

DIRECTORS AND OFFICERS  
INSURANCE – HOW OFTEN  
WILL IT BE A “RECOVERABLE  
ASSET” AVAILABLE TO A  
LIQUIDATOR?

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## 1. Background

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If there is no or little money in the bank when a company goes into liquidation and few easily realisable assets practitioners and creditors may seek to look elsewhere in order to recover funds. One source may be claims against directors for insolvent trading or other breaches of the *Corporations Act* (Cth) (the **Act**) or common law duties. Like many professionals who may be faced with personal liability in the future many directors take steps to ensure that they have few, if any, assets in their own name. For that reason there may be little benefit to a practitioner or creditors in successfully pursuing a director unless the director is covered by directors and officers (**D&O**) insurance giving the practitioner and creditors access to the funds of an insurance company (and hopefully not an insolvent one).

This paper:

- provides an overview of insolvent trading;
- provides an overview of D&O insurance;
- deals with the key exclusions – the Act and other limitations;
- considers whether D&O insurance can enhance the prospects of recovery in a successful insolvent trading action;
- considers how a negligence or fraud claim could enhance or interfere with a D&O recovery; and
- concludes with some consideration of the usefulness of D&O insurance in the context of insolvent trading.

## 2. Overview

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### 2.1 What is insolvent trading?

Section 588G of the Act imposes liability on a director of a company who allows the company to incur a debt at a time when the company is insolvent where, at the time that the debt was incurred, there existed reasonable grounds for suspecting that the company was, or may become as a result of incurring the debt, insolvent. A director will be liable if

at the time the debt was incurred he or she was actually aware of the existence of reasonable grounds to suspect insolvency or a reasonable person in a similar position within a similar company would have been so aware.

A director will commit an offence (under s588G(3)) if at the time the debt was incurred the director actually suspected that the company was insolvent (or would become insolvent by incurring the debt) and the director's failure to prevent the debt being incurred was dishonest.

One of the main problems directors and liquidators face is being able to identify when a company is insolvent. The somewhat vague definition of insolvency does not assist. Prior to 23 June 1993 no statutory definition of insolvency existed. The Act now<sup>1</sup> contains section 95A which states that a person (including a company) is insolvent if they are not solvent. A company is only solvent if it is able to pay all of its debts as and when they become due and payable. The emphasis is on the ability to discharge *all* of one's debts, rather than merely particular debts. Insolvency is not usually determined merely by looking at the balance sheet of a company and determining whether there is a surplus of assets over liabilities. Rather, the emphasis is on cash-flow. Of course companies may experience both types of insolvency simultaneously.

The Act specifies two rebuttable presumptions of insolvency. The first states that where it is proved that a company was insolvent at a particular time during the 12 months ending on the 'relation back day' (most often the date on which an application to wind up was filed or an administrator was appointed) it is presumed that the company was insolvent from that time until the relation back day. Under the second presumption a company will be presumed insolvent where it is proved that the company failed to keep proper accounting records which correctly explain and record its transactions and financial position and which enable true and fair financial statements to be prepared and audited (s588E(4)). These presumptions can be rebutted.

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<sup>1</sup> At the time of writing section 95A had been repealed by Act No 122 of 2001, s3, Sch 1, Pt 2 (329) (effective 11 March 2002). The writer understands that the legislature intends to reintroduce section 95A to have effect from 11 March 2002.

The term 'debt' has a wide meaning which often varies according to the context in which it is used. The courts have stated that the terms 'debt' and 'incurs' are not terms of precise definition but are to be applied flexibly in a practical and commonsense manner. The Full Court of the Supreme Court of South Australia considered the key issues of:

- what is a debt;
- when is a debt incurred; and
- what constitutes insolvency

in the 2001 decision of *Powell v Fryer*<sup>2</sup>. I have attached as attachment 1 to this paper a note on that case extracted from the Allens 2001 Annual Review<sup>3</sup>. The issue of when a debt is incurred was also considered in 2001 by Mandie J in the Supreme Court of Victoria in the decision of *Harrison v Lewis*<sup>4</sup>. I have also included as an attachment 2 to this paper a note on that case extracted from the Allens 2001 Annual Review.

## 2.2 Available Defences

A number of defences are available to directors against whom an insolvent trading action is brought:

- The director had reasonable grounds to expect that the company was solvent and would remain solvent even if it incurred the relevant debt. This requires a director to prove that he or she had an actual expectation of solvency as well as the existence of reasonable grounds for that expectation (section 588H(2)).
- The director relied upon information regarding the solvency of the company which was provided by another and which led to an expectation of the actual solvency of the company based on that information. The director also needs to show that he had reasonable grounds to believe and did believe that a competent and reliable person was responsible for providing him with information of the company's solvency and that that other person was fulfilling that responsibility (section 588H(3)).

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<sup>2</sup> Unrep, 8 March 2001

<sup>3</sup> Allens Arthur Robinson, 2001 Annual Review of Insolvency & Restructuring Law. The Annual Review is available online in a fully searchable format go to <http://www.aar.com.au/publications/ari/>

<sup>4</sup> Unrep, 23 February 2001

- The director did not participate in the management of the company at the time the debt was incurred because of illness or some other good reason. There must be a connection between the non-participation and the 'good reason' (section 588H(4)).
- The director took reasonable steps to prevent the company incurring the debt, such as appointing a voluntary administrator to the company (section 588H(5)).

The court can also excuse the director from liability if he or she has acted honestly and ought fairly to be excused (section 1317; section 1318).

### **2.3 What liability is imposed for insolvent trading?**

The liability which may be imposed on a director for insolvent trading falls into a number of categories: civil penalties, criminal penalties, compensation orders (available on either an application for a civil penalty order (section 588J) or a criminal prosecution (section 588K), liquidator recovery actions (under section 588M(2) and creditor recovery actions (under sections 588M(3), 588R, 588S, 588T and 588U). Where a director allows a company to trade whilst insolvent and this is done knowingly, intentionally or recklessly and was dishonest (with a view to gaining an advantage or was intended to deceive or defraud someone) then the director is guilty of a criminal offence. The maximum penalty payable for such criminal offence is a fine of \$200,000 and/or imprisonment for 5 years. A director who is guilty of a criminal offence is prohibited from managing any company for 5 years. Under section 588K the Court in criminal proceedings can, whether or not it imposes a penalty, order the director to pay compensation to the company equal to the amount of loss and damage.

Civil penalties do not include an automatic disqualification from managing companies. A director can be made to pay a pecuniary penalty, or a fine, to ASIC. This fine can be for an amount of up to \$200,000. A director can also be ordered to pay compensation to the company under either of two provisions facilitating the ordering of compensation. Under one (ss588J(1)) the compensation payable is equal to the loss and damage suffered by an unsecured creditor. Under the other (s1317H) the compensation payable is equal to the 'damage' suffered by the relevant unsecured creditor or creditors. Presumably these two

standards are the same, or at least substantially similar. Finally, a director can be prohibited from managing any company for a specified period if he or she is not a fit and proper person to manage a company.

Under section 588M(2) where a director has breached subsection 588G(2) or (3) whether or not the director has been convicted of an offence or had a civil penalty order made against him or her the liquidator can recover the amount which a creditor has suffered by way of loss or damage.

Under section 588M(3) creditors are given some rights to sue directors direct for compensation for insolvent trading:

- with the liquidator's consent (under section 588R);
- with the Court's leave after giving the liquidator notice under section 588S (pursuant to section 588T);
- unless the liquidator has already sought orders under sections 588FF or 588M in relation to the debt or in relation to a transaction under which the debt was incurred or has intervened in an application for a civil penalty order.

### **3. What is directors' and officers' insurance and indemnity?**

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#### **3.1 A policy in two parts**

Typically a D&O policy contains two separate insurance components. The first usually consists of a company reimbursement component which provides for the company to seek reimbursement for those amounts which it is obliged (or in some cases permitted), under its Constitution, to indemnify its directors and officers. The second usually consists of a direct cover component which provides indemnification directly to directors and officers where the company itself is unable to do so or sometimes where the company otherwise does not do so.

The definition of 'officer' within the Act was expanded in 2000 to include all persons who have the capacity to significantly affect the company's financial standing. This definition is somewhat uncertain in scope and differs from the old definition which listed various roles

as falling within the definition. Without careful review by insurers, many D&O policies may now perhaps unintentionally include a broad range of persons as insureds. The definition of “director” is also expanded by section 9 of the Act. In 2001 both the New South Wales Court of Appeal<sup>5</sup> and the Supreme Court of South Australia<sup>6</sup> found that persons who were not formally directors of a company nevertheless were directors under the extended definitions of ‘director’ contained in section 9 of the Act. I have included as attachments 3 and 4 respectively extracts from the 2001 Allens’ Annual Review on these cases.

