also extend to the costs of any administrative proceeding out of which the criminal or civil proceedings arose where the Court concerned with the criminal or civil proceedings is of the opinion that it is just that duty be imposed."¹³

Unfortunately, the abovementioned recommendation has not been incorporated into the Corporations Law 1991.

• Automatic cover for acquisitions

The key question here is does the clause require that subsidiaries "acquired or created" after the policy inception date be notified in writing to the underwriters within reasonable time, or is cover automatically granted with notification only required at the commencement of the period of insurance? The continual notification of subsidiary companies to insurers may cause administrative problems and expense for large geographically or operationally diverse organisations. The insurance document should be inspected to see whether the contract permits the underwriter to charge an additional premium for the subsidiary.

¹² The Committee comprised of Professor H.A.J. Ford as Chairman. The Committee members were Messrs G.W. Charlton, D.A. Crawford, A.B. Greenwood and D.R. Magarey. The Committee's director was Mr C.B. Sayer.

¹³ Paragraph 161 of the Companies and Securities Law Review Committee, Report No. 10 dated May, 1990 titled "Company Directors and Officers: Indemnification, Relief and Insurance".

- **Where Automatic Cover May Not Apply To Acquisitions**

US and Canadian jurisdictions cause problems with many insurers due to restrictions placed on the companies reinsurance treaties. This is because of the adverse litigation climate in these two countries. Consequently, automatic cover is rarely provided. Policy owners should peruse the contracts for the following jurisdictional condition:-

"...any Subsidiary Company acquired or created subsequent to the inception date of this policy, other than any domiciled and/or incorporated in the United States of America and/or Canada, ...shall be automatically included in the definition of the "Company, "..."⁸⁴

Furthermore, the document should be studied to discover whether there is a proviso on the granting of automatic cover. For example, it may be limited to:-

"...any Subsidiary Company acquired or created subsequent to the inception date of this policy,...the total assets of which do not exceed \$50 million at the date of acquisition or creation, shall be automatically included in the definition of the "Company "..."⁸⁵

An insured will need to be continually vigilant if the company's operations are likely to breach either of the above provisos as insurers will need to be notified in writing of any new subsidiaries prior to cover commencing.

- **Problems associated with companies that are no longer a subsidiary of an insured company.**

It is common market practice for the D & O insurance policy to refer to an officer as:

"Any past, present or future director, secretary, officer or employee of the Company."⁸⁶

However, the same broad (particularly the reference to the word "past") definition is not used when extending cover to subsidiaries. Consequently, a problem exists in relation to relinquished positions on companies that are no longer classified as a subsidiary of the insured company. This is because the D & O insurance contract is underwritten on a "claims made"⁸⁷ basis (refer to page 39) which means that it will

⁸⁴ Clause 1(ii) 1991 Reg Brown & Ors Non-Marine Lloyds of London Syndicate 702 Directors' & Officers' Liability Insurance Policy wording (Australia Contract).

⁸⁵ Ibid Clause 1(ii).

⁸⁶ Ibid Definition 1.1. Definition 2 refers to the "Company" as the Company identified in the policy schedule and shall include every Subsidiary company existing prior to or at the inception of the policy.

⁸⁷ As opposed to "an occurrence".

only respond to claims made during the policy period and not when the event occurred which gave rise to the claim. Therefore, an insured person could suffer an uninsured loss if the claim was made after the company ceased to be a subsidiary of the insured company but referred to an incident which happened when the company was insured under the policyholder's insurance contract. It would be prudent for the policyholders to have this position clarified and if necessary amend (by policy endorsement) the definition of "subsidiaries" to include past subsidiaries for claims arising from events up to the time the company ceased to be a subsidiary of the insured company.

• Claims Co-operation

It is a fundamental aspect of insurance law that the insured must try to mitigate the loss and to co-operate with the insurer. However, the following clause may cause concern where the underwriter has not admitted liability:-

"Solicitors retained by the underwriter to act on behalf of the Directors and Officers in relation to any Claim against the Directors and Officers shall at all times be at liberty to disclose to the Underwriter any information obtained in the course of so acting and whether from the Directors and Officers or whosoever, and the Directors and Officers hereby waive all claim to legal professional privilege which they might otherwise have between themselves and the Underwriter in respect of such information."

If the definition of claim in the D & O insurance policy includes a "circumstance" which could give rise to an insurance claim at a later date, then it would be wise for the insured to retain (as some policies specifically permit) a solicitor up until liability has been accepted by the underwriter. A more acceptable wording could have the following proviso attached to the claims co-operation condition. Namely,

"This condition does not oblige the Insured Person or his lawyers to disclose material to which legal professional privilege attaches and which may be relevant to any coverage dispute between the Underwriter and the Insured".

Clearly the above qualification may not disrupt the insurer's right to obtain relevant claim related information yet protects the insured in relation to any future legal action should the underwriter deny liability as a result of a dispute in relation to the scope of the insurance cover.

- " Clause 5.2 of the Pacific Indemnity Underwriting Agency Pty Ltd Directors' & Officers' Liability Corporate Reimbursement Insurance Policy wording (PACDO.91).
- " Condition (F) FAI Directors' & Officers' Liability Insurance Policy wording dated July, 1991.

It would be worthwhile for the policy holder to ensure that the insurance policy provides Advancement of Legal fees.

• Condition Precedent

It is usually a condition of insurance contracts that the insured must not admit liability or settle any claim or incur any costs or expenses without the written consent⁹⁰ of the underwriter. This is not an unreasonable request as the insurer must be given every opportunity to reduce its claim payout. In this context, the following quote may cause a great deal of concern to any D & O insurance underwriter.

The paper reported that:-

"The joint managing director of the merchant bank Fay, Richwhite & Company Ltd, Mr David Richwhite, has apologised publicly for the costly mistake of investing in the Bank of New Zealand. Mr Richwhite told shareholders at Fay's annual general meeting in Auckland last Friday, that "we bought the Bank of New Zealand without doing our homework sufficiently beforehand.

I'm sorry."⁹¹

At all times the insured must be careful not to prejudice the interests of their underwriters.

• Definition of Claim

The key points to look out for in the definition of a claim are as follows:-

- (a) Whether it is "any written or verbal demand alleging any wrongful act" or is it only a "written demand" alleging a wrongdoing by the director, officer or employee that must be reported to insurers?
- (b) Are there "any circumstances which might give rise to a future claim" included in the definition of claim? This could lead to an increase in legal costs by having to report more matters to insurers, as the legal requirements for reporting a claim will also include a "circumstance" that could give rise to a future claim⁹².
- (c) Is there an "in the opinion of a reasonable director, officer or employee" proviso attached to the circumstance reporting requirement? The objective test of a reasonable person in similar circumstances will be applied to any failure to report a circumstance that is likely to give rise to a future insurance claim.

⁹⁰ This consent should not be unreasonably withheld by the insurer.

⁹¹ Page 43, Australian Financial Review, 11 November, 1991.

⁹² Chubb Insurance, Australia reports past statistics show that only a small number of circumstances notified actually lead to an insurer having to pay out on a claim. Source, company interview in May, 1992.

It would be prudent of the policy holder to thoroughly understand the ramifications of the definition of "claim" contained in the D & O insurance contract, as failure to notify in accordance with the policy conditions could jeopardise the right to lodge a future insurance claim.

• **Extended reporting period**

As the D & O insurance policy is a "claims made" contract, reporting problems can occur at the expiry of the period of insurance.⁹³ To alleviate the problem, D & O policies normally contain an "extended reporting period" clause which comes into operation when the insurer does not wish to renew the policy. The major points to look out for are as follows:-

- (a) Is there an automatic and free of charge 21 or 30 day period after policy expiry date to report claims arising from wrongful acts which occurred during the period of insurance just completed?
- (b) What is the additional charge (say 15% or 50% of the previous year's premium) and how long (for example 120 or 365 days) is the extended period?

The "Extended Reporting Period" extension only activates when the underwriter declines to renew the policy. Some insurance contracts go to the extent of defining what is classed as not being a refusal to renew. For example, the following clause provides the insurer with wide scope:-

the quotation by Underwriters of different premiums and/or different terms and/or different conditions and/or different limitations and/or different exclusions and/or a different LIMIT OF UNDERWRITERS AGGREGATE LIABILITY at renewal **does not constitute a refusal to renew.**⁹⁴

Whereas the following definition:-

the offer of renewal TERMS, DEDUCTIBLE amount, CONDITIONS or premium different from those in effect prior to renewal shall not constitute refusal to renew PROVIDED ALWAYS THAT:

- (a) The said renewal premiums and deductibles (if any) are not increased by more than twenty-five percent (25%) of the expiring premiums or DEDUCTIBLES;

and

⁹³ This is particularly the case when the insurance company declines to renew the policy.

⁹⁴ Extensions clause 1(b)(iii) of the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

- (b) proviso (2)(a) immediately above does not apply where there has been a material change in the nature and/or degree of risk insured against⁹⁵

is more advantageous to the policy holder.

Finally, it must be understood that the "Extended Reporting Period" cover only applies to wrongful acts committed prior to the expiry of the D & O insurance policy.

Other Insurance

A policy holder should study their "other insurance" clauses to ascertain whether the wording is similar to that which follows:-

- 1.1 Not less than thirty days (but never beyond expiration of the Period of Insurance) prior to entering into any other contract of insurance the Assureds shall notify Underwriters of, and shall give Underwriters full details of , any such other insurance effected by or on behalf of the Assureds or any of them which provides indemnity for, in full or in part, the liabilities insured hereunder.
- 1.2 To the extent that the Assureds have any other **specific** insurance in force in respect of the liabilities insured hereunder, the Underwriters shall only be liable under this Policy for the **excess beyond any amount insured by such other insurance** in respect of that liability, whether or not such insurance is valid or collectable.⁹⁶

The above proviso could cause problems where, for example, the insured purchases Trustee Liability insurance (with a limit of indemnity of \$10,000,000) in order to protect the assets of the insured's superannuation fund. This form of cover not only insures the fund against amounts it is entitled to reimburse the trustee, but will also cover any additional loss that the fund may suffer as a result of the trustee's negligent action. As this class of insurance offers similar protection to that which is provided by a D & O insurance policy, the latter's "other insurance" clause will operate to impose a substantial excess⁹⁷ on the D & O policy. This excess is irrespective of whether or not a successful claim is lodged on the other insurer.

⁹⁵ Extensions Clause 3.3(2) of the 1991 Pacific Indemnity Underwriting Agency Pty Ltd Directors' & Officers' Liability Corporate Reimbursement Insurance Policy wording.

⁹⁶ Conditions Clauses 4.2 and 4.3 of the 1991 Directors' & Officers' Liability Insurance Policy wording (Australia Contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

⁹⁷ For example, \$10,000,000 being the indemnity provided by the other policy offering similar cover to the D & O policy.

Whether the above "Other Insurance" clause will be permitted to restrict the Insured's cover will depend on the interpretation of Section 45 of the Insurance Contracts Act 1984. This section titled "Other Insurance" states:-

"45.(1) 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**, not being a contract required to be effected by or under a law, including a law of a State or Territory, the provision is void.

(2) Sub-section (1) does not apply in relation to a contract that provides insurance cover in respect of some or all of so much of a loss as is not covered by a contract of insurance that is specified in the first-mentioned contract."

Section 45 makes "Other Insurance" provisions⁹ in insurance contracts ineffective. However, the section does not apply to other insurance which is compulsory (ie Employer's Liability) under any law or "excess" or "layer" insurance; where, for example, one insurer (Company A) provides an indemnity up to \$1,000,000 whilst another underwriter (Company B) offers an indemnity for sums in respect of \$1,000,000.

If the Section 45 is deemed not to operate, and it can be established that the insurer has not been prejudiced, then legislation in NSW and Victoria allows a Court to excuse an insured's failure to give notice of other insurance, this failure having breached the "other insurance" condition of the insured's policy. The relevant state legislation is as follows:-

1. Section 18 of the N.S.W. Insurance Act 1902 provides:-

"18(1) In any proceedings taken in a court in respect of a difference or dispute arising out of a contract of insurance, if it appears to the court that a **failure by the insured to observe or perform a term or condition of the contract of insurance** may reasonably be excused on the ground that the **insurer was not prejudiced by the failure**, the court may order that the failure be excused.

18(2) Where an order of the nature referred to in subsection (1) has been made, the rights and liabilities of all persons in respect of the contract of insurance concerned shall be determined as if the failure the subject of the order had not occurred."

⁹ As highlighted in the previous example.

The major issue to be determined under Section 18 is whether the insurer was prejudiced by the insured's failure to give notice of other insurance under a relevant condition in the contract; if the insurer was not prejudiced, then under Section 18(2), the insured's claim will be determined as if the failure to give notice had not occurred.

2. Section 27 of the Victorian Instruments Act 1958 states:-

"27 If by reason of accident, mistake or other reasonable cause any insured fails to give any notice or make any claim in the manner and within the time required by the contract of insurance such failure shall not be a bar to the maintenance of any proceedings (whether legal proceedings or arbitration proceedings) upon the contract by the insured unless the court or the arbitrator or umpire (as the case may be) considers that the insurer has been so prejudiced by such failure that it would be inequitable if such failure were not a bar to the maintenance of such proceedings."

Unlike the NSW legislation, prejudice to the insurer is not the only consideration under Section 27. The insured must establish that he failed to comply with the terms of the relevant condition "by reason of accident, mistake or other reasonable cause". However, having established this, it is then for the insurer to show that it has been prejudiced by the breach of the relevant condition; i.e. the onus of proof rests on the insurer. Section 27 was applied in Q.B.E. Insurance Ltd. & Ors. v G.R.E. Insurance Ltd.⁹⁹ to provide relief for insureds who failed to give notice of other insurance.