### 3.2 Claims made and notified

Most D&O insurance is written on a 12 monthly basis to provide coverage for claims made or circumstances notified to the insurer during the Policy period. If, when the liquidator is appointed, a D&O policy is in place and the 12 month policy period is still running, subject to any available exclusions, the Policy should respond if the liquidator makes a claim against the director before the expiration of the Policy period. If the claim is made by the liquidator and the insured director does not actually tell his or her insurer that the claim has been made on him or her until after the 12 month policy period has elapsed the insurance policy should still respond. This is because of the operation of section 54 of the *Insurance Contracts Act (Cth) (ICA)*. Essentially section 54 provides that an insurer will not be able to refuse a claim if, the only reason the insurer would otherwise be able to refuse the claim, is an act or omission of the insured. The Courts have found that section 54 will effectively enable an insured to notify claims late. The insurer can however attempt to have the claim reduced by the amount that fairly represents the extent to which the insurer’s interests were prejudiced as a result of the Act. This is normally very hard to do.

If the liquidator does not even make a claim against the director until after the Policy period of the relevant D&O policy has expired the D&O policy might still respond if the director was aware during the Policy period of circumstances which might lead to a claim. This result flows from section 54 as interpreted by the High Court in *FAI v Australian Hospital*

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<sup>5</sup> In *Natcomp Technology Australia Pty Limited v Graiche* (unrep) 30/4/01

<sup>6</sup> In *Perkins v Viney* (unrep) 1/11/01

*Care* [2001] HCA<sup>7</sup>. This case found that section 54 will effectively enable an insured to notify circumstances late if the Policy itself expressly provides for coverage of claims made or circumstances notified during the Policy period.

Some D&O insurance policies only expressly cover claims actually made during the Policy period. Even if this is what the Policy language provides, pursuant to section 40 of the ICA, notwithstanding the Policy wording, if an insured gives notice before the expiration of the Policy period, of circumstances that might give rise to a claim, the insurer will still have to pay the claim. Whilst there will no doubt be further litigation on this point it appears that if the Policy itself only expressly covers claims made during the Policy period and does not include an extension to also cover circumstances which might lead to a claim notified within the Policy period and all that occurs during the Policy period is that the director becomes aware of circumstances which might lead to a claim, section 54 will not interact with section 40 to enable the director to make a notification, after the expiration of the Policy period, of circumstances which might lead to a claim.<sup>8</sup>

### 3.3 The Liquidation Extension

Some companies include in their Constitution an indemnity of their directors – the indemnity may be:

- (a) mandatory (ie if a claim or inquiry by ASIC or examination by a liquidator etc) is made against a director the company (subject to any Act limitations) **will** indemnify the director; or
- (b) permissible or discretionary (ie the company **may** indemnify the director . . .).

Obviously enough if the company is in liquidation when the director wants to seek to rely on that indemnity (which clearly enough will always be the case when a liquidator wants to bring an insolvent trading claim against the director) that indemnity will not provide the

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<sup>7</sup> attached as Attachment 5 is an extract of the report at pages 13 to 16 on this case from the Allens Arthur Robinson Annual Review of Insurance Law 2001.

<sup>8</sup> see *CA & MEC McNally Nominees Pty Ltd & Ors v HTW Valuers (Brisbane) Pty Ltd & Ors* [2001] QSC 388 per Chesterman J. Attached as attachment 6 is an extract of the report on that case contained in the Allens Arthur Robinson Annual Review of Insurance Law 2001 at 17-18.

director with much comfort. However a D&O policy with a liquidation extension may assist. Some D&O policies provide that if a claim (or if circumstances which might lead to a claim) is notified during the Policy period for which the company would be required or permitted to indemnify the director but the company is unable to do so because at the time the claim was first made or the circumstances were first notified the company was in liquidation, the insurer will pay the director the amounts which the company is unable to pay.

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## **4. Key exclusions – the Act and other limitations**

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### **4.1 The Act**

A number of changes were made to the Act, which came into effect on 13 March 2000, which substantially modified provisions directly impacting D&O insurance and indemnities.

Sections 199B and 199C of the Act now provide that a company (and a related body corporate) is prohibited from paying, or agreeing to pay, the premium for insurance of an officer (including a director) or an auditor of the company against a liability (other than for legal costs) arising out of:

- conduct involving a wilful breach of duty in relation to the company; or
- a contravention of section 182 or 183 (which relate to directors' use of position and use of information).

Provided that these matters are excluded from the cover under the D&O policy, which they usually are, there are no restrictions on the ability of a company to pay for an insurance premium for their directors and officers.

As well as paying a premium for D&O insurance, a company can indemnify a director or officer for certain liabilities incurred. The provision which deals with the indemnification of directors and officers (s199A) deals separately with when an indemnity for liability for legal costs, and one other than for legal costs, will be allowed.

A company, or related body corporate, is prohibited from providing an indemnity, other than for legal costs, in a number of circumstances. This prohibition applies to an indemnity against liability incurred as a director, officer or auditor of the company which is:

- owed to the company or a related body corporate;
- for a pecuniary penalty order or a compensation order for a breach of certain provisions ; or
- owed to someone other than the company (or related body corporate) and arose out of bad faith.

A company must not indemnify a director, officer or auditor for legal expenses incurred:

- in defending proceedings in which the person is found to have a liability for which the company could not indemnify the person;
- in defending or resisting criminal proceedings in which the person is found guilty;
- in defending or resisting proceedings brought by ASIC or a liquidator for a court order if the grounds for making the order are established; or
- in connection with proceedings by the person for relief under the Law which are denied by the court.

In all other cases the company is able to indemnify the director, officer or auditor for his or her legal costs.

Interestingly, these provisions allow an indemnity for legal costs to be provided before the outcome of the proceedings is known. If an indemnity is advanced but an adverse decision is given by the court the costs already paid must be refunded. In addition, a company can provide a loan or advance to a director, officer or auditor in respect of legal costs. Again, if an adverse decision is reached such a loan or advance must be repaid.

As discussed above, sections 199B and 199C of the Act provide that a company must not pay an insurance premium of the company against a liability arising out of conduct involving a wilful breach of duty. So long as the D&O policy excludes such claims from its ambit a company is able to take out effective D&O insurance for its directors and officers.

As indicated earlier, there are a number of sanctions which may be imposed on a director by the court for insolvent trading. These fall into a number of categories: civil penalty provisions, criminal penalty provisions and compensation provisions enabling recovery by a liquidator or creditor. Basically a criminal offence is committed by insolvent trading where it is done with wilful deceit.

Section 199A of the Act prevents a company from indemnifying a director against liability incurred for a pecuniary penalty order under section 1317G or a compensation order under section 1317H. This is because such a fine or compensation is payable to the company as a result of wrongs committed against it. It might be thought to be against the policy of the Act to allow a company to indemnify a director or officer in such circumstances. As a result it might be thought that a company would be prohibited from indemnifying a director or officer for liability incurred for insolvent trading and to then seek reimbursement itself from its insurer under its company reimbursement policy. However this is not necessarily the case as compensation orders for insolvent trading are normally made under section 588K (in connection with a criminal prosecution) or section 588J (in connection with a civil penalty) rather than under section 1317G or 1317H which are the sections singled out for mention in section 199A of the Act. An indemnification of a director from insolvent trading claims brought by a liquidator may however be prohibited by section 199A(2). This section prohibits a company from indemnifying an officer from a liability owed to the company or a related body corporate. Although a liquidator brings an insolvent trading claim under section 588M(2) that section makes it clear that the amount of loss or damage is to be recovered “as a debt due to the company”. An indemnity for a debt due to the company is therefore probably barred by section 199A(2).

As D&O policies must not cover a director or officer for liability incurred as a result of a wilful breach of duty (s 199B), a D&O policy will not cover a director or officer for liability incurred for insolvent trading where such a contravention is a criminal offence. This is because a criminal offence is committed as a result of a wilful breach of duty, or wilful deceit.

Accordingly, D&O policies could only, in compliance with the limitations set out in the Act, cover the liability of directors or officers which is incurred under a civil penalty provision, such as an imposition of a fine, or the requirement to pay compensation to the company or a claim for compensation by a liquidator or creditor. In fact as will be discussed further below most D&O policies not only exclude coverage for criminal acts but also exclude coverage for civil penalties. Whilst this could be seen to restrict the effectiveness of D&O

policies in the context of insolvent trading, a criminal offence is difficult to prove and thus will rarely be made out. Most insolvent trading actions will be claims for compensation by a liquidator or creditor and would thus, subject to any other limitations in the policy be covered under the direct cover component of a D&O policy.

#### 4.2 Other Limitations

There are a number of standard exclusions from D&O policies which significantly restrict the ambit of their operation. These include:

- **prospectus-type liability exclusion** which will often be of importance to directors of companies who propose to embark on a public offering;
- **professional indemnity exclusion** which excludes cover for claims alleging a breach of duty other than the professional duties owed by a director;
- **improper profit exclusion** which excludes coverage for any claim based on, attributable to or in consequence of any director having gained in fact any personal profit or advantage or receiving any remuneration to which that insured was not legally entitled;
- **insured versus insured exclusion** which excludes claims brought by one person covered by the insurance against another, including by the company against a director. This is to prevent the manufacturing of a claim for example by the directors of a company breaching a duty and voting to sue themselves to get damages for which the company is insured. This is a significant exclusion because a director's duties are owed to the company itself and actions thus brought by the company are a significant potential source of liability. D&O policies normally include an exclusion to extend cover to claims brought in the name of the company against a director:
  - (i) as a shareholder derivative action;
  - (ii) by ASIC; or
  - (iii) at the instigation of a receiver, administrator or liquidator.

Unless the policy contains such an exception, a D&O policy is unlikely to provide relief for an action brought by the company/liquidator against a director for insolvent trading as the action would be brought on behalf of the company to recover loss or damage as a debt due to the company under section 588M(2). The insured versus insured exclusion would not be relevant to a direct claim by a creditor against the director for insolvent trading.

- **non-disclosure.** This is discussed in 4.3 and 4.4 below.
- **definition of Loss or Damage.** A D&O Policy will normally insure the insured against amounts which the Insured becomes legally obliged to pay arising from a claim made against the Insurance for breach of duty, breach of trust, negligence, error, omission, misstatement, misleading statement occurring in the course of the insured's duties to the company. Policies normally include damages, judgments, settlements and legal costs and expenses. In many policies however the definition of Loss or Damage excludes punitive, aggravated, multiple or exemplary damages **and fines or penalties including civil penalties.**

#### **4.3 What if there is not a full and proper disclosure of the company's circumstances at the time the D&O policy was taken out?**

The failure of a director or officer to disclose the insolvency of the company, the possible insolvency of the company or other circumstances which may give rise to a claim (such as the possibility of insolvent trading proceedings being commenced against him or her) at the time of taking out the D&O policy may lead to the insurer avoiding the insurance contract and refusing to insure or indemnify the director and/or the company.

##### **4.3.1 Statutory Provisions**

Essentially, an insured has two duties in respect to providing an insurer with accurate information as to the risk to be insured under an insurance policy, namely a:

- ◆ duty not to misrepresent material facts; and
- ◆ duty to disclose material facts.

With respect to contracts of insurance which fall within the ambit of the ICA, these duties are contained within sections 21 and 26 of the ICA.

**(a) Duty of disclosure**

Section 21 of the ICA relevantly provides:

- (1) *Subject to this Act, an insured has a duty to disclose to the insurer, before the relevant contract of insurance is entered into, every matter that is known to the insured, being a matter that:*
  - (a) *the insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms;*
  - (b) *a reasonable person in the circumstances could be expected to know to be a matter so relevant.*
- (2) *The duty of disclosure does not require the disclosure of a matter:*
  - (a) *that diminishes the risk;*
  - (b) *that is of common knowledge;*
  - (c) *that the insurer knows or in the ordinary course of the insurer's business as an insurer ought to know; or*
  - (d) *as to which compliance with a duty of disclosure is waived by the insurer.*
- (3) *Where a person:*
  - 1.1 *failed to answer; or*
  - 2.1 *gave an obviously incomplete or irrelevant answer to;*

*a question included in a proposal form about a matter, the insurer shall be deemed to have waived compliance with the duty of disclosure on relation to the matter.*

Section 13 ICA imposes a duty of utmost good faith on the insured. However, such duty does not impose any further duty of disclosure on an insured than that contained in section 21 ICA.<sup>9</sup>

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<sup>9</sup> Section 12 ICA.

The duty of disclosure under section 21 ICA is limited to matters “known to the insured”. This encompasses knowledge which is imputed to the insured.<sup>10</sup> However, it does not appear that it would encompass constructive knowledge of the insured, that is information which the insured *ought* to know.<sup>11</sup>

**(b) Misrepresentations**

Section 26 ICA states that:

- (1) *Where a statement that was made by a person in connection with a proposed contract of insurance was in fact untrue but was made on the basis of a belief that the person held, being a belief that a reasonable person in the circumstances would have held, the statement shall not be taken to be a misrepresentation.*
- (2) *A statement that was made by a person in connection with a proposed contract of insurance shall not be taken to be a misrepresentation unless the person who made the statement knew, or a reasonable person in the circumstances could be expected to have known, that the statement would have been relevant to the decision of the insurer whether to accept the risk and, if so, on what terms.*
- (3) *This section extends to the provision of insurance cover in respect of:*
  - (a) *a person who is seeking to become a member of a superannuation or retirement scheme; or*
  - (b) *a person who is a holder, or is applying to become a holder, of an RSA.*

The burden of proof rests on the insured in respect of establishing that the insured’s belief was one that a reasonable person in the circumstances would have held.<sup>12</sup>

A person shall not be taken to have made a misrepresentation merely because the person failed to answer a question included in the proposal form or gave an obviously incomplete or irrelevant answer to such a question.<sup>13</sup>

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<sup>10</sup> For example, knowledge of an agent of the insured if the agent is responsible for the business in respect of which the insurance is taken out. However, such knowledge will not be imputed to the insured where the agent is acting outside the scope of its authority or where the knowledge is a fraud committed on the insured.

<sup>11</sup> Kelly and Ball, Principles of Insurance Law at 2.0130.30.

Where a statement is made in answer to a question asked in relation to a proposed contract of insurance and a reasonable person in the circumstances would have understood the question to have the meaning that the person answering the question apparently understood it to have, that meaning shall, in relation to the person who made the statement, be deemed to be the meaning of the question.<sup>14</sup>

**(c) Time for compliance with duty of disclosure**

As provided by section 21 and section 26 ICA, the insured must comply with the duty of disclosure and duty not to misrepresent before entry into the insurance contract. Section 11(9) ICA defines entry into a contract of insurance to include:

- (a) in the case of a contract of life insurance---the making of an agreement by the parties to the contract to extend or vary the contract;*
- (b) in the case of any other contract of insurance---the making of an agreement by the parties to the contract to renew, extend or vary the contract; or*
- (c) the reinstatement of any previous contract of insurance.*

**4.3.2 Obligation on insurer to warn insured of duty of disclosure**

Section 22 ICA imposes a duty on an insurer to inform the insured of the nature and effect of the duty of disclosure.

Section 22 ICA states that:

- (1) The insurer shall, before a contract of insurance is entered into, clearly inform the insured in writing of the general nature and effect of the duty of disclosure and, if section 21A applies to the contract, also clearly inform the insured in writing of the general nature and effect of section 21A.*
- (2) If the regulations prescribed a form of writing to be used for informing an insured of the matters referred to in sub section (1) the writing to be used may be in accordance with the form so prescribed.*

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<sup>12</sup> ***Plasteel Windows Australia Pty Ltd v CE Heath Underwriting Agencies Pty Ltd (1990) 19 NSWLR 400***

<sup>13</sup> Section 27 ICA.

<sup>14</sup> Section 23 ICA.

(3) *An insurer who has not complied with sub section (1) may not exercise a right in respect of a failure to comply with a duty of disclosure unless that failure was fraudulent.*

To comply with section 22 ICA, an insurer must inform the insured of the consequences of breach of the duty of disclosure in addition to the content of the duty of disclosure.<sup>15</sup> Forms for notifying an insured of the duty of disclosure are prescribed by reg. 3 of the Insurance Contracts Regulations. However, use of such forms is not mandatory. Failure by an insurer to comply with section 22 ICA deprives the insurer of its rights to rely on an innocent non-disclosure.

The burden of proving satisfaction of the obligation under section 22 ICA is born by the insurer.<sup>16</sup>

To establish compliance with this notification requirement, the insurer must prove not only that it sent the relevant notification to the insured but that the insured received the notification. The burden of proof is on the balance of probabilities. Depending on the circumstances of the case, a court may draw an inference of receipt of the notification by the insured from evidence of dispatch by the insurer.<sup>17</sup>

An insurer is not required to warn the insured of the duty of disclosure in respect to a renewal, extension, or reinstatement of the insurance contract provided the insurer has complied with the obligation when the contract was first entered into.<sup>18</sup> Similarly, an insurer is not required to provide such a warning before varying the contract unless the variation is involved in a renewal, extension or reinstatement of the contract.<sup>19</sup>

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<sup>15</sup> *Australian Associated Motor Insurers v Ellis* (1990) 54 SASR 61; *Burns v MMI-CMI Insurance Limited* (1994) 8 ANZ Ins Cas 61-228 at 75,502.

<sup>16</sup> *Lumley General Insurance Ltd v Derphin* (1990) 6 ANZ Inscas 60 986 at 76, 565.

<sup>17</sup> *Delphin v Lumley* (1986) 6 SR (WA) 161.

<sup>18</sup> Section 11(10)(a) ICA.

<sup>19</sup> Section 11(10)(b) ICA.