In an attempt to circumvent the effects of Federal and State legislation on the scope of the "Other Insurance Clause", insurers are deleting the condition entirely and have amended the operative clause in a manner which has the same intended results. For example, the insuring clause may read as follows:-

Underwriters agree, after the Assureds have exhausted all entitlement to indemnity from any other source, and subject to the terms, conditions, limitations and exclusions contained herein, to indemnify the Assureds against Loss arising from any Claim first made against them jointly or severally and notified to Underwriters during the Period of Insurance by reason of any Wrongful Act committed in their capacity as a director or secretary or executive officer of the Company.¹⁰⁰

⁹⁹ QBE Insurance Ltd. & Ors v GRE Insurance Ltd (1983) ANZ Insurance Cases 60-533 (1984) 3 ANZ Insurance Cases 60-622.

¹⁰⁰ Insuring Clause (a) from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

The use of the words "after the Assured have exhausted all entitlements to indemnity from any other source" has much wider ramifications than the traditional "other insurance" condition.

- **Severalability/Non-imputation**

As a single D & O insurance policy can cover up to several thousand directors, officers and employees within a company it is essential that the action or inaction of one person cannot be imputed to the detriment of an innocent insured. It is important that the contract does not impute either incorrect or fraudulent underwriting or claim information to any other people covered by the insurance policy. The major point to be aware of is that the imputation provision should apply to both policy coverage (ie non-disclosure of a material fact at renewal) and the ability of an innocent insured to successfully lodge a claim under the contract.

- **Proper Law & Territory**

It should be confirmed that the D & O insurance policy is subject to Australian law; this will bring the policy holder under the protection of the Insurance Contracts Act 1984. It is important that the underwriters have agreed to submit to the jurisdiction of a competent court in the Commonwealth of Australia should a dispute regarding coverage emerge and that the insured is not subject to any restriction on the territory in which a "wrongful act" can occur.

- **Use of the term "Best Endeavours" in Policy Conditions**

Quite often legal agreements use the term "best endeavours". For example, a D & O insurance contract might, under the policy conditions section, state:-

- (a) The Named Company and any Subsidiary shall not encourage or procure the breach of any term or condition of this policy but shall use its **best endeavours** to promote, secure and facilitate compliance with the terms and conditions of this policy by the past and present Directors and Officers of the Named Company or any Subsidiary.
- (b) The Insured Persons, the Named Company and any Subsidiary shall use their **best endeavours** not to disclose to anyone the existence of this policy without the Underwriter's written consent where such disclosure may be prejudicial to the Underwriter.¹⁰¹

Negligence may, be defined as failing to exercise the level of skill and care which is **reasonable** in the circumstances of the particular case in question. The use of the superlative "**best**" clearly implies the highest possible standard achievable by a person or organisation, while the term "endeavours" suggests a striving to achieve a particular end.

¹⁰¹ Part B Conditions (a) and (b) from the 1992 FAI Insurance Group Liability Insurance for Directors & Officers Policy wording.

From a policyholder's perspective the term "reasonable endeavours" is clearly much less hazardous to use in an insurance contract. This is particularly so when committing an insured company (and its subsidiaries) to "promote, secure and facilitate compliance with the terms and conditions" of the insurer's policy by its past and present directors and officers.

Relevance of Insurance Policy Exclusions

It is the responsibility of the insured to prove that the loss falls within the ambit of the D & O insurance policy's operative clause¹⁰². The insurer is then required to identify an exclusion clause which will operate to deny the claim. Consequently, although it is important for the insured to understand the scope of the policy coverage it is perhaps more important to realise which policy exclusions are contained in the policy holder's insurance contract and the extent of their purpose.

• Standard Exclusions

The following list of D & O insurance policy exclusions are universal to all the contracts surveyed for this paper. The insurers' intentions are not to pay claims for any losses caused by:-

- * prior litigation
- * known circumstances at policy inception
- * fines, penalties or punitive damages
- * bodily injury (whether physical or mental) or property damage and consequential loss
- * seepage, pollution or contamination
- * insider trading and illegally obtained profits or advantage
- * wrongful acts after a company ceases to be a subsidiary.

The purpose of words such as "for, or arising out of, or in relation to, or in respect of or directly or indirectly" which are found in the exclusion section of a D & O insurance policy is to provide a blanket exclusion to any loss no matter how remotely connected to the event claimed.

¹⁰² Exhibit 4 lists a series of events which are likely to give rise to a D & O personal liability claim. Depending on policy terms and conditions not all these events are likely to be covered by a standard D & O insurance policy wording.

• **Non-Standard Exclusions**

The following list of exclusions warrant particular attention by the policyholder or insurance broker as they are either additional to or at variance with the standard number usually contained in a D & O insurance policy. Not knowing the ramifications of these restrictions on coverage could result in an uninsured personal loss to an insured person. The relevant exclusions are as follows:-

- Any claim arising from the failure to effect and maintain insurance for or on behalf of the Insured Company.¹⁰³
- A claim made or threatened or in any way intimated on or before the inception date of this Policy or after the expiration date of this Policy.¹⁰⁴

The intention of this exclusion is to confine cover to claims made or reported during the period of insurance.

- Any wrongful act which is in conflict with, or in preferment of, the interest of the Insured Company over those of any entity referred to in the "Outside Directorships" and "Shadow Directorships" extensions.¹⁰⁵

This is a particularly onerous exclusion as it limits the application of the Outside Directorships¹⁰⁶ and Shadow Directorships¹⁰⁷ extensions. A conflict of interest situation is one of the very real dangers which employees face when holding official positions on other companies at the request of their employer.

¹⁰³ Exclusion 9 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹⁰⁴ Exclusion 11 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹⁰⁵ Exclusion 11 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹⁰⁶ Refer page 73.

¹⁰⁷ Refer page 78.

- Any claim where a Company or any entity referred to in the Outside Directorships extension and/or the Shadow Directorships extension is required or permitted to indemnify an insured person.¹⁰⁸

Where the policyholder finds this exclusion present in the D & O insurance contract, it would be wise to ensure that the policy also contains a "Preservation of Indemnity" extension. This extension¹⁰⁹ enables the Insured Person to claim under the D & O insurance policy - as opposed to the Company Reimbursement contract - where the Insured Company is unable to provide reimbursement due to involuntary liquidation and having insufficient funds available to indemnify the director and/or officer.

- To the extent that an indemnity is available from any other source.¹¹⁰

The key word is "available" for this exclusion. The indemnity may be available but of little assistance if the company concerned has insufficient funds to reimburse the insured person. Consequently, it would be prudent for the insured person to ascertain whether their policy also contained a "Preservation of Indemnity" benefit.

- Any claim based upon, arising out of, directly or indirectly resulting from or in consequence of, or in any way involving, any actual or alleged violation of any of the provisions of the Trade Practices Act 1974, or any amendments thereto.¹¹¹

This is a particularly onerous exclusion as the Trade Practices Act 1974 (especially Section 52 titled "Misleading or deceptive conduct") is one area of legislation which is expected to produce a fertile ground for personal liability actions in the future¹¹².

¹⁰⁸ Exclusion 15 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹⁰⁹ Refer to page 77 for further details on the "Preservation of Indemnity" extension.

¹¹⁰ Exclusion 18 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹¹¹ Ibid Exclusion 29.

¹¹² Refer to page 91 under "External Advisers" section for further details on the scope of Section 52 of the Trade Practices Act 1974.

Section 75B(c) of the Act empowers the Court to make an award of damages against any person who "has been in any way, directly or indirectly, knowingly concerned in, or party to, the contravention" of the act by a corporation. Such a personal liability award would be in addition to any which the company would be required to pay for breaching the Trade Practices Act 1974.

- An intentional breach of contract procured by the insured person and/or company.¹¹³

This again, is a rather onerous exclusion as the "intentional breach of contract" could result from a negligently based decision on the part of the insured person. In such circumstances the above exclusion would act to deny a claim.

- Insured v Insured Exclusion¹¹⁴

It is particularly important to confirm that this clause does not exclude claims resulting from "wrongful dismissal, sexual harassment, discrimination, denial of natural justice or misleading representation or advertising involving employment or claims arising out of the mismanagement of the company's own superannuation or pension funds"¹¹⁵ as it is Australian market practice to usually provide insurance protection against these contingencies.

Furthermore, it would be wise to inspect the Insured v Insured exclusion to examine whether it does not specifically incorporate actions brought by a receiver, a receiver and manager, an official manager or a liquidator formally appointed by the Court. For example, the exclusion could read as follows:-

The insurer shall not provide an indemnity against any loss arising out of:-

Claims made against an Insured Person by or on behalf of any company, incorporated association or society insured under The Company Reimbursement Section of this policy.

¹¹³ Exclusion (q) from the July 1991 FAI Directors' & Officers' Liability Insurance Policy wording.

¹¹⁴ This is perhaps one of the most important exclusions in the D & O insurance policy because it is the one that governs the most common type of insurance claim. i.e. sexual discrimination/harassment or mismanagement of staff superannuation fund. It is important that the policyholder fully understand the ramifications of this exclusion clause.

¹¹⁵ Exclusion 3.5 of the 1991 Directors' & Officers' Liability Company Reimbursement Insurance Policy wording offered by Pacific Indemnity Underwriting Agency Pty Ltd.

This exclusion does not apply in respect of any claims brought by:

- (i) the Named Company or any Subsidiary as part of a shareholder derivative action, or
 - (ii) the Named Company or any Subsidiary at the instigation of a receiver, a receiver and manager, an official manager or a liquidator formally appointed by a court.¹¹⁶
- Libel, slander, infringement of copyright or passing off, plagiarism¹¹⁷.
 - Personal guarantee or warrant (other than Warrant of Authority) given by any Assured.¹¹⁸

This exclusion might be limited only to cover loans provided to the company or it could cover all guarantees provided by the insured in relation to the business.

- Remuneration paid to directors and officers (or their respective families or family companies) without shareholder approval and which is subsequently held to be illegal.¹¹⁹

The most important factor here is that the remuneration is held to be illegal. If this is not included in the clause then the exclusion will operate whether or not the payment was illegal. This would deny the insured the opportunity of having the defence costs refunded as a result of a successful court finding.

- Dishonest, fraudulent or malicious conduct of directors or officers.¹²⁰
Care should be taken that this exclusion does not apply where:-
 - a) the allegation is successfully refuted;
 - b) the court held that the Wrongful Act did not involve a dishonest, fraudulent or malicious act on the part of the insured.

If the exclusion does not contain the above provisos, then it will operate irrespective of the insured's innocence.

¹¹⁶ Part A Exclusion (i) from the 1992 FAI Insurance Group's "Liability Insurance for Directors & Officers" policy wording.

¹¹⁷ Exclusion 1 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹¹⁸ Ibid Exclusion 3.

¹¹⁹ This clause has been constructed to present, in one example of a "Remuneration of Office holders" exclusion, a number of the requirements found in the different policies surveyed. For a specific example of such a clause refer to Exclusion 6 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹²⁰ Ibid Exclusion 4.

- Illegal market or price fixing.¹²¹
- Depreciation or loss of investment value due to causes outside the control of the insured.¹²²
- Actions involving subsidiaries incorporated and/or domiciled in the USA or Canada.¹²³
- Royal commissions and/or Australian Security Commission Investigations.¹²⁴

Policyholders and/or their insurance brokers should ensure that they read the insurance contracts carefully and are fully cognisant of the intention and effect of these exclusion clauses contained in any D & O insurance policy.

¹²¹ Exclusion 19 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹²² Ibid Exclusion 21.

¹²³ Ibid Exclusion 25.

¹²⁴ Although the policy may not specifically refer to these investigations it would be prudent for the policyholder to ensure (prior to entering the contract) that the policy covered legal expenses incurred for representations before such enquiries.

Liability for the Debts of a Company Exclusion

Some D & O insurance policies will not provide coverage against a successful action brought against an insured person in relation to the insured company contracting unpayable debts¹²⁵.

Coverage may not be provided for corporate entities which are either not trading profitably or have negative shareholders funds at the date of affecting the insurance. However, the policy will respond where unprofitable trading or the shareholders funds turn negative during the period of insurance. An example of such an exclusion clause is as follows:-

"No indemnity is provided to an insured person(s) in respect of the insured company if, at the commencement of the period of insurance, the insured company is trading unprofitably or does not have a surplus of shareholder's funds."¹²⁶

A wider version of this type of company debt exclusion is one that is found in a D & O insurance policy which does not provide an indemnity against any claim:-

"arising out of any liability assumed by or imposed upon the insured person for debts of the insured company or of any other entity."¹²⁷

The "or of any other entity" is an important extension as it would exclude any creditor action brought against an insured person covered by the "Outside Directorships" extension.¹²⁸

A more specific exclusion could read as follows:-

The insurer will not be liable to indemnify the insured person for any loss in respect of , or arising from:

Loss, including liability for the debts of a company, in connection with or consequent upon proceedings (civil or criminal) successfully brought against a director or officer pursuant to Sections 592 or 593 of the Corporations Law 1991 of any State or Territory or any equivalent law making a director or officer liable for the debts of an insolvent company.¹²⁹

¹²⁵ Examples of such Creditor actions are the Statewide Tobacco Services Limited v Morley (1990) 8 ACLC 827 and the Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946 decisions.

¹²⁶ Exclusion 4.3 of the 1991 C.E. Heath Underwriting and Agency Services Ltd Directors and Officers Liability Policy wording.

¹²⁷ Exclusion 13 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹²⁸ Refer to page 73 for further details on the "Outside Directorships" extension.

¹²⁹ Exclusion (h) from the FAI Directors' & Officers' Liability insurance policy wording dated July, 1991.

So far as is relevant, Corporations Law 1991 Section 592 titled "Offences relating to incurring of debts or fraudulent conduct" provides as follows:-

"592(1) (Liability for debts etc.) Where:

- (a) a company has incurred a debt;
- (b) immediately before the time when the debt was incurred:
 - (i) there were reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or
 - (ii) there were reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due; and
- (c) the company was, at the time when the debt was incurred, or becomes at a later time, a company to which this section applies;

any person who was a director of the company, or took part in the management of the company, at the time when the debt was incurred contravenes this subsection and the company and that person or, if there are 2 or more such persons, those persons are jointly and severally liable for the payment of the debt.