### 3.3.3 Remedies for breach

The ICA provides for exclusive remedies which are available to an insurer in respect of a failure by the insured to disclose the matter to the insurer before the contract was entered into and in respect of a misrepresentation or incorrect statement.

The relevant provision for contracts of general insurance is section 28 ICA which provides:

(1) *This section applies where the person who became the insured under a contract of general insurance upon the contract being entered into:*

(a) *failed to comply with the duty of disclosure; or*

(b) *made a misrepresentation to the insurer before the contract was entered into, but does not apply where the insurer would have entered into the contract,*

*for the same premium and on the same terms and conditions, even if the insured had not failed to comply with the duty of disclosure or had not made the misrepresentation before the contract was entered into.*

(2) *If the failure was fraudulent or the misrepresentation was made fraudulently, the insurer may avoid the contract.*

(3) *If the insurer is not entitled to avoid the contract or, being entitled to a void to the contract (whether under sub section (2) or otherwise) has not done so, the liability of the insurer in respect of a claim is reduced to the amount that would place the insurer in a position in which the insurer would have been if the failure had not occurred or the misrepresentation had not been made.*

The onus of proving a breach of the duty of non-disclosure rests on the insurer.<sup>20</sup>

With respect to a fraudulent non-disclosure or fraudulent misrepresentation, the Court has the discretion to disregard any avoidance of the contract of insurance by the insurer if it

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<sup>20</sup> *Commercial Union Assurance Company of Australia Ltd v Beard & Ors* [1999] NSWCA 422

would be harsh and unfair not to do so<sup>21</sup>. In such circumstances, the insured will be allowed to recover the whole, or such part as a Court thinks just and equitable in the circumstances, of the amount that would have been payable if the contract has not been avoided. The Court is only entitled to exercise this power where it considers the insurer has not been prejudiced by the non-disclosure or misrepresentation or, if any such prejudice exists, the prejudice was minimal or insignificant. This power only applies in relation to the loss that is the subject of the proceedings before the Court and does not otherwise operate to reinstate the contract.<sup>22</sup>

The ability of an insurer to avoid an insurance contract on the basis of non-disclosure was highlighted in the 1992 case involving the former directors of Compass Airlines<sup>23</sup>. The directors were defendants to insolvent trading proceedings commenced against them in the Federal Court by the ASC, as it was then known. The directors claimed that their insurer was obliged under their D&O policy to cover their legal costs and commenced proceedings in the Federal Court. The relevant D&O policy included both a company reimbursement policy and a direct cover component. The insurer sought to avoid the contract on the basis of non-disclosure of the insolvency of the company at the time the insurance was taken out. The directors argued that they were not parties to the contract of insurance and that they were therefore not under any duty of disclosure.

The NSW Court of Appeal decided that the directors were parties to the D&O policy. This was because the directors and probably paid the insurance premiums and also because the terms of the particular policy led to that conclusion. The court was unsure of whether each individual director was aware that the insurance was being taken out for their benefit and that what was being done was being done with their general authority. Regardless of whether they were called upon to contribute to the cost of the premium, and thus arguably should have been so aware, the policy was effected with the knowledge of the chief

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<sup>21</sup> For a recent and some might say harsh example of a case in which the Court refused to exercise this discretion *Tiep Thi Tov Australian Associated Motor Insurers Ltd* [2000] V5CA; (2001) 11 ANZ Insurance Cases 61-490; Allens Arthur Robinson 2001 Annual Review of Insurance Law 31-33.

<sup>22</sup> Section 31 ICA.

<sup>23</sup> *CE Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25.

executive officer and company secretary. As a company has no mind of its own and can only perform through the acts of its directors, the court looked to the actions of those within the company who were responsible for the management of the company and who were the 'directing mind and will' of the company. In this case it could be said that at least the Chief Executive Officer was in such a position and ought to have disclosed all matters to the insurer as were known to him, such as the possible insolvency of the company at the time the insurance was taken out. Accordingly, the Chief Executive Officer at least was under a duty of disclosure. One judge went as far as to say that even those directors who may have had no such knowledge but were beneficiaries under the D&O policy may be under a duty of disclosure. Accordingly, the insurance company was able to avoid the D&O policy and avoid paying the legal costs of the directors in the Federal Court insolvent trading proceedings.

This judgment was appealed but was finally settled out of court. Despite this, the Compass Airlines case highlighted that the courts are willing to take a strict view of the duty of disclosure as it relates to D&O policies. After this judgment many insurers developed the practice of requiring each director to sign the insurance proposal form and complete a declaration stating that they were unaware of circumstances which may give rise to a claim against them. This practice avoids the complexities of the Compass Airlines case and ensures that all directors and officer who are beneficiaries under the D&O policy are subject to the duty of disclosure.

#### **4.4 Contractual Provisions**

In addition to statutory requirements for insureds to make disclosure prior to entering into an insurance policy most insurance policies include contractual provisions which specifically exclude certain past events.

An example of the type of exclusion for past events is set out below:

*"This policy does not insure loss arising out of any claim . . .*

*(i) first made against the director prior to the period of insurance; or*

- (ii) *arising from any matter disclosed to the insurer prior to the period of insurance as being either a claim, against the director; or*
- (iii) *arising from any matter notified to any insurer prior to the period of insurance as being either a claim, or circumstances which may give rise to a claim, against the director; or*
- (iv) *arising from any litigation or inquiry that was either in progress or pending prior to the period of insurance; or*
- (v) *arising from circumstances of which **any** insured had become aware prior to the period of insurance AND which **that** insured knew (or ought reasonably to have known) to be circumstances which may give rise to a claim."*

#### **4.4.1 Non-disclosure by one director – effect on other directors**

A non-disclosure clause such as that considered in 4.3 clearly has the potential for the knowledge of one director for example of a claim having been made or circumstances (such as incurring debts whilst insolvent) to vitiate the coverage of all directors whether they knew about that fact or not.

Many policies give insureds some level of protection from that risk. For example by providing that the exclusion, which I have referred to as (v) in 4.3 above, will not apply to any director who was not aware of those circumstances. Similarly the policy may provide that improper profit, insider trading and fraud exclusions will not apply to any director who had no direct personal involvement in, or knowledge of, the matters upon which the operation of those exclusions are based.

Some policies seek to deal with the non-disclosure issue by providing that with respect to named exclusions and with respect to the statements and disclosures in the application for the policy, the wrongful act or knowledge of any director shall not be imputed to any other director.

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## 5. Can Directors and Officers Insurance enhance the prospects of recovery in a successful insolvent trading action?

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Insolvent trading claims against directors are not the easiest claims to succeed in. The *Perkins v Viney*<sup>24</sup> case of late last year is an example of a case where even though the insolvent trading claim was established the Court was prepared to substantially reduce the director's liability exercising its discretion under section 1317JA of the Act. The Court in *James v Andrew*<sup>25</sup> however showed that it would not allow directors to sidestep the insolvent trading provisions by asserting that board meetings were held outside of Australia.

D&O insurance does have the potential to provide liquidators with a source of recovery in insolvent trading claims particularly where the relevant directors may not themselves have sufficient assets to satisfy a judgment. However, as noted above each policy must be separately and carefully considered along with the facts of the claim. It will be particularly important to consider when it is alleged the director knew about the insolvency of the company as if the relevant director knew about the insolvency prior to effecting cover this may constitute a non-disclosure which would enable the insurer not to pay out. It is also important to recognise that insolvent trading claims are not the only claims potentially available to a liquidator against a director. Directors owe a range of statutory and fiduciary duties to the companies on whose board they sit. The *Maronis Holdings Ltd v Nippon Credit Australia Ltd*<sup>26</sup> is a recent example of a successful claim brought against a company's directors for breach of fiduciary duties.

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<sup>24</sup> Unreported 1/11/01. See attachment 4 being an extract from the 2001 Allens Annual Review of Insolvency and Restructuring Law.

<sup>25</sup> Unreported 23/8/01 See attachment 7 being an extract from the 2001 Allens Annual Review of Insolvency and Restructuring Law.

<sup>26</sup> *Maronis Holdings Ltd v Nippon Credit Australia Ltd* (unrep) 7/6/01. See attachment 8 being an extract from the 2001 Allens Annual Review of Insolvency & Restructuring Law.

## **6. Will a negligence or a fraud claim enhance or interfere with a Directors and Officers recover?**

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If a negligence claim is available against a director access to the directors and officers insurance may be more straightforward as many of the exclusions referred to in 4.2 above will not be available.

Fraud on the other hand may itself be an exclusion in a directors and officers policy.

If the director is found to have acted fraudulently or to have deliberately breached the law most D&O policies will not respond. An example of a wording is to exclude all claims.

*“based upon, attributable to, or in consequence of:*

- (i) any dishonest, fraudulent, criminal or malicious act or omission; or*
- (ii) any deliberate breach of any statute, regulation or contract;*

*where such act, omission or breach has in fact occurred.”*

## **7. How useful is Directors and Officers Insurance in the context of insolvent trading?**

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The insolvent trading provisions impose an onerous duty on directors. A breach of these provisions may result in a substantial liability being imposed on directors personally.

However, in pursuing such directors, liquidators may often find that their success in litigation is an empty and fruitless exercise as such directors often do not hold property in their own name and there may be insufficient funds left in the company to cover the liquidator's costs, fees and remuneration, thus not practically providing any benefit of return to creditors. In such circumstance liquidators and other insolvency practitioners will often be loathe to take action.

Unless there has been a relevant non-disclosure which disentitles a director to rely on his or her D&O insurance the existence of D&O insurance may overcome this concern.

D&O insurance may provide a source of funds for liquidators and creditors where the remedy sought is compensation at the suit of a liquidator or creditor rather than a criminal or civil penalty order. Where the proceedings allege a criminal offence, consisting

essentially of wilful deceit, D&O insurance is unlikely to prove useful as such insurance policies are precluded by the Act from covering directors and officers for wilful breaches of duty. However, as criminal offences for insolvent trading are difficult to prove, most insolvent trading actions commenced will seek a civil remedy. The difficulty of making out a criminal offence, combined with the possibility of recovering under D&O policies may encourage liquidators to seek litigation funding, bring proceedings against directors for insolvent trading seeking compensation.

Developments in the field of litigation funding mean that liquidators have an increasing capacity to threaten or to take action against directors for insolvent trading.

Before deciding whether or not to commence proceedings for insolvent trading, liquidators should investigate the existence of a D&O policy, and particularly if there are insufficient funds in the company itself, consider a proposal to an insurer or other third party for litigation funding.

Each policy needs to be carefully considered to ensure that there are no relevant exclusions. The knowledge of the directors at the time the relevant policy commenced must also be considered in determining the likelihood of the policy responding.

**Michael Quinlan**  
**Partner**  
**Allens Arthur Robinson**

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**This paper is intended only to provide an alert service on matters of concern or interest to readers. It should not be relied on as advice. Matters differ according to their facts. The law changes. You should seek legal advice on specific fact situations as they arise.**

## ATTACHMENT 1

### Are taxes debts and what constitutes insolvency anyway?

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<b>Case Name:</b>	<b><i>Powell v Fryer</i></b>
<b>Citation:</b>	Unreported, Supreme Court of South Australia – Full Court per Olsson, Driggan and Williams JJ
<b>Date of Judgement:</b>	8 March 2001
<b>Issues:</b>	<ul style="list-style-type: none"><li>• Insolvent trading</li><li>• Sections 588G, 588H and 588M CL</li></ul>

**This case involved an appeal against a finding of liability against directors of a company. Judgment for loss or damage suffered by creditors was entered against the directors in respect of debts said to have been incurred while the company was insolvent. Debts incurred included taxes, levies, employee entitlements and penalties for late payment of taxes.**

The appellants were company directors appealing against the judgment entered against them under s588M CL for loss or damage suffered by creditors due to contraventions of s588G(2) CL (failure to prevent incurring of debt) and/or s588G(3) CL (debt offence). The respondents were the joint liquidators of Noelx Yachts Australia Pty Ltd (**Noelx**).

On appeal, the Full Court examined the following questions:

- what is a debt?
- when is a debt incurred?
- what constitutes insolvency?

#### **What is a debt?**

The Court held that the normal meaning of the word is “a liability or obligation to pay or render something; that one person is bound to pay to or perform for another” (Macquarie Dictionary, Second Revision). There is nothing in the CL to suggest that any other special meaning is intended.

#### **When is a debt incurred?**

Olsson J stated that it is well established that a statutory impost is capable of being a debt and it follows that, if by reason of the normal operations of a company it is rendered liable to pay a statutory impost, it may properly be said that the impost has been “incurred” as a debt by the company. A debt is taken to have been incurred when, by its conduct or operations, a company has necessarily subjected itself to a conditional, but unavoidable, obligation to pay a sum of money at a future time.

### **What constitutes insolvency?**

Olsson J set out the following propositions established by case law:

- Whether or not a company is insolvent at a given point in time is a question of fact to be determined by the trial judge.
- The conclusion of insolvency must be derived from a proper consideration of the company's financial position, in its entirety, based on commercial reality.
- It is legitimate to take into account any indulgences extended to a company by its creditors as to trading terms.
- It is not appropriate to base an assessment on the prospect that the company might be able to trade profitably in the future, thereby restoring its financial position.

The Court went on to comment that the test to be applied in relation to s588G(1)(c) is objective, and by reason of s588G(2)(b) it is sufficient that a reasonable person in a like position in a company in the company's circumstances would be so aware.

It was further held that the "loss or damage" in question in s588M will normally be the quantum of relevant unpaid debts.

On the facts the appeal was dismissed.

**The case is a handy revision of the factors to be taken into account by a Court considering whether there has been a breach of s588G(2) and (3) CL. The full text of the judgment contains reference to all the relevant authorities.**

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**ATTACHMENT 2**

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**Insolvent trading – when is a debt “incurred”?**

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<b>Case Name:</b>	<b><i>Harrison (as Liquidator) v Lewis</i></b>
<b>Citation:</b>	Unreported, Supreme Court of Victoria, per Mandie J
<b>Date of Judgement:</b>	23 February 2001
<b>Issues:</b>	<ul style="list-style-type: none"><li>• 588G CA – director’s duty to prevent insolvent trading</li><li>• When debt was incurred</li><li>• Whether company was insolvent at that time</li></ul>

**The liquidator of Wine Bank International Pty Ltd claimed that the company’s sole director, Lewis, had engaged in insolvent trading. Critical to the Court’s determination was the question of when Wine Bank, by ordering and later taking delivery of wine supplies, incurred the debt.**

Wine Bank ran a business which sourced investors for Australian wine products. The wine would be bought and on-sold to the investors, stored until mature, and hopefully exported at a profit. However, Wine Bank failed to make export sales and went into voluntary administration. Subsequently a liquidator was appointed after the business was sold. The liquidator alleged that insolvent trading occurred in respect of an order of more than 9000 cases of wine.

This order was placed in October 1997, subject to tasting by an expert panel. Wine Bank’s agents then sourced some investors. The order was confirmed in January 1998 and the wine was then bottled and packed. Delivery occurred in February 1998.

Lewis claimed the debt was incurred in October 1997. However, the liquidator claimed that by early February 1998, and before the wine was delivered, Lewis knew, or should have known, that his company was in financial trouble.

It was conceded by the liquidator that, in October 1997, there were insufficient grounds to suspect that the company was insolvent, or that it would become insolvent as a result of this transaction.

The critical issue was therefore when the debt was incurred.

To prove insolvent trading under s588G of the CL, it must be shown that the company was insolvent when the debt was incurred or became insolvent by incurring the debt, or that there were reasonable grounds to suspect that the company was or would become insolvent at that time. If so, the director(s) of a company may be personally liable for insolvent trading by failing to prevent the company incurring the debt.

Mandie J quoted the following with approval:

*“A company incurs a debt when, by its choice, it does or omits something which, as a matter of substance and commercial reality, renders it liable for a debt for which it otherwise would not have been liable. In relation to sale of goods, it seems to me that, in some cases, it will be the order which in substance and commercial reality renders the*

*company liable for the price of the goods, even if that price is not actually payable until delivery; while in other cases, it will be the acceptance of delivery which, as a matter of substance and commercial reality, so renders the company liable. And intermediate positions are possible.”*

Mandie J said that although it is necessary to consider the terms of the relevant contract, the question of when the debt is incurred within the meaning of s588G does not depend on strict legal analysis but turns on when, in substance and commercial reality, the company is exposed to the relevant liability. Section 588G must be applied to the facts which punishes insolvent trading but in a way which avoids absurd results.

Adopting that approach on the facts, Mandie J held that in substance and commercial reality the debt was incurred no later than January 1998 when the order was confirmed and the supplier was instructed to bottle and pack the wine.

Accordingly, the claim was unsuccessful as the liquidator could not adduce evidence that the company was insolvent or likely to be insolvent at the time the debt was incurred.