592(2) (Defence) In any proceedings against a person under subsection (1), it is a defence if it is proved:

- (a) that the debt was incurred without the person's express or implied authority or consent; or
- (b) that at the time when the debt was incurred, the person did not have reasonable cause to expect:
 - (i) that the company would not be able to pay all its debts as and when they became due; or
 - (ii) that, if the company incurred that debt, it would not be able to pay all its debts as and when they became due."

Section 593 titled "Powers of Court" of the Corporations Law 1991 permits the Court to declare that a person convicted of contracting unpayable debts under Section 592(1) has unlimited personal liability to repay those debts. The declaration of the Court is initiated by an application of the Australian Securities Commission or of the person to whom the debt is payable. Court has discretion to make the person liable for the whole debt or for an amount it thinks appropriate.

Finally, it is important that policyholders peruse their D & O insurance contracts for such an exclusion clause because in the CBA v Friedrich case¹³⁰, Tadgell J held that Section 1318¹³¹ titled "Power to Grant Relief" of the Corporations Law 1991 could not be used in a Section 592 action. Consequently, an insurance policy provides a valuable asset against actions by creditors.

¹³⁰ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946.

¹³¹ Exhibit 1 provides a copy of this section.

Prospectus Liability Exclusion

A director of the issuing company and an underwriter of the share issue (being the subject matter of the prospectus) may be found be liable under Australian law if the prospectus is found to be inaccurate. For example, a person is in breach of Section 995(2) of the Corporations Law 1991 if they "engage in conduct that is misleading or deceptive or is likely to mislead or deceive" when issuing a prospectus in relation to securities. In addition to this it is a contravention of Section 996(1) if a prospectus is issued:-

- in which there is a material statement that is false or misleading; or
- from which there is a material omission.

If there is a contravention of the Corporations Law 1991, civil liability will attach to any person who authorised or caused or is involved in the issue of a prospectus. The issuing company, its directors and any underwriters involved in the issue will be normally considered to have authorised or caused the issue of a prospectus and therefore held to be involved in a contravention of the legislation and may be liable. This may occur notwithstanding the fact that they were unaware that the statement was false or misleading or that there was a material omission in the prospectus. Criminal liability may also be imposed on a director and underwriter who has been involved in the issue of a prospectus that contains a false or misleading statement or which has a material omission.

In addition to the Corporations Law 1991, the Trade Practices Act 1974 (and equivalent state Fair Trading legislation) will have applicability where a director or underwriter engages in conduct that is misleading or deceptive in relation to the issue of shares pursuant to a prospectus. The common law torts of deceit and negligence may also have applicability to directors and underwriters.

Liability under these laws is absolute as there are no defences to liability incurred. However, the proper conduct of the due diligence inquiries carried out before issuing the prospectus will be helpful in establishing that the necessary elements for bringing legal actions under these laws do not exist.

Should an insured person covered by a D & O insurance policy be held liable for issuing an inaccurate prospectus then more than likely the following exclusion will act to deny a claim under the policy. The relevant exclusion is as follows:-

"Insurers will not provide an indemnity against any loss arising out of any claims:-

1. arising solely out of any stock or commodity or investment failing to perform as represented or as expected to perform."¹³²

- **USA/Canada Issues**

It is not uncommon for an insured company (for instance, a financial institution or a large corporate borrower) to issue a prospectus in the United States. For example, this could be for the raising of funds via a subordinated debt issue which would require the borrower to issue a prospectus in that country.

If the issuing company's D & O insurance policy contained no exclusion relating to "any stock or commodity or investment failing to perform" then it could have a clause which specifically excludes issues offered in North America. Such an exclusion could state:-

"...indemnity against any loss arising out of any claim or claims:-

1. based upon, arising out of, directly or indirectly resulting from or in consequence of, or in any way involving, any actual or alleged violation of any of the provisions of the Securities Act of 1933, the Securities Exchange Act of 1934 or any similar federal or state law, or any common law relating thereto in respect of USA/Canada activities of the Assured."¹³³

The above exclusion would operate to deny any liability resulting from breaches of Sections 11, 12 or 15 of the U.S. Securities Act of 1933.

¹³² Exclusion 22 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹³³ Ibid Exclusion 26.

• Prospectus Indemnity Insurance

With the removal of the discussed exclusion clauses the policyholder's D & O insurance policy would, in most circumstances, provide an indemnity for liability arising from the issue of a prospectus. However, the insured may consider taking out a separate Prospectus Liability insurance product. This specific policy provides an indemnity to directors, officers and underwriters for claims made against them for loss resulting from negligent errors or omissions contained in a prospectus.

Some of the benefits of this specific insurance product are as follows:-

- (i) Cover includes specific guarantees and warranties given by directors in connection with an issue.
- (ii) Other guarantors/warrantors who are not directors or officers of the company can be included in the indemnity offered by the policy.
- (iii) When appropriate, the Company's potential liability can also be insured.
- (iv) There can be a single premium and policy period for the life of obligations under the issue. Insurers are however reluctant to issue policies for a period in excess of three years for general obligations and six years in respect of any taxation indemnity.

The advantage of a policy relating to a specific prospectus avoids the possibility of cover not being renewed or terms being dramatically revised at the first renewal. This may occur if the policyholder were to rely solely on the Directors & Officers Liability Insurance in circumstances where there may be some suspicion of an impending problem in connection with a prospectus. The reason for this is because the D & O insurance policy is issued on a "claims made" not an "occurrence" basis. Therefore, insurers could reduce the scope of the cover by simply including a "prospectus" exclusion upon renewal of the D & O insurance policy.

Prospectus Liability insurance can, therefore, be seen as a means of:

- (i) supplementing Directors & Officers Liability insurance, both in terms of amount (Difference in Limits) and scope of cover (Difference in Conditions); or, alternatively
- (ii) protecting the Directors & Officers Liability insurance policy against claims arising from a relatively infrequent activity in the form of a share issue with a view to, as far as possible, preserving continuity of cover and terms in what is seen as a particularly sensitive class of insurance.

A potential insured should note that Prospectus Liability insurance is an insurance product developed in the United Kingdom which, to date, has yet to be adapted for availability to Australian Companies. Modification of the existing UK product being resisted by the limited number of underwriters/insurers involved in the London market. Consequently, it may be some time before a Prospectus Indemnity insurance policy is available in Australia.

Professional Indemnity Exclusion

It is not uncommon for a D & O insurance policy to contain the following exclusion:-

"Underwriters shall not provide an indemnity against any loss arising out of any claim or claims:-

- made by any client or customer based upon breach of duty in the provision of professional services."¹³⁴

An insurance policy could define Professional Services "as..... all services performed or advice given by the Insured provided such services or advice are customary to the business and provided any fees accruing from these services are for the benefit of the insured's business."¹³⁵

¹³⁴ Exclusion 7 from the 1992 Directors' & Officers' Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹³⁵ This example was adapted from a definition of "Professional Services" contained in page 2 the E. Fick (partner, Norton Smith & Co, solicitors) paper titled "Some aspects of Professional Indemnity insurance."

The purpose of the above exclusion is not to cover claims that should be insured under a separate Professional Indemnity insurance policy. As previously stated, the purpose of a Professional Indemnity policy is to protect the business against third party claims that it has incurred as a result of the vicarious liability arising from the actions (or inactions) of its employees. However, as also highlighted, it is not uncommon to include the employee as a named insured under the employer's Professional Indemnity insurance policy. The intention is to protect the employee in situations where both the employer and employee are named in Court documentation. Otherwise, the employees could be held responsible for the legal costs in investigating and defending an allegation of negligence against them.

Section 241 titled "Indemnification of Directors & Officers" of the Corporations Law 1991 prohibits¹³⁶ a company from indemnifying an officer in relation to:-

"negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company....."¹³⁷

However, Section 241(3) permits the existence of insurance to cover such a contingency as long as the premium is not paid "by the company or by a related corporation."

Unfortunately, a legal argument could be advanced that negligence or breach of duty to a third party (ie a customer) is also a concurrent" negligence breach of duty in relation to the company." Consequently, if the directors and officers have not contributed to the professional indemnity insurance premium, then the underwriter would not have to meet that portion of the damages and legal expenses attributable to the director or officer involved in the breach. This is because the insurance claim would be considered a voidable payment.

The taking out of insurance by an employer company to cover its own vicarious liability for loss caused by the wrongs of its work-force is a well established practice. For a time it was possible that if an employer were made vicariously liable to a third person for harm caused by the wrong of an employee and the employee caused that harm through negligence, the employer could sue the employee by way of indemnity for the employee's breach of his or her contractual promise to perform duties with reasonable care and skill:¹³⁸

¹³⁶ Refer to Exhibit 1 for a copy of Section 241.

¹³⁷ Section 241 of the Corporations Law 1991.

¹³⁸ The case of Lister v Romford Ice and Cold Storage Co Ltd 1975 AC 555 serves to highlight this point.

In New South Wales the possibility of the employer suing an employee for indemnification has been removed by statute through the Employee's Liability (Indemnification of Employer) Act 1982 section 2(3). This legislation suggests¹³⁹ the existence of a principle that for non-fraudulent harm caused in the course of carrying on an enterprise, the burden should in the first instance fall on the enterprise rather than the particular person whose fault caused the harm. This is because the existence of a system of legal liability insurance within the business community provides an opportunity whereby a business can spread (via the payment of a single insurance premium) its loss over all the organisations which pay premiums to insure against the same class of risk. If it is accepted business practice for a company to take out insurance with respect to injuries that may be caused to third persons by the activities of its officers and other employees on terms that relieve them from personal liability. Then there does not seem to be any reason why a company should not be able to take out comparable insurance cover providing similar relief in respect of the harm caused to third persons by non-fraudulent activity of directors in the course of their activities as directors. This is because Section 241 refers to directors, officers and employees of the company.

In addition to the above argument, the fact that Sections 241¹⁴⁰ and 1318¹⁴¹ are related, assists the interpretation of the words "in relation to the company". It has been held that provisions in the United Kingdom's legislation similar to Section 1318 apply only to proceedings against a director, officer or employee by or on behalf of, or for the benefit of the company for breach of his or her duty as a director, officer or employee.¹⁴² Consequently, the relationship between Sections 1318 and 241(1) suggests that Section 241(1) should be limited in the same way¹⁴³. Furthermore, since section 241(2) operates by withholding the prohibition in Section 241(1) there is an implication that Section 241(2) gives authority only in relation to proceedings in respect of any liability that by law would attach to the director, officer, employee or auditor in respect of any negligence etc of which he or she "may be guilty in relation to the company."¹⁴⁴ It is hard to imagine a situation where a company would be vicariously liable to third parties for the actions of its auditor.

¹³⁹ Paragraph 129 of the Companies and Securities Law Review Committee's Report No 10 titled "Company Directors and Officers : Indemnification, Relief and Insurance" dated May, 1990.

¹⁴⁰ Refer to Exhibit 2 for a copy of Section 241.

¹⁴¹ Refer to Exhibit 1 for a copy of Section 1318.

¹⁴² Paragraph 100 of the Companies and Securities Law Review Committee's Discussion Paper No 9 titled "Company Directors and Officers : Indemnification, Relief and Insurance" dated April, 1989.

¹⁴³ Ibid paragraph 60.

¹⁴⁴ Paragraph 158 of the Companies and Securities Law Review Committee's Report No 10 titled "Company Directors and Officers : Indemnification, Relief and Insurance" dated May, 1990.

It should be noted that the argument in relation to directors, officers and employees contributing to the Professional Indemnity premium is not commonly supported by the insurance community as it is standard market practice not to issue two separate contracts for this form of insurance cover.¹⁴⁵ Furthermore, it is not unusual to have a company's General and Products Liability insurance policy define the insured as follows:-

"The Named Insured stated in the Schedule hereto, and:-

(c) any director, officer, employee of the Insured whilst acting within the scope of their duties in such capacity."¹⁴⁶

Again, it is not industry practice to issue separate contracts under a Combined Legal Liability insurance policy. Nor are the directors and officers covered by this form of insurance required to pay a portion of the annual premium. The object of such an insurance policy is to protect the company purely against actions where it is held to be vicariously liable to third parties arising from the negligent actions of its directors, officers and employees.

For the concerned policy-holder it could be possible to set up an argument to have the professional services exclusion removed from the D & O insurance policy yet retained in the Company Reimbursement contract. Furthermore, the underwriter could make this extension conditional on the company maintaining a Professional Indemnity insurance policy with the employees as a named insured. The cost of this extension should be minimal because the only time the D & O insurance policy would operate when it could be established conclusively that the employer was not legally entitled to reimburse the employee. Finally, the likelihood of any award being large is remote as the amount being paid by the D & O insurance contract would only be that for which the insured is personally liable, as the larger amount for which the business is responsible would normally be met by the company's Professional Indemnity insurance policy or from its own resources.

¹⁴⁵ That is, because of Section 241 of the Corporations Law 1990 it is market practice in relation to Directors & Officers Liability insurance to issue two separate contracts. These contracts are issued in the names of the directors, officers, and employees as well as the company itself with respective premium costings.

¹⁴⁶ This subsection of a definition of a "named insured" is taken from a Sedgwick Limited (international insurance broker) Combined Legal Liability insurance policy wording. Such a definition is used by the insurance broker for liability policies it recommends to large corporate insurance buyers.

Extensions

Although the coverage provided by the D & O insurance policy is broadly based, specific cover may be required in view of the peculiar nature of the business in which directors and officers are engaged. The policyholder should study their document carefully to discover whether any of the following extensions might be required.

• Enquiries/Defence Costs

If a business operates in an area where it is possible to be subject to a government or an industry enquiry¹⁴⁷, then the policyholder's insurance contract should be extended to meet such a contingency. The policy should provide an indemnity against all costs, charges and expenses of legal representation incurred¹⁴⁸ arising out of the attendance at any official investigation, inquiry or other proceedings conducted by any official body or institution which is empowered to investigate the officers of the insured's business.

It is important for the policy holder to ensure that the definition of either "claim," "enquiries" or "defence costs" has been extended to cover not only Royal Commissions and Liquidator's examinations but also other quasi-judicial hearings such as an investigation by the Australian Securities Commission (hereafter referred to as the ASC). It may be common knowledge that a Receiver & Manager's duty of care is owed to the company under management and to its creditors; what may not be so well known is that under the Corporations Law 1991 Section 422 titled "Matters to be reported" a Receiver is required to lodge a report to ASC. As far is relevant, Section 422 states:-

422(1) (Matters to be reported) If it appears to the receiver of property of a corporation that:

(a) a past or present officer, or a member, of the corporation may have been guilty of an offence in relation to the corporation: or

(b) a person who has taken part in the formation, administration, management or winding up of the corporation:

(i) may have misapplied or retained, or may have become liable or accountable for, any money or property (whether the property is within or outside Australia) of the corporation: or

¹⁴⁷ For example, a Royal Commission or an Australian Stock Exchange enquiry.

¹⁴⁸ The costs should only be incurred with the prior consent of the policyholder's insurer.

(ii) may have been guilty of any negligence, default, breach of duty or breach of trust in relation to the corporation:

the receiver shall:

- (c) lodge as soon as practicable a report about the matter; and
- (d) give to the Commission such information, and such access to and facilities for inspecting and taking copies of any documents, as the Commission requires.

Section 422(3) permits "a person interested in the appointment of the receiver or its own motion" to apply to the Court for an order to direct the receiver to lodge a report with ASC.

It would be prudent for the insured to confirm that policy incorporates an "Advanced Legal Costs" clause in order that costs could be reimbursed as incurred, not at the end of the proceedings. A potential problem exists with the operation of the "Enquiries/Defence costs" extension in relation to a position held on non-insured companies. Although the D & O insurance policy may contain an "Outside Directorships" extension¹⁴⁹ it does not operate to reimburse the non-insured company where it is entitled to meet the costs of the insured person when the allegations have been successfully refuted. A problem may emerge where the non-insured company goes into involuntary liquidation and the insured person remains primarily liable for the legal costs incurred in successfully refuting the allegation or being exonerated by the enquiry. In such a situation the insured person becomes an unsecured creditor of the insolvent company. To avoid this from happening it would be advisable for the insured person to inspect their D & O insurance policy to ascertain whether there is a "Preservation of Indemnity" extension¹⁵⁰. Furthermore, if such an extension exists, then it should also incorporate the situation of a non-insured company¹⁵¹ becoming insolvent and being unable to meet the insured person's legal costs.

¹⁴⁹ Refer to page 73 for an explanation of the extension.

¹⁵⁰ Refer to page 77 for an explanation of the extension.

¹⁵¹ This non-insured company being the "subject" organisation of the Outside Directorship extension of the policyholder's insurance contract.

- **Estates and legal representatives**

A relatively standard extension clause incorporates the estate and/or legal representative of a deceased, mentally incapacitated or bankrupt director, officer or employee under the policy's definition of the "insured".

- **Fines and Penalties**

This is a standard exclusion since it is not considered to be in the public interest to permit a wrongdoer to insure against the community's pecuniary punishment for committing a breach of its laws. Despite this it is possible¹⁵² to have the policy cover fines and penalties where the person concerned is found "not to be blameworthy" yet the law provides no discretion to waive the fine. It should be noted that the extension does not apply to fines or penalties arising from either Federal or State taxation offences. In addition to this, the scope of the "fines and penalties" extension may not be particularly wide. This is because it is more than likely that the statutory liability offences will be excluded under a D & O insurance policy by either the operation of the absolute pollution or bodily injury/property damage exclusion clauses. These restrictions are standard to almost all such insurance policies.

- **Outside Directorships**

It is quite common for employees of the business to hold official positions in another organisation. Insurance cover can be provided for these individuals where the sole purpose for holding the position is to represent the interests of the policyholder's business. Cover is usually granted subject to the following provisions:-

- a) directors, officers or employees of the other organisation who are not representatives of the policyholder's business are not insured;
- b) the other organisation is not insured against the costs incurred where the policyholder is entitled to indemnification;
- c) the coverage provided by the insured's policy is in excess of that which the policyholder is able to receive from any insurance policy that the other organisation has in force¹⁵³.

¹⁵² Refer Extension Clause 3.4 titled "Fines and Penalties" from the 1991 Pacific Indemnity Underwriting Agency Pty Ltd Directors' & Officers' Liability Company Reimbursement Insurance Policy wording.

¹⁵³ For example, the other business may also have its own D & O insurance policy. This policy would, in the first instance, protect the interests of the person (who at the request of their employer) holding an official position on another company's board of directors.

The Outside Directorship extension should be read carefully to establish whether any of the following qualifications might apply. Namely,

- a) are positions held on companies that are either "domiciled and/or incorporated in the United States of America or Canada" excluded under the policy,
- b) has the insurer the right to decline to accept a person holding an outside directorship, and
- c) does cover apply where the D & O underwriter is the same insurer for both companies.

Point (c) can cause some concern where the other organisation holds, for example, a \$2,000,000 each and every loss and in the annual aggregate D & O insurance policy, and the insured business holds a similar policy with the same underwriter with a limit of indemnity of \$20,000,000. If a large claim (eg. \$10,000,000) were to be incurred by the other organisation then it is quite possible that the insured's representative could face a large uninsured loss with no chance of reimbursement from the Outside Directorship extension of the policy holder's D & O insurance policy. Unfortunately, Section 45¹⁵⁴ titled "Other Insurance" of The Insurance Contracts Act 1984 may not operate to protect an insured person holding a position on a non-insured company because the key words to the section are:-

"...by reason that the insured has entered into some other contract of insurance..."

In the above example, "the Insured", did not enter into another insurance policy but only through a coincidence happened to have the same underwriter providing the D & O insurance protection to the non-insured company where their representative holds an official position. If the "same insurer" proviso on the Outside Directorships extension is not struck out by Section 45 then policyholders are placed in a particularly onerous position in that they will have to ascertain the name of the D & O underwriter insuring each non-insured company where their personnel hold an official position.

The importance of this extension cannot be under-estimated as there exists the potential of conflict of interest between the duties owed to the employer and those of the company upon which the employee holds a directorial position at the request of the employer. The New Zealand case of Kuwait Asia Bank v National Mutual Nominees Ltd (1991) 1 AC 187 provides a useful insight into the potential problems that could exist with employees holding positions with associate¹⁵⁵ or unrelated companies.

¹⁵⁴ Refer to page 51 for further details on Section 45.

¹⁵⁵ A company where the insured's equity is 50% or less.

In this case it was established that the Bank had appointed its own employees as directors of a finance company which had issued false certificates to trustees for debenture holders, the directors of the finance company having guaranteed the accuracy of those certificates. The Plaintiff sought to make the Bank liable for its employees' actions as directors of the finance company. The Privy Council held that:-

"The liability of a shareholder would be unlimited if he were accountable to a creditor for the exercise of his power to appoint a director and for the conduct of the director so appointed. It is in the interests of a shareholder to see that directors are wise and that the actions of the company are not foolish; but this concern of the shareholder stems from self-interest, and not from duty...It does not make any difference if the directors appointed by a shareholder are employed by the shareholder and are allowed to carry out their duties as directors while in the shareholder's employment."¹⁵⁶

Furthermore, the Privy Council said that:-

"An employer who is also a shareholder who nominates a director owes no duty to the company **unless the employer interferes with the affairs of the company.** A duty does not arise because the employee may be dismissed from his employment by the employer or from his directorship by the shareholder or because the employer does not provide sufficient time or facilities to enable the director to carry out his duties. It will be in the interests of the employer to see that the director discharges his duty to the company but this again stems from self-interest and not from duty on the part of the employer. The plaintiff's counsel referred to *Ryde Holdings Ltd v Sorenson* (1988) 2 NZLR 157, but in that case the employer interfered with the affairs of the company by **instructing** the director to sell the assets of the company to a subsidiary company of the employer at an undervalue. None of the other authorities cited, New Zealand, English or Australian supported the submission that the bank is vicariously liable to the plaintiff either as employer or as principal or personally liable for its own negligence."¹⁵⁷

¹⁵⁶ Kuwait Asia Bank v National Mutual Nominees Ltd (1991) 1AC 187 at 221.

¹⁵⁷ Kuwait Asia Bank v National Mutual Nominees Ltd (1991) 1AC 187 at 223.

As a result of this case the Privy Council narrowed the circumstances in New Zealand in which a creditor could sue in those situations where the shareholder had actually interfered in the running of a company. Although this judgement only provides persuasive direction for Australian Courts it is a timely warning for people holding positions on outside companies at the request of their employer. The warning is that if a conflict of interest position exists between the duties owed to the insured person's employer or to the company on which a directorial position is held, then, more than likely, either the insured person or the insured company or both will be held liable for any losses emanating from such conflict.

It would be wise for the policyholder/insurance broker to review the definition to confirm whether The Outside Directorships extension includes the following entities:-

"any corporation, joint venture, partnership, trust or other enterprise which is not included in the definition of the insured business named in the policy schedule."¹⁵⁸

The above addition is particularly important when read in conjunction with the "Enquiries" and "Advanced Legal Costs" extensions.

Finally, where a D & O insurance policy contains an Outside Directorships extension the policyholder should request his/her insurance broker or underwriter to clarify the position regarding **discontinuances of directorships** that were previously covered by the extension¹⁵⁹. For example, a claim could arise after the insured person ceased to hold a directorship on a non-insured company yet refer to an incident which occurred when the position was held. Although the Outside Directorships extension would cover the insured person when holding the position it may not protect the person when the claim was lodged. This is because a D & O insurance policy is written on a **claims made** - rather than an **occurrence** - basis.¹⁶⁰ Consequently, cover will only be provided if the non-insured company remains specifically mentioned on the current insurance policy. This situation creates an administrative¹⁶¹ nightmare in order that insured persons continue to be held covered for positions which are no longer held yet where a potential exposure remains.

¹⁵⁸ "Outside Directorship" definition from page 7 of the Chubb Insurance Company of Australia Limited Directors and Officers Liability Policy wording.

¹⁵⁹ It is quite possible that underwriters will charge an additional premium to provide a continuing cover under such circumstances.

¹⁶⁰ Refer to page 39 for an explanation of the difference between "claims made" and "occurrence" policy wordings.

¹⁶¹ The administrative cost of maintaining up-to-date policy schedules can be quite expensive for a large and diverse organisation.

- **Pre Acquisition Liability**

It is standard underwriting practice to insure subsidiaries acquired during the period of insurance against loss arising from wrongful acts committed after acquisition date. This is a reasonable restriction, as otherwise the underwriter would have to meet claims arising from events which were outside the control of the management of the insured business. However, it is possible by way of extension, and possibly at an additional premium, to cover this contingency. In addition to this, prior to extending this cover most underwriters will require the submission of proposal forms and/or financial statements in order that the risk can be correctly assessed and, if necessary, priced.

- **Preservation of Indemnity**

Where the business is entitled to and agrees to reimburse the director, officer or employee and subsequently goes into liquidation, the person concerned then becomes an unsecured creditor of the business. It is possible to incorporate an extension into the D & O insurance policy to cover the situation where the insured business goes into liquidation (other than voluntary) and there are insufficient funds to reimburse the person concerned. The value of this extension will depend on the size of the deductible. For example, if the person is owed \$20,000 and the company reimbursement deductible is \$200,000 then the extension will not respond. It would be in the policyholder's interest to ensure that the D & O policy and not the Company Reimbursement excess applied to this extension.

It needs to be recognised that although there are separate Directors' & Officers' and Company Reimbursement insurance policies (or in the case of a single contract with differing insuring clauses) they are both subject to a single aggregate limit of indemnity. Therefore, if the Company Reimbursement policy has already exhausted the aggregate limit, the Preservation of Indemnity extension is of no value.

- **Run-Off Cover**

Where the insured business (as opposed to the underwriter) does not want to renew the policy, then it is possible to extend, at an additional premium, the policy for a further 12 months¹⁶² against claims arising from wrongful acts committed prior to the expiry of the D & O insurance policy. This is a valuable extension in relation to the acquisition of subsidiary companies, as it is a desirable method of protecting the D & O insurance programme of the purchasing company against claims that occurred from events which were outside its management control. Furthermore, the cost of such run-off cover can be treated as a pre-acquisition cost and reflected in the purchase price of the business.

¹⁶² Or longer if both insured and underwriter agree.

- **Shadow Directorships**

Policyholders with business operations subject to United Kingdom legislation should peruse their documents to see whether the policy extends to cover an insured whilst acting in the capacity of a "Shadow Director" as specifically defined in the UK's Companies Act 1985.

- **Superannuation Fund Trustee Liability**

With Australia's head long rush into superannuation, this extension has become particularly valuable. Its value has been highlighted by press reports of the action taken by the Australian Bank Employees Union, on behalf of a member of the superannuation fund against Westpac over the decision of the Bank's senior management to transfer \$300 million in surplus funds back to Westpac. Although the Union was unsuccessful its action attracted widespread interest as several other large corporations have transferred similar superannuation fund surpluses back into their business operations over the last few years.