**This decision illustrates that in determining whether a transaction constitutes insolvent trading, it is critical to precisely determine when, in substance and commercial reality, the company incurred the debt. Liability will only arise where the incurring of the debt coincides with evidence to support a reasonable suspicion that the company is, or may become, insolvent.**

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**ATTACHMENT 5**

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**Section 54: High Court delivers judgment in *FAI v Australian Hospital Care***

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<b>Case Name:</b>	<b>FAI v Australian Hospital Care</b>
<b>Citation:</b>	[2001] High Court of Australia, Gleeson CJ, McHugh, Gummion, Kirby and Hayne JJ
<b>Date of Judgment:</b>	27 June 2001
<b>Issues:</b>	<ul style="list-style-type: none"><li>• s54 of Insurance Contracts Act</li><li>• failure to give notice of circumstances arising during the policy period</li><li>• <i>FAI v Perry</i> overruled</li></ul>

**The High Court on 27 June gave its long awaited decision in *FAI v Australian Hospital Care Pty Limited*. The decision concerns the application of s54 of the Insurance Contracts Act 1984 (Cth) to a standard “claims made and notified” professional indemnity policy. Although the decision on the whole is bad news for insurers and good news for insureds, it removes some uncertainty which has existed concerning the application of s54, while there are still other issues which remain unresolved. The decision has important practical implications for insurers.**

**The facts**

The facts may be stated briefly as follows:

1. The insured hospital had a professional indemnity policy with FAI. The policy covered the hospital against any claims first made and notified during the period of cover. The policy also contained a number of standard conditions, one of which provided that, if the hospital became aware of any occurrence which may subsequently give rise to a claim and gave notice of that occurrence during the period of the policy, then any subsequent claim arising out of the occurrence will be covered. This provision may be referred to as an “occurrence notified” clause.
2. During the period of cover the insured received a letter from the firm of solicitors representing a former patient. The letter gave notice that a claim may be made by the hospital in respect of treatment received by the patient. The hospital, contrary to its usual practice, gave no notice of this occurrence to the insurer during the period of cover.
3. The central issue was whether s54(1) of the ICA precluded FAI from refusing to pay the hospital’s claim on the ground that it failed to give to FAI, within the period of cover, notice of any occurrence which may give rise to a claim.
4. Section 54 deals with acts or omissions occurring after the contract of insurance was entered into where the effect of the contract of insurance is that the insurer may refuse to pay a claim by reason of that act or omission. It provides that the insurer may not refuse to

pay the claim by reason only of that act or omission. The insurer may only reduce its liability to the extent to which its interests were prejudiced.

## The decision

The decision of the majority is contained in the joint judgment of McHugh, Gummow and Hayne JJ. In giving their reasons, those judges placed considerable reliance on the decision of the High Court in *Antico* and in particular the finding that, for the purpose of s54, an “omission” may be “a failure by the insurer to exercise a right, choice or liberty which the insured enjoys under the policy”. The majority considered that it followed that s54 can be engaged by an omission by the insured to give notice of an occurrence, even if that omission results from a deliberate choice by the insured. Consequently, the decision of the majority of the New South Wales Court of Appeal in *FAI v Perry* has been overruled. The majority also expressly rejected the proposition that a distinction can be drawn between omissions and “non events” as the New South Wales Court of Appeal had attempted to do in *Greentree* and Hodgson CJ in Eq had done in *Permanent Trustee v FAI*.

The majority considered that if a contract has an occurrences notified clause and an insured becomes aware of an occurrence that may subsequently give rise to a claim during the period of cover, an event of the type contemplated by the contract of insurance has occurred. The effect of the contract of insurance was that FAI could refuse to pay the claim by reason only of the fact the insured did not give notice of the occurrence to it. Section 54 therefore required the conclusion that FAI may not refuse to pay the insured’s claim.

However, the majority noted that the decision in *Greentree* was correct on its facts. In that case, the third party had failed to make a claim or demand within the period of the policy. Consequently, there was no notifiable claim or circumstance within the policy period. While s54 can be engaged to excuse a failure to notify, it cannot extend the operation of the policy to cover claims or circumstances which did not arise during the policy period.

Kirby J delivered a separate but concurring judgment. In finding that the hospital’s failure to give notice was an “omission” for the purpose of s54, Kirby J appeared to place some reliance on evidence to the effect that it was the hospital’s usual practice to have notified its insurer about such matters. It is not clear whether his decision would have been different if the hospital had made a deliberate decision not to notify.

## Implications for the insurance industry

The broad interpretation of s54, which has now been endorsed by the High Court, has important implications for insurers not only at the claims level but also at the underwriting level:

1. the decision means that the policies do not mean what they say. In particular, the notification requirements have been dispensed with altogether. Consequently, insurers in setting reserves and fixing premiums on renewal will need to make allowances not only for *claims made* during the period which were not notified but also for claims arising out of *circumstances which became known* to the insured during the period of the policy, but were not notified. The policies are therefore inherently less certain and longer tailed;
2. the decision reduces the pressure or compulsion on insureds to give full and complete disclosure when completing proposals for successive cover. Insureds can now be more comfortable that if they become aware of circumstances even if they do not notify their

- current insurer of them that insurer would have to meet the claim. It is now clear that even where the insured makes a deliberate decision not to notify of circumstances for the purposes of obtaining more favourable terms on renewal, s54 will prevent the insurer from denying liability;
3. the case illustrates that there will be reduced scope for a gap in the insured's coverage, and increased scope for double insurance. On the one hand, but for s54 the insurer would be able to deny liability on the basis that no notification was given during the period of the policy. If the known circumstances are then not disclosed prior to a renewal, the insurer may deny liability under the subsequent policy on the basis of non disclosure. On the other hand, by reason of the decision, in some cases the claim may be covered under both policies. This can arise where the insured becomes aware of circumstances which may give rise to a claim but does not in fact believe (or reasonably believe) that a claim is likely to be made. In such cases, the claim may be a notifiable occurrence for the purposes of the existing policy but not a matter calling for disclosure for the purposes of the duty of disclosure under the subsequent policy. This was in fact the case in *Hospital Care* itself. In 1999, the Queensland Court of Appeal in *Australian Hospital Care v Swinbank* held that the hospital's claim was also covered by a subsequent Lloyd's policy. The Queensland Court held that the hospital, having investigated the matter after receiving the letter from the patient's solicitor, did not believe that a claim was likely and therefore had not breached its duty of disclosure;
  4. the possibility of double insurance may be significant where the insured changes insurer or where the level of cover is increased. Insurers should consider whether provisions excluding claims covered by any prior policy and questions in proposal forms which may have an impact on notification requirements are adequate to ensure that a subsequent policy will not apply where liability attaches under a prior policy by reason of s54;
  5. in appropriate cases insurers may argue prejudice within the meaning of s54(1) to reduce their liability. One source of prejudice may be loss of an opportunity to charge additional premiums on renewal. Even if that argument were valid, its proof would inevitably involve the discovery of documents relevant to the insurer's practices and policies in fixing premiums. Such documents are likely to be highly confidential and commercially sensitive. Consequently, it is unlikely that insurers will wish to run such arguments. In any event, now that the decision has been handed down, insurer's policies and practices are bound to have regard to it and to factor in the longer-tail nature of the business. The consequence is likely to be increased premiums;
  6. the decision does not make it clear whether s54 will apply to a failure to notify circumstances which might give rise to a claim when the contract contains no "occurrences notified" provision. In those circumstances, the insured would have to rely on s40 of the ICA to obtain cover for notified occurrences. Section 40 provides that, *whatever the terms of the contract*, if the insured becomes aware of circumstances which might lead to a claim and notifies the insurer of those circumstances before the insurance cover provided by the contract expires, any claim later arising from those circumstances will be covered by the policy. In *Einfeld*, Rolfe J found that s40 provided a statutory extension to the policy and there was no reason why the provisions of s54 could not apply to it. However, s40 does not expressly provide that its provisions become a term of the policy as such. Section 40

confers a statutory entitlement. The majority in *Hospital Care* stated that any tension or overlap between s54 and s40 should not be resolved by reading s54 down. However, that begs the question whether there really is any tension or overlap between the two sections. In its terms, s54 is concerned with the effect of contracts of insurance rather than with the effect of statutory provisions. The recent decision of Chesterman J in *CA & MEC McInally Nominees Pty Ltd*, also reported in this Review, drew this distinction in holding that, where an insured must rely on s40, the notice requirement is mandatory and s54 has no application. If they were commercially able to do so, insurers might wish to consider removing from their policies provisions relating to the notification of circumstances and leaving their insureds to rely on s40 in that regard;

7. a question arises as to whether the insured has any incentive to give notice of circumstances which the insured becomes aware of during the period of the policy. There may still be reasons why the insured may want to give such notification:
- (a) it leaves less room for argument as to whether the insured has become aware of circumstances which might give rise to a claim. It was accepted for the purpose of the High Court appeal in *Hospital Care* that the insured had that knowledge. However, this issue, which can be a difficult factual one, was a significant issue for the trial judge to determine.
  - (b) where the insured relies on s40 rather than a contractual provision, there is uncertainty whether s54 will assist the insured (see 6 above);
  - (c) in some circumstances the insured's conduct in failing to give notice may amount to a breach of its duty of good faith;
  - (d) notification avoids the possibility of any issue of prejudice being raised by the insurer to reduce its liability to the insured;