It is possible to extend the D & O insurance policy to cover directors, officers and employees when acting as trustees of the business's own superannuation or pension fund. The policy holder should read the extension carefully to ensure that the clause does not state:-

"when acting on behalf of the business as a director, administrator, trustee or secretary of any superannuation fund created for the benefit of the insureds."¹⁶³

The key words "on behalf of the business" may restrict cover where employees are acting as a superannuation trustee on staff funds of their own volition (ie they were voted to the position by their fellow employees and not at the direction of their employer). In addition to this it is essential to inspect the "insured v insured" exclusion to ensure that actions resulting from the "mismanagement of superannuation funds" are specifically removed from the clause. Furthermore, the policy holder should study the "professional services" exclusion to see whether it specifically includes reference to "the management of investment of funds under the control of superannuation or pension funds of any description".¹⁶⁴

¹⁶³ "Definitions" clause 1.2 from the 1991 Directors & Officers Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

¹⁶⁴ Refer to Definitions of "Wrongful Act" and "Professional Services" under the 1991 Directors and Officers Liability Policy wording offered by C.E. Heath Underwriting and Agency Services Ltd.

• Superannuation Fund Trustees' Liability Insurance

Rather than extending the organisation's D & O insurance policy to cover losses arising from the mismanagement of the staff superannuation fund, it may be prudent to purchase a separate Superannuation Fund Trustees' Liability insurance policy. This class of insurance provides an indemnity for:-

- * Trustees,
- * Sponsoring employer, and
- * Superannuation Fund.

This is a specialised form of insurance and it is quite possible that the coverage is wider and the deductibles lower than those found in a standard D & O insurance policy. As there is a duplication of cover with the D & O insurance policy, the policyholder should study the "other insurance" clause¹⁶⁵ of their document to ensure that by acquiring this additional insurance contract it does not result in the imposition of a substantial excess on the insured's existing D & O insurance policy.

• Worldwide Coverage

It is quite normal underwriting practice for D & O insurers to exclude claim judgements emanating from foreign jurisdictions such as the United States of America or Canada. However, it is possible to find some D & O insurance policies which state:-

"coverage shall extend to claims made anywhere in the world against the insured for wrongful acts wherever committed, attempted or allegedly committed or attempted."¹⁶⁶

Although the territorial limit may be worldwide the policyholder should inspect his/her insurance contract carefully to see whether there is a jurisdictional limitation similar to that which follows:-

"any legal action or litigation actually brought or intended to be brought or threatened to be brought in a court of law constituted in the United States of America or Canada or in a court of law outside of the United States or Canada to seek the enforcement or the upholding or a judgment made in the United States of America or Canada whether by way of reciprocal agreement or otherwise".¹⁶⁷

For an additional premium, it may be possible to have the above jurisdictional limitation removed from the D & O insurance policy wording.

¹⁶⁵ Refer to page 50 for a discussion on the ramifications of the "Other Insurance" clause.

¹⁶⁶ Clause 3.1 titled "Territory" from the Chubb Insurance Company of Australia Limited Directors and Officers Liability Policy wording.

¹⁶⁷ Extensions clause 3(iv) from the 1991 Directors & Officers Liability Insurance Policy wording (Australia contract) offered by the Reg Brown and Others Non-Marine Lloyds of London Syndicate 702.

Excess

In order to maintain premiums at cost-effective levels and also to reduce the number of small "working-type" losses, it is quite common to include an individual claim excess on a D & O insurance policy. The standard industry practice is to have either a "nil" or relatively small (ie \$500 or \$2500) excess for individual directors, officers and employees while maintaining a much larger excess (ie \$20,000 or \$200,000) for claims which fall under the company reimbursement policy. It is possible that the D & O insurance policy might also include an additional excess which is not uncommon to this form of insurance. The policyholder should inspect their document carefully to determine if either of the following deductibles apply:-

• Professional Adviser's Fees

It is possible that, in order for an insurer to reduce its expenses incurred in either investigating and/or resolving a claim, the following clause might be included in the insurance contract:-

When the amount of the Excess specified in the Schedule is \$20,000.00 or more all expenses incurred by the Company pursuant to the engagement of professional advisers considered necessary to adequately determine the liability of the Insured and to **resolve the claim to the satisfaction of the Company** shall be borne by the Insured provided that the total amount to be borne by the Insured in respect of **any one Wrongful Act** shall be limited to the amount of the Excess Applicable specified in the Schedule.¹⁶

The above clause acts as a hidden additional cost on the policy. If the contract also includes a **"Waiver of Professional Legal Privilege"** clause, then policy holders could find themselves in the position of actually paying for legal advice which they are not entitled to use against the insurer should a coverage dispute occur.

¹⁶ Clause 3 titled "Excess Clause" from the 1991 C.E. Heath Underwriting and Agency Services Ltd Directors' & Officers' Liability Insurance Policy wording.

• **Territorial Excess**

While it is customary to have a "nil" excess on a D & O insurance policy and a much larger deductible on the Company Reimbursement contract, it is not unusual to also include an additional territorial excess on the former insurance policy. Consequently, the policy holder's contract may, for example include the following excesses:-

Territorial Excess

	Worldwide excl USA/ Canada	USA/Canada
1. Directors & Officers Liability Insurance policy		
(a) each director, each claim or series of claims attributable to the one cause	Nil	A\$5,000
(b) in the aggregate for all directors, each claim or series of claims attributable to the one cause	Nil	A\$25,000
2. Company Reimbursement Insurance policy		
Deductible for each claim or series of claims attributable to the one cause.	A\$250,000	A\$250,000

Prior to agreeing to purchase a D & O insurance policy, it would be wise for the policyholder to fully understand how the excess¹⁶⁹ operates on their insurance contract.

¹⁶⁹ Be it either a "Professional Fees" or "Territorial" excess.

Indirect Uninsured Losses

Although the scope of the coverage provided by the D & O insurance policy is generally very broad the policyholder should be aware of indirect company costs which are not insurable. Some examples follow:-

1. Executive time involved.¹⁷⁰
2. Loss of management time through commitment to dealing with claim.
3. Opportunity cost of lost future income as a result of being involved in a time-consuming D & O insurance claim.
4. Effects of disruption on staff involved in the claim. (ie reduced customer service time).
5. Opportunity cost of an uninsured loss.¹⁷¹
6. Legal expenses incurred in preparing a D & O insurance claim.
7. Cost of adverse publicity.

The combination of the above indirect costs may have a dramatic impact on the performance and viability of a business.

¹⁷⁰ For example, senior executives of a company are often required to brief the media or report to the organisation's Audit Committee or Board of Directors on a specific loss. Preparation for such interviews can be very time consuming and distracting.

¹⁷¹ Not all losses are covered by an insurance policy. Therefore, there is an opportunity cost when the organisation has to pay out funds because there is no insurance settlement.

Risk Management Issues

Risk management is the process of identification, analysis and treatment of those risks which threaten the financial well-being of either an individual or an organisation. Having identified and analysed the exposure, the treatment of the risks can be carried out by way of a combination of risk minimisation and transfer strategies.

An effective risk management programme could accomplish¹⁷² numerous objectives, including:

- Reduce the liability exposure not only of the directors and officers, but also the corporation to the extent that it indemnifies losses incurred by management;
- Improve the organisation's ability to recruit qualified directors and officers;
- Avoid time-consuming, distracting and potentially embarrassing claims and litigation;
- Enhance the defence of claims and reduce the potential recovery by a claimant;
- Improve the organisation's ability to obtain favourable D & O insurance coverage for its directors, officers and employees at reasonable premiums.

• Risk Minimisation Strategies

The object of this strategy is to either eliminate the risk exposure or to reduce it to an acceptable level. The following is a list of suggestions which directors and officers could adopt in order to minimise the likelihood of their being found liable for a breach of their duties at either common or statute law.

• Audit Committee¹⁷³

Where the organisation is large enough then the Audit Committee provides the Board of Directors with a valuable insight into the financial health of the enterprise. This is because the committee provides a forum for discussion with the external auditor (free from the influence of senior management), as the director members are usually non-executive. The committee's central purpose is to provide a permanent forum to ensure close co-operation between the directors and internal and external auditors. The committee should ensure that the external auditor is invited to attend the board meeting when the annual statutory financial statements are approved. The Audit Committee is the only committee to be recommended by the Senate Standing Committee for establishment as a requirement for the public

¹⁷² Page 5 "Directors & Officers Liability Loss Prevention" A booklet prepared by the USA Chubb Insurance Group of Companies, 1988.

¹⁷³ Page 13 "A guide for the Company Director. Role, duties and liabilities" Ernst & Young, 1991.

listing of a company. While the emphasis is on audit, the committee's functions often embrace wider financial matters. In light of Mr Justice Roger's findings in the AWA¹⁷⁴ case the importance of an Audit Committee cannot be over emphasised for large organisations. By way of example, the major function of such a committee could be defined as follows:-

- oversee and appraise the quality of audits conducted by the Company's internal and external auditors;
- maintain open lines of communication between the Board, the organisation's internal audit, the external auditors and management;
- perform an independent review of financial information prepared by management for external parties; and
- assess the adequacy of the Company's internal control systems, including systems established for ensuring compliance with prudential supervision and other requirements.

It would be advisable for the majority of the members of the Audit Committee to be non-executive directors with one member acting as the Committee's Chairman. Furthermore, any executive director present should be independent of the organisation's finance function. In addition to this, it would be very much in the company's interest if the external auditors were provided with the opportunity to discuss all matters of audit concern with the Audit Committee in the absence of senior management.

If the organisation is a large and diverse business operation it would be advisable to have complementary Audit Committees established in relevant subsidiary companies and operating under a similar framework as described above.

• Board Structure

Directors need to have a sound working knowledge of their organisation, an awareness of the economic, political and social environment in which the business is conducted, an understanding of the availability of financial, labour and technical resources and the level of current and proposed investments for the company which they hold a directorial responsibility¹⁷⁵. As the judgement in CBA v Friedrich¹⁷⁶ has highlighted, the director is also required to have some understanding of the concepts of financial and management accounting, the degree of understanding required depends on the director's skill, knowledge and training.

¹⁷⁴ AWA Ltd v Daniels (1992) 10 ACLC 933

AWA Ltd v Daniels (No 2) (1992) 10 ACLC 1643.

¹⁷⁵ Page 16 "Corporate practices and conduct" Working group chaired by Mr H. Bosch A.O. Business Council of Australia, 1993.

¹⁷⁶ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946.

- **Business Judgement Rule¹⁷⁷**

In the United States of America directors and officers are presumed to have acted properly and to have satisfied the three basic duties, diligence, loyalty and obedience owed to the organisation if the Business Judgement Rule is satisfied. The five elements of this rule are generally recognised as:-

1. Business decision - with the benefit of hindsight the Court will not rule against a commercial business decision, it will not act to protect a decision where the claim alleges inaction on the director's part.
2. Disinterest or no conflict of interest by the directors.
3. Due care - an informed opinion after making a reasonable effort to ascertain and consider all relevant information.
4. Good Faith - decision was in the best interests of the organisation.
5. No abuse of discretion - the rule protects directors and officers against errors of judgement, however it does not provide protection against decisions that cannot be rationally supported.

Any Australian director or officer satisfying the above criteria may be well placed to defend any allegation made against him or her under Australia's Corporations Law 1991.

- Constant updating of knowledge peculiar to the organisation and in relation to the business environment in general.

In order to deflect an allegation of a breach of directorial duties, it is wise for the person concerned to keep up-to-date on business events (eg. changes in Government's tariff policy, the AWA¹⁷⁸ court decision) which could impact on the company's operations.

¹⁷⁷ Page 7, "Directors & Officers Liability Loss Prevention" A booklet prepared by the USA Chubb Insurance Group of Companies, 1988.

¹⁷⁸ AWA Ltd v Daniels (1992)
AWA Ltd v Daniels (No 2) (1992).

- **Dissenting directors¹⁷⁹**

In the first instance a director should be mindful that a board acts collectively and, as such, he or she is bound by the decision of the majority of the board. The director becomes party to what flows from the board decision. A director may continue to be dissatisfied and be of the opinion that a particular course of action is not in the best interests of the company. In such cases, the director should insist on his or her protest being recorded formally in the minutes which, in most instances, will finalise the matter. It should not be pressed further and the majority decision should be accepted.

The director should not threaten to resign because it has been asserted that an inadequate reason for threatening to resign carries the risk of continued participation in the course adopted. Not carrying out a threat, must result in the director being implicated in the consequences of a board decision which has been accepted by the director's non-resignation.

Finally and only if all else fails, the director should resign. To protect the director from breach of fiduciary duty, he or she may have to issue a statement of explanation to the shareholders. Should a director fear some illegality, it may be wise for that person to seek legal advice which, in turn, may lead to informing the regulatory authorities or approaching the court.

- **Due Diligence Exercises**

Due diligence may be defined as:

"An activity which is conducted for the purpose of independently verifying representations made to and the key assumptions made by a lender, buyer, etc to the extent to which information is independent and verifiable."¹⁸⁰

The above process brings together many professional, management and technical skills in numerous individual activities which comprise the overall due diligence investigation. It would be very much in the interests of directors and officers to have these investigations carried out by independent third parties in situations which are either very technical or where a potential conflict of interest exists. It is also important to ensure that the financial costs of the exercise do not exceed any likely benefits to the organisation.

¹⁷⁹ Pages 25/6 "A Guide for the Company Director. Role, duties and liabilities" Ernst & Young, 1991.

¹⁸⁰ Page 6 "Due Diligence" The Australian Corporate Treasurer journal dated August, 1990.

- **Minimise Outside Directorships**

Quite frequently employees are required, as part of their normal employment duties, to hold official positions¹⁸¹ in an organisation where the employer's interest is 50% or less of the voting capital or where there is no equity relationship at all. This latter situation could arise where the employer is a lender to the organisation or where, as part of its normal business activities,¹⁸² it is required to provide employee officeholders.

Duties owed to the "other" organisation

Each director must ensure that the company is properly managed and constantly improved so as to protect and enhance the shareholders' interests. The employee who is also a director of another organisation in which their employer has an interest must be aware that he or she:-

- acts at all times in the interests of the general body of shareholders of the "other" organisation rather than any sectional interest (ie the employer).
- Avoid conflicts of interest; and
- Is independent of their employer's interests in his or her judgements and actions.