## Comments

**The decision effects a rewrite of claims made and notified policies to dispense with notification requirements altogether. As such, it undermines the purpose for which such policies were developed, namely to achieve greater certainty and to assist insurers in setting reserves and closing their books at the end of the policy period. In view of these uncertainties, the case for legislative reform is now stronger than ever. The Insurance and Superannuation Commissioner in 1995, after considering relevant authorities, rejected the suggestion of a legislative amendment to s54, seeing no need for it in light of the decision in *East End* and *FAI v Perry*. In light of the High Court's decision in *Hospital Care*, the Commissioner's successor, the Australian Prudential Regulation Authority or ASIC may be prepared to take a different view. At the time of print, the ICA is presenting a case to those authorities for legislative reform.**

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**ATTACHMENT 6****Section 54 Unable To Assist Insured Relying On Section 40: Notification Requirement Mandatory**

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<b>Case Name:</b>	<b>CA &amp; MEC McNally Nominees Pty Ltd &amp; Ors v HTW Valuers (Brisbane) Pty Ltd &amp; Ors</b>
<b>Citation:</b>	[2001] QSC 388 per Chesterman J
<b>Date of Judgment:</b>	16 October 2001
<b>Issues:</b>	<ul style="list-style-type: none"><li>• sections 54 and 40 of the Insurance Contracts Act</li><li>• professional indemnity policy</li><li>• effect of failure to give notice of circumstances in the policy period</li></ul>

**The facts**

The defendants comprised certain valuers and a firm of solicitors in the business of lending money on the security of mortgages over real property. The plaintiffs were clients of the solicitors. The plaintiffs lent money to finance the acquisition of a gymnasium and fitness centre in reliance on valuations prepared by the valuers. The valuations were negligent in that they grossly inflated the sustainable market rent and inflated the true value of the property.

The valuers had a policy of insurance issued by Commercial Union Assurance Company of Australia Limited (**CUA**) for the period 15 September 1998 to 15 September 1999. The policy covered claims made against the valuers during that period and claims about which CUA was given notice in that period.

No claim was made against the valuers until 6 December 1999 when the plaintiffs made a claim and 22 November 2000 when the solicitors made a claim. The valuers did not give CUA notice of the claim, or indeed, of the possibility that there might be a claim, until March 2000.

The valuers argued that they had nevertheless become aware of circumstances in the policy period which may give rise to a claim. They argued that they were entitled to rely upon a combination of s40 and s54 of the Insurance Contracts Act (the **Act**). Section 40 applies to claims made and notified policies of the type issued by CUA. It provides that, where the insured gives notice of facts that might give rise to a claim as soon as practicable after the insured becomes aware of those facts but within the policy period, the insurer is not entitled to deny liability by reason only that the claim was made after the expiry of the policy period. Section 54 provides that, where the effect of a contract of insurance is that the insurer may refuse to pay a claim by reason of some act or omission of the insured after the contract was entered into, the insurer may not refuse to pay the claim by reason only of that act or omission.

The valuers argued that their failure to give the notice required by s40 was an omission for the purpose of s54 the effect of which was that CUA could refuse to pay the claim.

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## The decision

Chesterman J rejected the valuers' submission. He reasoned:

- (a) Although s40 applied to the policy, the valuers did not comply with its requirements. They did not give notice of facts which might give rise to a claim against them before the expiry of the policy. The critical distinction between this case and the *Australian Hospital Care* case was that in *Australian Hospital Care* the policy contained a provision expressly granting coverage in the event that the insured became aware of any occurrence which might give rise to a claim within the policy period and gave notice to the insurer within that period. The present case was different. The policy would not have entitled the valuers to indemnity even if CUA had been given notice of their negligent valuation within the policy period. The statute would have required CUA to grant indemnity, but that indemnity would have flowed from the intervention of the statute, not the effect of the policy. The judge placed some significance on the words "but for this section" which appears in s54. He considered that those words could not be read as if they meant "*but for this section and s40*".
- (b) Section 40 does not imply into policies of insurance a term to the same effect as the sub-section in the way in which terms are implied, for example, under the *Sale of Goods Act*.

Chesterman J concluded that s40 confers rights on an insured and obligations on an insurer, but to obtain the section's protection an insured must comply with its terms, by giving notice in the policy period.

Strictly speaking, the judge's remarks are obiter because he held that the valuers did not become aware of facts which gave rise to the plaintiff's claims against them until after the policy had come to an end. It was therefore unnecessary for the judge to decide the issue concerning s40 and s 54.

## Comments

**This case provides some comfort to insurers. It supports the proposition that where a professional indemnity policy contains no "occurrences notified" clause of the type considered by the High Court in *Australian Hospital Care*, then an insured, becoming aware of a circumstance which might give rise to a claim during the policy period, must give notice of that claim in order to obtain cover. The decision is contrary to the view expressed by Rolfe J in *Einfield v HIH Casualty* reported in our 1999 Annual Review. The final resolution of this issue must await further decision of the High Court. In the meantime, as a consequence of the *Australian Hospital Care* decision and in the expectation that this decision is correct, insurers may wish to consider removing occurrences notified clauses from policies if they are commercially able to do so.**

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**ATTACHMENT 3**

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**The test for shadow/de facto directors**

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<b>Case Name:</b>	<b><i>Natcomp Technology Australia Pty Limited v Graiche</i></b>
<b>Citation:</b>	Unreported, New South Wales Court of Appeal per Spigelman CJ, Stein and Heydon JJA
<b>Date of Judgement:</b>	30 April 2001
<b>Issues:</b>	<ul style="list-style-type: none"><li>• Company directors</li><li>• Test for “shadow” and “de facto” directors</li></ul>

**How do you determine a “shadow” or “de facto” director?**

This case involved the liquidation of Amtech Industries Pty Ltd (***Amtech***). The appellant creditor brought proceedings to the NSW Court of Appeal against the respondent, arguing that the respondent’s involvement in Amtech was so great that he was either a de facto or shadow director and accordingly liable under the insolvent trading provisions.

Under the CL, a ‘director’ includes a person:

- who is not validly appointed as a director if they act in the position of a director, or
- to whom the directors of the company are accustomed to acting in accordance with that person’s instructions or wishes.

However, a ‘director’ does not include a person giving advice in the proper performance of functions attaching to their professional capacity or their business relationship with directors of the corporation.

The respondent had previously accompanied the appointed directors of Amtech and the managing director of the appellant to a trade fair in Taiwan, at which the respondent distributed a business card which carried the Amtech logo, the company’s address, and described the respondent as ‘CEO’ of the company. The respondent also informed the managing director of the appellant that he was at the fair as a representative of Amtech and frequently used the term ‘we at Amtech’ when discussing the potential of Amtech to build a strong trading relationship with the appellant. On other occasions, the respondent had been introduced to various business contacts as the ‘brains behind Amtech’, the company’s business adviser and as someone who had a financial interest in the company.

When determining the conduct and circumstances relevant to the question of whether the respondent was acting as either ‘shadow’ or ‘de facto’ director, the Court considered whether he:

- exercised actual (and statutorily extended) top-level management functions;
- acted with full discretion, and in the case of a small company ‘as the company’, in relation to matters of great importance to it (other than as an arms’ length expert engaged for a limited purpose);

- performed the duties of a 'director' in the context of the operations, circumstances and size of the particular company concerned; and
- was reasonably perceived as a 'director' by outsiders who dealt with the company (which may aid a conclusion that the supposed director held himself or herself out as such).

Neither the trial judge nor the Court of Appeal were convinced that the respondent was a 'shadow' or 'de facto' director. In particular, the Court of Appeal considered there was no evidence that the respondent was involved in any fashion in the principal aspect of the company's business, namely the sale of computer packages, nor was the respondent involved in the company's day-to-day operations. The Court found that the respondent's involvement with Amtech was "limited to an interest in the development and marketing of possible new products".

**This case is an example of the considerations the Court will take into account when weighing up if an individual or body corporate has behaved in such a way as to hold himself/herself/itself as a shadow or de facto director.**

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**ATTACHMENT 4**

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**Spared from personal liability**

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<b>Case name:</b>	<b><i>Perkins v Viney</i></b>
<b>Citation:</b>	Unreported, Supreme Court of South Australia per Burley J
<b>Date of Judgment:</b>	1 November 2001
<b>Issues:</b>	<ul style="list-style-type: none"><li>• Insolvent trading</li><li>• Personal liability of director</li><li>• Section 1317JA CL</li></ul>

**A liquidator brought an action against a director of LVS Meat Company Pty Ltd for insolvent trading. The director submitted that he was not a director of LVS Meat Company Pty Ltd at the relevant time, that he had reasonable grounds for believing that the company was solvent at the relevant time and that, in any event, he had acted honestly and ought fairly to be excused.**

The director, Mr Clark, submitted that he was not a director of LVS Meat Company Pty Ltd (**LVS**) as he had never executed a consent to act as director. The Court held that Mr Clark was a de facto director of LVS. Mr Clark had held the position of Chairman, which the constitution of LVS required to be held by a director. Mr Clark was also held out to be a director and was shown as a director on a number of notices sent to ASIC and in various financial statements published from time to time. A number of minutes of directors meetings indicated that Mr Clark engaged in activities which were consistent with him being a director, such as engaging in financial dealings on LVS' behalf, engaging in discussions with third parties on behalf of LVS and instructing solicitors on behalf of LVS.

The Court considered whether or not Mr Clark had reasonable grounds for suspecting that LVS was insolvent at the time that the relevant debts were incurred or whether a person in his position would have been so aware. An abundance of evidence was placed before the Court which indicated that LVS was insolvent for at least the period during which Mr Clark acted as Chairman. The evidence indicated that the financial position of LVS did not improve during Mr Clark's period as a de facto director. Mr Clark had made a number of comments during Board meetings with respect to "extended creditors" and liquidity problems. In particular, during one Board meeting Mr Clark had stated that even with an injection of capital LVS was still under-capitalised and that the directors should not be led into a false sense of security. The Court held that the financial position of LVS was tenuous and such that Mr Clark must or should have suspected that LVS was insolvent or would become insolvent if it continued to trade.

Mr Clark sought to escape liability by virtue of s1317JA of the CL, which provides that the Court may excuse a director from liability in circumstances where the director has acted honestly and ought fairly to be excused. The Court held that there was no doubt that Mr Clark had acted bona fide in the best interests of LVS, including the unsecured creditors, and was in this sense acting

'honestly'. For example, Mr Clark was constantly making suggestions to the Board which, if implemented, he believed would increase LVS' financial viability. Mr Clark had not attempted to take advantage of creditors and had not performed his duties negligently.

The Court then considered whether or not Mr Clark ought fairly to be excused. The Court considered the circumstances in which Mr Clark became a director – particularly that he was originally brought in to bring calm to the Board. He had no financial interest in LVS and was not remunerated for his services. The Court thought it appropriate to balance the seriousness of directors' duties with these circumstances. In the Court's view, if a proper balance were struck, Mr Clark's liability should be limited to what he would have been required to contribute if there had been a joint judgment against all four directors of LVS. Mr Clark's personal liability was reduced accordingly.

**This case provides a useful analysis of the circumstances a court will take into account in deciding whether or not to excuse a director from personal liability.**

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**ATTACHMENT 7**

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**Insolvent trading: overseas directors can be liable**

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<b>Case Name:</b>	<b><i>James v Andrews</i></b>
<b>Citation:</b>	Unreported, Supreme Court of New South Wales, per Berecroy AM
<b>Date of Judgment</b>	23 August 2001
<b>Issues:</b>	<ul style="list-style-type: none"><li>• Insolvent trading (s588G CA)</li><li>• Place at which relevant act or omission occurs</li></ul>

**The New South Wales Supreme Court rejected a Notice of Motion to set aside proceedings commenced against a director (the second defendant in the proceedings) for breach of the duty to prevent insolvent trading.**

The company was incorporated in New South Wales and registered in New Zealand. The relevant director resided in New Zealand. The director submitted that he failed to prevent the company incurring a debt not in New South Wales but in New Zealand, and, accordingly, the omission was beyond the jurisdiction of the Corporations Law (as it then was). This submission was made on the basis that most of the directors' meetings of the company were held in New Zealand and decisions regarding the management of the company were made in New Zealand. The Director submitted that the cause of action arose at those meetings when no steps were taken by the directors to ensure that the company was not trading whilst insolvent.

The Court considered that it makes the most legal sense to speak of the place of the act or omission of a defendant in the context of which the omission assumes significance and to identify that place of the 'cause of complaint'.

The Court held that it would be manifestly absurd, unreasonable and against public policy to constrain the interpretation of s588G so as to prevent a liquidator from suing a director who is out of the jurisdiction simply because board meetings are conducted in another country. The Court held that it would be unrealistic and lacking in commonsense to look at the directors in isolation and to say that directors only make decisions when at board meetings which fall within those acts or omissions contemplated by s588G. In the Court's view, the cause of action arose in New South Wales for these reasons and also as the company traded in New South Wales and there was evidence that the majority of its creditors were Australian companies and the debts owed to those companies were incurred in New South Wales.

**This case provides a clear indication to directors that they are required to be continually involved in the management of the company and constantly vigilant of their duties, even where directors meet overseas. Their performance as a director will not be judged only in respect of their acts or omissions at board meetings.**

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**ATTACHMENT 8**

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**Directors must consider benefit to company**

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<b>Case Name:</b>	<b><i>Maronis Holdings Ltd v Nippon Credit Australia Ltd</i></b>
<b>Citation:</b>	Unreported, Supreme Court of New South Wales per Bryson J
<b>Date of Judgement:</b>	7 June 2001
<b>Issues:</b>	<ul style="list-style-type: none"><li>• Breach of duty of directors</li><li>• Consideration of Charterbridge case</li></ul>

**Facts**

This 10-year litigation arose out of financing arrangements related to the proposed development of land at Cross Roads, near Liverpool New South Wales.

In 1988, Maronis Holdings Ltd (***Maronis***), a wholly owned subsidiary of Girvan Corporation (New Zealand) Ltd (***Girvan NZ***) was the beneficial owner of the Cross Roads property. On 2 September 1988, Girvan Corporation Ltd (***Girvan Australia***) acquired a majority interest in Girvan NZ. Contemporaneously, Girvan Australia entered into an agreement to sell all the shares in Dextran Investments (New Zealand) to Girvan NZ (***the Dextran Agreement***). As part of the Dextran Agreement, Girvan Australia gave covenants that it would spend the first \$8 million in establishing the required infrastructure works for the Cross Roads property and that the cost of completing the infrastructure works would not exceed A\$15 million. Girvan Australia was to receive a refund of the \$8 million on practical completion of the infrastructure works.

Maronis was in no position to obtain financing in the order of A \$15 million as it had no business or affairs except to own the Cross Roads property. It had no revenue, and no capacity to service any borrowings. Instead, in June 1989, Girvan Australia borrowed A \$15 million (***the Loan***) from Nippon Credit Australia (***NCA***). Maronis gave a mortgage over the Cross Roads property as security and both Maronis and Girvan NZ gave guarantees. In early 1990, Girvan Australia became unable to discharge the Loan, and NCA exercised its rights under the mortgage, eventually selling the Cross Roads property (although not until 1998).

**Directors' duties and corporate benefit**

The primary allegation made against the directors of Girvan NZ and Maronis was that they gave no genuine or real consideration to the interests of Girvan NZ and Maronis in determining that the transactions of the guarantees and the mortgage should go ahead but instead, acted solely in the interests of Girvan Australia in order to facilitate the loan which was to be used for Girvan Australia's own purposes.

Justice Bryson left out the interests of Girvan NZ in considering this central issue on the basis that Girvan NZ had a number of economic ties and contractual relationships with Girvan Australia, had

interests associated with it and had the benefit of the covenants in the Dextran Agreement. In contrast, Maronis had no contractual relationships with Girvan Australia or any of its subsidiaries.

For the purposes of entering into the NCA arrangements, there were meetings of the directors of Girvan Australia, Girvan NZ and Maronis on 1 June 1989. In the minutes of the meeting of the directors of Maronis there is no record of terms or conditions or any protections or arrangements for the benefit of Maronis and no record of any consideration of the circumstances in which Maronis was to execute the guarantee and the mortgage.

Justice Bryson examined the test to be applied to determine a breach of director's duty in some detail. In the circumstances of this case, he held that it was not necessary to apply the "proper" test outlined by Justice Pennycuick in *Charterbridge Corporation Ltd v Lloyds Bank Ltd & Anor* [1970] Ch 62 that examines whether an intelligent and honest man in the position of the director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company. Instead, he advocated that in this context, if directors do not give separate consideration to the benefit of the company which they decide should enter into a transaction then they are in breach of their fiduciary duty to that company.

In considering the action of the 2 directors of Maronis, Warren Duncan and Alan Ambler, Justice Bryson stated:

"To put the affairs of Maronis wholly in the hands of Girvan Australia was entirely to disregard their separate corporate personalities and the separate ownership interests represented by the minority shareholding. It was simply and obviously wrong and unreasonable to adopt a point of view in which the interests of Maronis and Girvan Australia were equated."

Although Justice Bryson rejected the "proper" test, he held that even if he were to apply this test, intelligent and honest men in the position of Mr Duncan and Mr Ambler could not have reasonably believed the transactions were for the benefit of Maronis as there was an absence of commitment by Girvan Australia to act for the benefit of Maronis and Maronis obtained no tangible advantage from Girvan Australia by giving the mortgage.

**This case is a forceful reminder to directors of the need to give separate and adequate regard to the best interests of the relevant company in order to fulfil their fiduciary duties. Although Australian courts and regulatory bodies have recently espoused the principles of an enterprise theory of corporate law, this case acknowledges that the separate entity principle still remains an important feature of corporate law.**