Conflict of Interest

At all times a Director must be able to act in the interests of the company as a whole. The interests of associates, individual shareholders, other companies, personal interests of the director or the director's family must not be allowed to prevail over those of the company's shareholders generally. Where a conflict does arise the director must consider whether to refrain from participating in the debate and voting on the matter, or to resign from the board. In any event full disclosure of the conflict or potential conflict must be made to the board.

As a result of the conflict of interest position employees holding¹⁸³ official positions on outside organisations would be well advised to keep the number of such positions to a minimum.

¹⁸¹ As either a director or an officer.

¹⁸² For example, a Corporate Trustee providing employee directors to deceased estates with corporate entities.

¹⁸³ At their employer's request.

- Monitor compliance with statutory requirements.

Insufficient review¹⁸⁴ by the organisation of compliance with a range of legislative requirements¹⁸⁵ could be an early warning sign that the enterprise is not operating effectively. Aiding and abetting provisions in, for example, environmental legislation can assign personal liability to the directors and officers of the offending organisation. Furthermore, losses arising from polluting activities are standard exclusions in a D & O insurance policy. Any fine or penalty or civil damages are likely to be to the individual's own account. In some Australian states there are appeal restrictions¹⁸⁶ on rights contained in the environmental statutes.

- **Non-Executive Directors¹⁸⁷**

The boards of public companies should include a majority of non-executive directors with an appropriate mix of skills and experience. Non-executive Directors are not employees but bring special qualifications, experience, expertise and an independent perspective to the board. The main function of a non-executive director is to bring an independent view to the board's deliberations and to help the board provide the company with effective leadership. The independence of a non-executive director may be defined as not having:

- 1) a contractual relationship with the company other than the office of director (and therefore not subject to the control or influence of any other director or group of directors);
- 2) any relationship (ie., a major supplier of services) with the company which could affect the exercise of independent judgement.

All non-executive directors must be continually aware of their fiduciary duties to the company and must not allow conflicting interests to interfere in the discharge of those duties.

¹⁸⁴ Page 17 A Guide for the Company Director. Role, Duties and Liabilities. Ernst & Young, 1991.

¹⁸⁵ Including non-financial matters.

¹⁸⁶ No appeal rights exist in Victoria in relation to the environmental statutes.

¹⁸⁷ Pages 15/16 "Corporate practices and conduct" Working group chaired by Mr H. Bosch A.O. Business Council of Australia, 1993.

- Regular contact with external advisers

In order to obtain a well-informed view of the matter under consideration both directors and officers should have unrestricted access to the organisation's external advisers such as accountants, solicitors and technical consultants. This was one of the main salutary lessons emanating from the CBA v Friedrich¹⁸⁸ court action.

- Reliable reporting system¹⁸⁹

Directors and officers should ensure that the organisation has a reliable reporting system in place to report on a wide range of legislative requirements and regulations concerning both financial and non-financial matters. Many of these regulations include the potential for civil and criminal liability for directors, as well as actions for large damages against the company. Examples include:

- waste disposal;
- storage of explosives;
- control of dangerous substances;
- occupational health and safety;
- sexual harassment;
- equal opportunity and anti-discrimination;
- smoking and alcohol in the workplace;
- various environmental issues; and
- condition of the air conditioning system with the risk of legionnaires' disease.
- trade practices

If there is continuing doubt about the reliability of any management information system, an investigation by an independent consultant should be initiated. Failing to maintain a reliable reporting system could result in the directors of a company incurring statutory fines for such failure. As previously highlighted, fines and penalties are a standard exclusion under the D & O insurance policy.

¹⁸⁸ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946.

¹⁸⁹ Page 24 "A Guide for the Company Director. Role, duties and liabilities". Ernst & Young, 1991.

- **Spirit of the law¹⁹⁰**

Office holders of an organisation must take all reasonable steps to ensure that not only do their actions comply with the letter of the statute law but also that they are in full compliance with the general fiduciary duties owed to the enterprise. At all times, in their observance of the law and their duties, officeholders of the organisation should remember that there is, a standard of ethical behaviour by which all their actions should be judged. If there is the slightest doubt as to whether an officeholder, in engaging in a particular activity, is not complying with any aspect of his/her fiduciary duties then he/she should seek competent and independent advice and be prepared to rely upon that advice.

The risk of failing to adopt adequate risk minimisation strategies is clear and simple. This risk was succinctly highlighted in an article appearing in the Australian Financial Review¹⁹¹. The article concluded by quoting Sydney lawyer Mr G. Sutherland:-

"But the alternative is clear - the risk is prison, bankruptcy and total social and commercial leprosy."¹⁹²

- **Asset Transfer**

Although questionable on moral grounds, a final risk minimisation strategy is for the officeholder to arrange his or her own affairs in such a manner which ensures that their assets are outside the reach of any successful litigant.

Risk Transfer

Although directors and officers are not entitled to abrogate their responsibility in relation to the duties owed to the organisation, it may be possible, via the risk transfer mechanism, to "share some of the blame" with another party.

- **Insurance**

The most common form of risk transfer is by means of insurance which changes an uncertain exposure into a certain cost. For example, an insurance premium is exchanged for the insurer accepting the organisation's risk exposure. Officeholders should ensure that the organisation not only has adequate levels of D & O insurance protection but also other classes of insurance such as, for example, professional indemnity, public liability, material damage and business interruption, and marine cover.

¹⁹⁰ Page 29 "Corporate practices and conduct" Working group chaired by Mr H. Bosch A.O. Business Council of Australia, 1993.

¹⁹¹ Page 26 Australian Financial review 22 November, 1991 issue. An article titled "A Ready Reckoner for Directors" and quoting Sydney lawyer Mr G. Sutherland.

¹⁹² Ibid.

- **External Advisers**

If the officeholder has suffered a loss as a result of acting on the incorrect advice provided by the organisation's external advisers¹⁹³, then it might be possible to institute proceedings against those advisers to recoup the loss. An action could be instigated claiming either (or all three) breach of contract, breach of a duty of care under the tort of negligence or a breach of legislative provisions concerning misleading or deceptive conduct.¹⁹⁴ This last allegation has obvious advantages to the party bringing the action because liability arises without the need to prove proximity. The defendant can be liable for advice which is not given negligently but which, in conjunction with other factors, has the effect of being misleading or deceptive and disclaimers in legal contracts may not operate.¹⁹⁵ Even silence on the part of the adviser can be grounds for instigating an action under this type of legislation.

- **Insurance Brokers**

Prior to entering into a binding contract, professional advisers may be required to fully inform their clients of the "complexity and difficulty" contained in the contract they are about to purchase. This principle was highlighted in the foreign currency Loan case of Chiarabaglio v Westpac¹⁹⁶, 1989 when Mr Justice Foster stated:-

"If the substantial complexity and difficulty involved in monitoring and management had been brought to (the male applicant's) attention in the discussions prior to the taking of the loan, he would have been apprised of the risks and difficulties involved and would simply have refrained from off-shore borrowing."¹⁹⁷

The key word in the above quotation is the word "prior". Furthermore, in the 21 November, 1991 issue of the Sydney Morning Herald it was reported that Mr Justice Lee held in another foreign currency Loan case Ferneyhough v Westpac¹⁹⁸ that there were three implied terms of contract in the loan agreement between the borrower and the bank. These were:-

- * the bank must provide substantial and accurate advice in relation to borrowing in foreign currencies;

¹⁹³ For example, the organisations accountant or solicitor.

¹⁹⁴ Refer to the State Fair Trading legislation equivalent to section 52 of the commonwealth's Trade Practices Act 1974.

¹⁹⁵ Page 376 "Professional negligence of lawyers, accountants, bankers and brokers". G.R. Masel. Second Edition. 1989. CCH.

¹⁹⁶ Chiarabaglio & Anor v Westpac Banking Corporation (1989) ATPR paragraph 40 - 971.

¹⁹⁷ Ibid.

¹⁹⁸ Ferneyhough v Westpac Banking Corporation Federal Court of Australia (Unreported Pincus J 23 May 1991).

- * the bank must give sufficient advice to allow the borrower to make an informed decision, including advice on hedging; and
- * the bank must exercise reasonable care and skill.

The above principles apply not only to bankers but also to professional advisers including inter alia accountants, solicitors and insurance brokers.

Insurance brokers owe their clients a duty to fully explain the operation of the D & O insurance policy's enhancements/restrictions, exclusions, excesses and extensions prior to entering the contract.¹⁹⁹

Understanding the Corporate Environment

"The Red Queen seized Alice by the hand and dragged her, faster and faster, on a frenzied run through the countryside, but no matter how fast they ran they always stayed in the same place. Alice was understandably puzzled saying, "Well, in our country you generally get to somewhere else - if you run very fast for a long time as we have been doing". "A slow sort of country!" said the Queen. "Now, here you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that".²⁰⁰

Alice's problems in the Looking Glass World - a world where you have to run hard just to stand still and where the more you are entitled to, the less you get - are somewhat analogous to the problems facing directors and officers in today's litigious society. These office holders are required to remain a "step ahead" because what is considered today to be undertaking duties with a "reasonable degree of diligence" may not be considered so when the action is decided upon several years (possibly 8 or more) into the future. At that time the interpretation placed on such vague words like "reasonable" and "improper" will be determined by the prevailing attitudes at that time and will be influenced by whatever significant Court decisions in the relevant area may have been made in the intervening period.²⁰¹

¹⁹⁹ Exhibit 5 contains a list of questions which the policyholder should ask their professional insurance adviser to complete prior to their entering into any D & O insurance contract.

²⁰⁰ Chap 2. "Through the Looking Glass" by Lewis Carroll (1832-1898).

²⁰¹ "Directors Liability - a perspective under the Corporations Law" J. Syme Partner Corrs Chambers Westgarth. Page 151 Corporate Management September/October, 1991.

Limitation periods for commencing litigation and the delay in having cases decided means that developments in the common law since the wrongful act occurred can effectively operate retrospectively in a way in which changes to the statute law can not.²⁰²

D & O insurance can operate to reduce the personal costs that a director, officer or employee might incur due to the retrospective nature of advances in the common law. It cannot be too strongly emphasised that it is the responsibility of the policy holder to fully understand that this form of insurance does not act as a safety blanket²⁰³ for errors and omissions that might arise in the undertaking of duties owed to a business. As the insurance contract is written on a "claims made" basis, the policy holder should continually review coverage to ensure that the policy's scope has not been reduced due to recent changes in either the common or statute law. It should not be forgotten that the broad, general definition of "wrongful act" may be restricted by the excesses, exclusions and endorsements (or lack of them) contained in the policy document.

The message from Statewide Tobacco²⁰⁴, CBA v Friedrich²⁰⁵ and AWA²⁰⁶ is clear. While directors and officers can delegate their authority, responsibility is theirs alone!

²⁰² "Directors Liability - a perspective under the Corporations Law" J. Syme Partner Corrs Chambers Westgarth. Page 151 Corporate Management September/October, 1991.

²⁰³ The D & O insurance protection is equivalent to a Safety net with big holes through which someone could accidentally fall.

²⁰⁴ Statewide Tobacco Services Limited v Morely (1990) 8 ACLC 827.
Statewide Tobacco Services Limited v Morely (1992) 10 ACLC 1233.

²⁰⁵ Commonwealth Bank of Australia v Friedrich & Ors (1991) 9 ACLC 946.

²⁰⁶ AWA Ltd v Daniels (1992) 10 ACLC 933.
AWA Ltd v Daniels (1992) 10 ACLC 1643.

EXHIBITS

1. Section 1318 Power to Grant Relief Corporations Law 1991
2. Section 241 Corporations Law 1991
3. Indemnity from Articles of Association
 - An acceptable indemnity
 - An unacceptable indemnity
4. Events that could give rise to a D & O Insurance claim.
5. D & O Insurance Questionnaire

Section 1318 Power to Grant Relief

The application clauses of the section are:-

1318(1) (Court's power to relieve certain persons from liability). If, in any civil proceedings against a person to whom this section applies for negligence, default, breach of trust or breach of duty in a capacity as such a person, it appears to the court before which the proceedings are taken that the person is or may be liable in respect of the negligence, default or breach but that the person has acted honestly and that, having regard to all the circumstances of the case, including those connected with the person's appointment, the person ought fairly to be excused for the negligence, default or breach, the court may relieve the person either wholly or partly from liability on such terms as the court thinks fit.

1318(2) (Application for relief) Where a person to whom this section applies has reason to apprehend that any claim will or might be made against the person in respect of any negligence, default, breach of trust or breach of duty in a capacity as such a person, the person may apply to the Court for relief, and the Court has the same power to relieve the person as it would have had under subsection (1) if it had been a court before which proceedings against the person for negligence, default, breach of trust or breach of duty had been brought.

Section 241 Indemnification of Directors & Officers

- "(1) Any provision contained in the articles or in a contract with the company or otherwise, for exempting any officer or auditor of the company from, or indemnifying him against, any liability that by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company is void.
- (2) Notwithstanding anything in this section, a company may, pursuant to its articles or otherwise, indemnify an officer or auditor against any liability incurred by him in defending any proceedings whether civil or criminal, in which judgment is given in his favour or in which he is acquitted or in connection with any application in relation to any such proceedings in which relief is under this Code granted to him by the Court.
- (3) Sub-Section 1 does not apply in relation to a contract of insurance, not being a contract of insurance the premiums in respect of which are paid by the company or by a related corporation."

Indemnities

Valid indemnity under Section 241, Corporations Law 1991

Subject to the provisions of and so far as may be permitted by the Statutes, every Director, Auditor, Secretary or other officer of the Company shall be entitled to be indemnified by the Company against all costs, charges, losses, expenses and liabilities incurred by him in the execution and discharge of his duties or in relation thereto.

Invalid indemnity under Section 241

Indemnification. The Indemnifier does hereby covenant and agree to indemnify the Director and to hold the Director harmless from and against any and all claims, threats, suits (whether instituted by the Company or any other person or entity), damages, penalties, liabilities, costs and expenses (including, without limitation, legal fees, costs and disbursements) incurred, suffered or expended by or threatened against the Director with respect to any action or inaction taken in the course of the Director's duties as a director of the Company.

ANY OF THE FOLLOWING COULD GIVE RISE TO A
DIRECTORS' AND OFFICERS' LIABILITY CLAIM

Misuse of Corporate Funds	Tender Offer Suits
Political Contributions	Corporations Law
Violations	
Misuse of Inside Information	Customers Suits
Actions by Creditors	Actions by Shareholders
Conflict of Interest	Failure to Maintain
	Insurance
Antitrust Violations	Auditing & Accounting
	Practices
False Statements to Government Agencies	Foreign Business Activities
Breach of Duty to Minority Shareholders	Management Integrity
Irregularities in Securities Issues	Breach of Trade Practices
	Act
Questionable Payments	Quality of Management
Failure to Honour Employment Contracts	Questionable Practices
Misleading Representations	Civil Rights Denial
Inadequate Supervision	Improvident Expansion
Financial Loss to Corporation	Actions Brought by
	Competitors
Public Activist Groups	Collusion to Defraud
Mergers and Acquisitions	Conspiracy to Defraud
Bankruptcy Suits	Granting Share Options
Fiduciary Responsibilities	

Source: Chubb Insurance Company of Australia

Prior to entering into the D & O insurance contract the policyholder should have their professional insurance adviser complete (and sign) this questionnaire against the policy wording that they are recommending. **Any answers which indicate a reduction in coverage should be fully explained before agreeing to take out the insurance policy.** It cannot be emphasised too strongly that failure to fully understand the scope of the policy could result in a personal loss to the director, officer or employee concerned for which no reimbursement is permitted by the law. The relevant questions (and pages within the Research Paper) are as follows:-

Insured:

Insurer:

Policy No: Expiry Date:

A. Enhancements/Restrictions (p. 41)

- | | |
|--|--------|
| (1) Action Against Underwriters (p. 42) | No/Yes |
| (2) Advancement of defence costs (p. 43) | No/Yes |
| (3) Automatic indemnification (p. 44) | No/Yes |
| (4) Automatic cover for acquisitions (p. 45) | No/Yes |
| (a) All territories (p. 46) | No/Yes |
| (b) Notification only at renewal (p. 46) | No/Yes |
| (c) Past Subsidiaries/Relinquished Positions (p. 46) | |
| (5) Claims co-operation clause <u>does not</u> (p. 47)
effect legal professional privilege. | No/Yes |
| (6) Definition of claim <u>does not</u> refer to: (p. 48) | |
| (a) a "circumstance" that could give rise
to a future claim | No/Yes |
| (b) "Verbal allegations" | No/Yes |
| (c) In the opinion of a "reasonable director", etc | No/Yes |
| (7) Extended reporting period provides:- (p. 49) | |
| (a) 30 day automatic period at no extra cost | No/Yes |
| (b) additional premium for 365 day period | No/Yes |
| (8) "Other insurance" clause <u>does not</u> operate (p.50) | No/Yes |
| (9) Severalability/Non-imputation clause operates (p. 54) | No/Yes |

(a) Worldwide Jurisdiction	No/Yes
(b) Wrongful Act Worldwide	No/Yes
(c) <u>Insurance Contracts Act</u> 1984 applies	No/Yes
(11) Use of Term "Best Endeavours" (p. 54)	No/Yes
B. Exclusions	
Policy coverage is <u>not</u> provided for:-	
(1) Failure to maintain insurance (p. 56)	No/Yes
(2) Claims made or threatened before or after commencement/expiry of policy (p. 56)	No/Yes
(3) Conflict of interest between insured and non-insured companies (p. 56)	No/Yes
(4) Indemnification provided by non-insured companies (p. 57)	No/Yes
(5) Indemnification available from all other sources (p. 57)	No/Yes
(6) Trade Practices Act (p. 57)	No/Yes
(7) Intentional Breach of Contract (p. 58)	No/Yes
(8) Insured v Insured clause does not cover claims arising from "dismissal, discrimination, denial of natural justice or misleading representation or advertising involving employment or claims arising out of mismanagement of company's own superannuation or pension fund.	No/Yes
• Insolvency professionals whether or not appointed by the court (p. 58)	No/Yes
(9) Personal guarantee applies only to company loans (p. 59)	No/Yes
(10) Remuneration without shareholder approval (p. 59) must subsequently found to be illegal	No/Yes
(11) Libel, slander, infringement of copy right or passing off, plagiarism (p. 59)	No/Yes
(12) Dishonest, fraudulent and malicious acts. (p. 59) However, exclusion does not apply are where:-	
(a) allegation is successfully refuted	No/Yes
(b) Wrongful act claim is not connected to the dishonest, fraudulent or malicious act.	No/Yes

(a)	Failure to effect insurance (p. 56)	No/Yes
(b)	Illegal market or price fixing (p. 60)	No/Yes
(c)	Loss of investment value outside the control of the insured (p. 60)	No/Yes
(d)	Subsidiaries domiciled or incorporated in North America (p. 60)	No/Yes
(e)	Royal Commissions and/or ASC investigations (p. 60)	No/Yes
(14)	Liability for the Debts of a Company (p. 61)	No/Yes
(15)	Prospectus Liability (p. 64)	No/Yes)
	• USA/Canada (p. 65)	
(16)	Professional indemnity exclusion does not apply (p. 67)	No/Yes
C.	Extensions	
	Policy is extended to include:-	
(1)	Enquiries/Defence Costs - legal costs for government or industry enquiries (p. 71)	No/Yes
(2)	Estates and legal representatives (p. 73)	No/Yes
(3)	Fines and Penalties excluded where insured is not to be found blameworthy (p. 73)	No/Yes
(4)	Outside Directorships (p. 73)	No/Yes
	Extension Includes:-	
(a)	North American domiciled/incorporated organisations	No/Yes
(b)	Right to decline by insurer	No/Yes
(c)	Cover applies whether or not the insurer is the same as covering the outside organisation	No/Yes
(d)	Any corporation, joint venture, partnership, trust or other enterprise which is not included in definition of insured organisation.	No/Yes
(e)	Relinquished positions (p. 76)	No/Yes

- | | | |
|------|--|--------|
| (6) | Preservation of Indemnity (p. 77) | No/Yes |
| | • Company reimbursement excess does not apply | No/Yes |
| (7) | Run-off cover (p. 77) | No/Yes |
| (8) | Shadow directorships for UK operations (p. 78) | No/Yes |
| (9) | Trustee liability for employee superannuation or pension funds (p. 78) | No/Yes |
| | • covered whilst representing either employer or fellow employees | No/Yes |
| (10) | Worldwide coverage (p. 79) | No/Yes |
| | (a) Wrongful acts anywhere in world | No/Yes |
| | (b) Worldwide jurisdiction | No/Yes |

D. Excess

Policy excess does not include:-

- | | | |
|-----|---|--------|
| (1) | Professional adviser's fees proviso (p. 80) | No/Yes |
| (2) | Territorial deductibles (p. 81) | No/Yes |

.....
(Professional Insurance Adviser)

.....
(Date)

AWA Judgement on apportionment of liability

AWA's 1987 audited accounts declared a \$49.8 million loss from foreign currency trading having previously indicated a series of profits from this revenue raising activity. The company discovered that the losses were the result of unsupervised speculative trading conducted by its 23 year old Foreign Exchange Manager, Andrew Koval. AWA sued their auditors, Deloitte Haskins and Sells (now Deloitte Ross Tohmatsu) for failing to detect losses from foreign currency trading and for failing to maintain adequate foreign exchange records.

In his judgement¹ handed down in July, 1992 Mr. Justice Rogers of the Supreme Court of N.S.W. found that:-

1. As a result of their failure to inform AWA's Board of Directors that the Company was not keeping proper records, the auditors were negligent in their duty owed to AWA, and
2. Because of the negligence of AWA's senior management in not establishing appropriate internal controls,² the company was guilty of contributory negligence, and
3. Due to the negligence of Mr Hooke, the Chief Executive Officer and Chairman of AWA, the auditors liability to the company would be reduced.

On the 18 November, 1992 His Honour delivered a further judgement apportioning liability between the negligent parties.

Principles of Apportionment

Mr. Justice Rogers took into consideration the degree of departure from the "reasonable man" test when determining the liability of the respective parties who were responsible for the loss which AWA incurred. As well as this he also considered³:-

- the extent to which the respective actions of the parties causally contributed to the loss;
- the positions and the activities of the parties; and
- the extent to which the activities of each party posed a risk to the other.

¹ AWA Ltd v Daniels (1992) 10 ACLC 933

² Having, on two occasions, had the weakness in the internal controls drawn to their attention the AWA's external auditors.

³ AWA Ltd v Daniels (No 2) (1992) 10 ACLC 1643 at 1644. Comments taken from the headnote to the case by the CCH Corporations Law Editors.

Apportionment

Liability was apportioned on the following basis:-

Negligence of Auditors	80%
Contributory Negligence on the part of the Company	<u>20%</u>
	<u>100%</u>

Mr Hooke was required to contribute to 10% of the auditors 80% for which they were liable, making the effective apportionment 20%, 72% and 8% respectively.

Findings

On the general question of whether auditors were supposed to be watchdogs or bloodhounds, His Honour said:-

"Whether auditors are watchdogs, or bloodhounds, or any other form of canine, they cannot allow themselves to be utterly toothless. Daniels did not simply fail to show his teeth, he kept his mouth firmly shut when he signed, without qualification the auditor's certificate."⁴

The court found that the auditors could not rely on a defence of contributory negligence in relation to their failure to inform the Board of AWA of the company's inability to keep proper books of account. His Honour held that:-

"...in my opinion, the negligence of the auditors in failing to report on the plaintiff's failure to keep proper books of account cannot be met by any assertion of contributory negligence on the part of the plaintiff. The failure to report the plaintiff's neglect meant that, unaware of the true position in this regard, the directors took no action. That meant that Koval was allowed to carry on with his activities uncontrolled and able to speculate without restraint. Accordingly I reject the defendants' submission that there is no causal relationship between the breach and the damage suffered."⁵

The rationale behind this reasoning is that had the directors of AWA been made aware of the lack of internal controls in September,⁶ 1986 they could have taken preemptive action before the foreign exchange losses began ballooning out of control. This failure on the part of the auditors resulted in them being held liable for 80% of the loss suffered by AWA.

⁴ AWA Ltd v Daniels (No 2) (1992) 10 ACLC 1643 at 1652.

⁵ Ibid at 1654 (Bolding added).

⁶ This was the month when the auditors of AWA became aware that there were serious deficiencies in the company's foreign exchange bookkeeping system.

The contributory negligence of the senior management of AWA in failing to adopt appropriate internal controls was a factor in reducing the liability incurred as a result of the auditors neglect in failing to report the absence of such controls to the Board of the company. This negligence on the part of senior management was the initial cause of the company's ultimate loss. Chief Justice Rogers stated:-

"...The primary obligation to put in place appropriate internal controls rested on management. Furthermore, it has to be borne in mind that the auditors did draw the deficiencies to the attention of senior management, both on 28 October 1986 and 13 March 1987 and that persons in authority took note of the deficiencies drawn to their attention. However, they did nothing about it. ...Nonetheless, in the total context, the primary duty and obligation remained on management, the auditors discharged their initial obligation to draw attention of management to the deficiencies. In other words management was fully aware, not only of the failure, but of the need to put a system in place. Senior management, for reasons of its own, then failed to discharge that duty."⁷

AWA was required to have its loss reduced by 20%.

Refusal of Relief from Liability

Mr Hooke sought an order under Section 535⁸ of the Companies Code 1981 seeking relief on the grounds that he had acted honestly and the breaches of duty found against him were the result of errors of judgement. In refusing relief Chief Justice Rogers said:-

"Hooke sought an order that he be relieved of liability in whole, or in part, on the basis that the breaches of duty found against him were in substance errors of judgment. It was pointed out that he had acted honestly, derived no personal gain from the breaches of duty, had no motive to act inappropriately and had no actual knowledge of the true facts. In the first place, that is not entirely correct. For example Hooke was told by Wickham of the \$12 million loss but accepted Wickham's reassurance that Koval could recoup the position. A minute's thought should have shown Hooke that something was very wrong. The whole year's profit was to be \$10 million. What transactions would have to be entered into to make a profit of \$12 million to recoup the loss? With profit of that kind ran the possibility of huge losses. How was the \$12 million lost? ...First, the very complaint against Hooke, in part, is that he failed to obtain knowledge of the true facts. Second, Hooke held the two most important offices in the company. I have found him to have been

⁷ AWA Ltd v Daniels (No 2) (1992) 10 ACLC 1643 at 1655.

⁸ Now Section 1318 of the Corporations Law 1991.

negligent in the discharge of his duties. It is essential for the purposes of corporate law that the courts rigorously enforce the obligations of those who seek and obtain high corporate office. Shareholders are entitled to look to the law and to the courts to ensure that loss to the company, due to negligence in the administration of their company, is compensated by the negligent actors, be they auditors, executives or senior management.Honest bungling is no appropriate basis for relief from liability."⁹

Judgement on Quantification

In his judgement on quantum, which was issued on 7 April, 1993 Chief Justice Rogers determined that the auditors liability towards AWA's \$38m loss amounted to \$12.24m plus interest. Arriving at this complex and difficult loss assessment decision his Honour held:-

"... courts of authority have directed that a judge may not decline to make an assessment on the basis that the task is all too difficult. At the same time, the judge is enjoined against speculating. The conclusion required is as to probabilities or possibilities, drawing on such evidence as there is. The assessment will be based on what, in fact, the state of the FX market was, from time to time, during the period 27 September to July 1987, the underlying exposure of AWA during this period time, the time when it was likely that the person in charge of the FX operation would have become aware of the exchange variation clauses in the contracts, the general financial position of AWA, and most of all, the character of the directors of AWA and their likely response to the results of the FX operations in accordance with policy and the results of those operations. At the risk of repeating myself, they would have aimed for a result which would have exposed them to the risk of as little loss as possible, but at the same time, protected the company, as much as possible, against losses on the underlying contracts".¹⁰

⁹ AWA Ltd v Daniels (No 2) (1992) 10 ACLC 1643 at 1658 (Bolding added).

¹⁰ AWA Ltd v Daniels (No 3) (1993) (unreported, Rogers CJ 7 April, 1993)

Mr. Justice Rogers held that "for directors of a company in the position of AWA not to hedge against currency fluctuations would be negligent".¹¹ However, he emphasised Mr Koval's role in contributing to the company's profit by speculating in foreign currency trading outside the Board's policy. His Honour concluded that:-

"It has to be borne in mind that Mr Koval was the largest profit centre in AWA. He had made \$7.5 million in the preceding year and for the quarter ended 30 September he was making a profit of \$8.8 million. In my opinion, the defendants' submission overlooks the fact that to achieve those results, Mr Koval was speculating in a way which infringed the Board's policy. The discovery by the Board of the exposure of the company to three and half times the permitted amount in FX contracts, in my opinion, would have had precisely the same consequence as it had nine months later."¹²

His Honour rejected the auditors argument that had the directors of AWA known in September, 1986 that the value of the company's open foreign currency contracts was \$750 million, they would not have immediately called in an appropriate expert to advise them on a suitable course of action to bring the exposure back to within Board policy.

The auditors argued¹³ that irrespective of their own actions, due to the Board's ledging policy, AWA would have lost about \$32 million of the \$38 million. Chief Justice Rogers disagreed and held:-

I am required to determine the likelihood of AWA changing its policy for FX after 22 September, when the policy would have been changed and the extent of the change before I can decide the financial consequences.

Making the best assessment of probabilities, in my view, in round figures the loss would have been \$21 million . . . That gives an amount of \$17 million which will be required to be apportioned in accordance with my judgement of 18 November, 1992.

To the principal so calculated it will be necessary to add interest".¹⁴

Based on his November judgement, the \$17 million would be apportioned on the following basis:-

	<u>Amount</u>	<u>%</u>
Negligence of Auditors	\$13.6m	80%
Contributory negligence on the part of AWA	<u>\$ 3.4m</u>	<u>20%</u>
	<u>\$ 17m</u>	<u>100%</u>

¹¹ AWA Ltd v Daniels (No 3) (1993) (Unreported, Rogers CJ 7 April, 1993) at page 28

¹² Ibid page 5

¹³ Ibid page 3

¹⁴ Ibid page 37

The auditors were entitled to seek from Mr Hooke,¹⁵ AWA's former Chief Executive Officer and Chairman, a contribution of \$1.36 million (being 10% of Deloitte's 80%) thereby reducing their liability to \$12.24 million plus interest.

Costs

In his judgement, Mr Justice Rogers said he was inclined to award costs to AWA for the case up to July, 1992. His Honour stated:-

"In my view the defendants were not justified in putting the plaintiff to the horrendous cost of a hearing exceeding sixty days, not to mention the various interlocutory applications, in order to vindicate its rights. The mediation to which I directed the parties to submit was designed to provide an opportunity to eliminate liability as an issue. In complex litigation of this kind the luxury of requiring the plaintiff to prove its case has to be paid for.¹⁶

It is estimated¹⁷ that some \$20 million in legal costs has been spent on the case to date. The auditors have committed¹⁸ themselves to appealing Mr. Justice Rogers July, 1992 judgement on liability.

¹⁵ Due to the indemnity (refer to page 2 of Chief Justice Rogers' quantification judgement) which had been given to him by AWA, Mr Hooke was not liable for the amounts awarded against him. It is interesting to note that if Section 241 (refer Appendix 2) of the Corporate Law Reform Bill (No 2) 1992 becomes law, companies like AWA will no longer be able to provide negligent officers and/or directors with such an indemnity.

¹⁶ AWA Ltd v Daniels (No 3) (1993) (unreported, Rogers CJ, 7 April, 1993) at page 38.

¹⁷ Article titled "Deloitte ordered to pay AWA \$23.9 million" which appeared on page 19 of the 8 April, 1993 issue of The Age newspaper.

¹⁸ Ibid

Corporate Law Reform

Section 241 Provision Indemnifying Officers or Auditors

Section 241(1) of the Corporations Law 1991 states that any provision indemnifying any officer or auditor against a liability incurred in relation to the company, arising from any negligence, default, breach of duty or breach of trust, is void. However, Section 241(3) permits an insurance policy to provide such an indemnity as long as the premium is not paid by the company or a related corporation.

Corporate Law Reform

The Corporate Law Reform Bill (No 2) 1992 was introduced into Federal Parliament on 26 November, 1992. Though the Bill is yet to become law, the proposed legislation in relation to the indemnification of officers and auditors as well as the companies right to pay for insurance protecting such officers and auditors is worthy of comment.

Under the proposed legislation the new Section 241 relates to indemnification whereas a totally new Section 241A dealing with the type of insurance that a company can purchase on behalf of its officers and auditors has been incorporated into the Bill.

Payments, made by a company or a related body corporate, for the purposes of the revised Section 241 and the proposed Section 241A are subject to the usual requirement under Section 232 of the Corporations Law 1991. This being that any decision to pay be made in good faith and in the best interest of the company.¹

The New Section 241²

The proposed new section states:-

241. (1) A company or a related body corporate must not:

(a) indemnify a person who is or has been an officer or auditor of the company against a liability incurred by the person as such an officer or auditor, or

(b) exempt such a person from such a liability.

(1A) A memorandum, articles, or any other instrument, or an agreement or arrangement, is void in so far as it provides for a body corporate to do something that subsection (1) prohibits.

¹ Refer to paragraph 323 of the Explanatory Memorandum to the Corporate Law Reform Bill (No 2) 1992.

² Much of this commentary is taken from a Dunhill Madden Butler (solicitors) Newsletter titled "Changes to the Corporations Law - Amendments to Section 241 and New Section 241A" dated 10 February, 1993.

(2) Subsection (1) does not prevent a person from being indemnified against a liability to another person (other than the company or a related body corporate) unless the liability arises out of conduct involving a lack of good faith.

(3) Subsection (1) does not prevent a person from being indemnified against a liability for costs and expenses incurred by the person:

- (a) in defending proceedings, whether civil or criminal, in which judgment is given in favour of the person or in which the person is acquitted; or
- (b) in connection with an application, in relation to such proceedings, in which the Court grants relief to the person under this Law.

(4) In this section:

"indemnify" includes indemnify indirectly through one or more interposed entities;

"officer", in relation to a company, means:

- (a) a director, secretary or executive officer;
- (b) a receiver, or receiver and manager, of property of the company;
- (c) an official manager or deputy official manager of the company;
- (d) a liquidator of the company; and
- (e) a trustee or other person administering a compromise or arrangement made between the company and another person or other persons.

Broadly, the new section permits a company to indemnify its officers or auditors for certain liabilities to third parties and for liability for costs and expenses in successfully defending proceedings.

The new section prohibits a company (or a related company) indemnifying (or exempting from liability) an office holder for any liability incurred by the person in that capacity. An exception to the prohibition will enable a company (or a related company) to indemnify an officer or auditor for any liability (or exempt them from liability), incurred by the person in that capacity:-

- to third parties not involving lack of good faith (that is, according to paragraph 313 of the Bill Explanatory Memorandum, not involving conduct which was dishonest or otherwise illegal); and
- for costs and expenses involved in successfully defending proceedings (which represents no change to the present position).

Changes of note are:

- Under the existing Section 241, while agreements providing for indemnification were rendered void, indemnification per se by the company was not prohibited (apart from, possibly, by implication). The new Section 241 prohibits indemnification per se by the company and renders agreements to indemnify void (subject to the stated exceptions);

- The scope of liability to third parties which may be indemnified will be clarified. Previously, the commentators believed that the prohibition contained in Section 241(1) did not prohibit a company indemnifying its officers in respect of breaches of duty owed to third parties. There was uncertainty, however, which led to recommendations in Report³ No. 10 of the Companies & Securities Law Review Committee that Section 241(1) be amended to make it clear the prohibition was limited to proceedings brought by or on behalf of the company. Under the Bill it appears clear that indemnification by the company with respect to proceedings brought by or on behalf of the company is prohibited, while liability to third parties (not involving lack of good faith) may be indemnified;
- The definition of "officer" would no longer include "employees", rendering the prohibition in Section 241 inapplicable to employees. This again implements a recommendation from paragraph 22 of the CSLRC report. Consequently, under the revised section the relevant officers will be "a director, secretary or executive officer".

Section 9 of the Corporations Law 1991 defines an "executive officer" as

"any person by whatever name called and whether or not a director of the corporation, who is concerned, or takes part in the management"

In the case CCA(Vic) v Bracht (1988) 14 ACLR 728 at 734 Mr Justice Ormiston considered the responsibilities of an executive officer to include:-

"activities which involve policy and decision making, related to the business affairs of a corporation, affecting the corporation as a whole or a substantial part of that corporation, to the extent that the consequences of the formation of those policies or the making of those decisions may have some significant bearing on the financial standing of the corporation or the conduct of its affairs."

His Honour did not have to decide whether the language referred only to the central direction of the company's affairs but he was inclined to doubt that it was so confined;⁴

³ Paragraph 122 of the Companies and Securities Law Review Committee's Report No 10 issued in May, 1990 and titled "Company Directors and Officers: Indemnification, Relief and Insurance". Hereafter referred to as the CSLRC report.

⁴ Paragraph 1535 titled "Who besides a director are officers?" from the 6th edition (1992) of Ford's Principles of Corporations Law by HAJ Ford and RP Austin.

- The definition of "indemnify" to be added includes indemnifying indirectly through one or more interposed entities. This, according to paragraph 316 of the Bill's Explanatory Memorandum, is intended to prevent circumvention of the prohibition by the company arranging payment of an indemnity via a third party.

The New Section 241A⁵

The proposed new section states:-

241A. (1) A company or a related body corporate must not pay, or agree to pay, a premium in respect of a contract insuring a person who is or has been an officer or auditor of the company against a liability:

- (a) incurred by the person as such an officer or auditor; and
- (b) arising out of conduct involving:
 - (i) a wilful breach of duty in relation to the company; or
 - (ii) without limiting subparagraph (i), a contravention of subsection 232(5) or (6).

(2) If subsection (1) is contravened, the contract is void in so far as it insures the person against such a liability.

(3) Subsections (1) and (2) do not apply to a liability for costs and expenses incurred by a person in defending proceedings, whether civil or criminal and whatever their outcome."

(4) In this section:

"officer" has the same meaning as in section 241;

"pay" includes pay indirectly through one or more interposed entities.

Broadly, the section permits (by implication) the company to pay the premiums on policies of insurance indemnifying Directors and Officers. Under the section, a company (or a related company) would only be prohibited from paying insurance premiums in relation to policies insuring officers for their liability as such were there is:-

- a wilful breach of duty in relation to the company; or
- a contravention of Section 232(5) of (6) of the Corporations Law 1991. These subsections relate to the improper use of inside information or positions by a director or officer, whether past or present, to gain an advantage for himself or another person.

If the company pays the premium in contravention of the prohibition, the contract of insurance is rendered void insofar as it insures the person against the liabilities in question. However, the company may pay for insurance covering costs and expenses of the officer in defending those proceedings (whatever the result).

⁵ Much of this commentary is taken from a Dunhill Madden Butler (solicitors) Newsletter titled "Changes to the Corporations Law - Amendments to Section 241 and New Section 241A" dated 10 February, 1993.

The company is not prohibited (and therefore, by implication, is permitted) to pay insurance premiums in relation to policies insuring office holders for their liability as such where there is no wilful breach of duty in relation to the company. This would appear to permit insurance contracts, paid for by the company, covering officers' liabilities arising out of proceedings brought by or on behalf of the company.⁶

Impact upon the Insurance Industry⁷

The passing of this Bill should obviate the need for the Directors and Officers/Company Reimbursement policy dichotomy. A single Directors and Officers policy, premiums for which are paid by the company, could protect company officer holders for all liability and legal costs.⁸ The ability of the company to pay the total premium cost should see an increase in the purchase of this class of insurance by smaller companies where previously the D & O premium was considered to be too high for the individual directors and officers.

Proven dishonesty and other illegal activities are, as a matter of public interest, automatic exclusions under an insurance policy. For example, a policy would not provide an indemnity against any claim,

for the wilful, dishonest, fraudulent, criminal, malicious act or omission of any Director or Officer, regardless of whether or not any advantage has been gained by the Director or Officer.⁹

Consequently, even though the law under the proposed Section 241A may permit a company to arrange legal cost and expenses insurance, it is highly improbable that underwriters would agree to provide such cover for situations where the insured was found guilty of an illegal act.

⁶ Although it is unfortunate that the words in the new Section 241A "a wilful breach of duty in relation to the company" appear to provide precisely the same ambiguity with respect to the scope of liability to third parties that led in the first place to the recommendations to amend Section 241(1).

⁷ Much of this commentary is taken from a Dunhill Madden Butler (solicitors) Newsletter titled "Changes to the Corporations Law - Amendments to Section 241 and New Section 241A" dated 10 February, 1993.

⁸ Other than liability arising from conduct involving a wilful breach of duty in relation to the company or a breach of Section 232(5) or (6), which liabilities would presumably be excluded from cover in any case.

⁹ Exclusion 4.1 from the 1991 Pacific Indemnity Underwriting Agency Pty Ltd Directors' & Officers' Liability Company Reimbursement Insurance Policy wording.

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