

# Directors' and Officers' Insurance A Changing Landscape

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# Directors' and Officers' Insurance

## A Changing Landscape

This paper brings together a number of recent developments in the directors' and officers' (**D&O**) insurance landscape. Recent significant decisions by Australian courts and pronouncements by Australian policy makers mean that it is critical for directors and officers, as well as those who indemnify them, to be up to date with these latest developments and to understand their wider implications for D&O insurance in the future. This paper highlights the lessons to be learned from these developments and how insurers and corporates can benefit from those lessons when underwriting or purchasing D&O cover.

### 1. Background – what is D&O insurance and why is it important?

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Directors and officers of Australian corporations face ever increasing exposure to claims. This exposure is not limited to the board of directors, however, and there is a tendency for non-directors involved in the management of the corporation to incur liability in a wider variety of circumstances than may previously have been the case. Traditionally, the directors were the decision makers of a corporation but in modern times managers and other individuals are often responsible for important decision-making that has the potential to create significant gains for the corporation but also the potential to give rise to significant liability.

The increasing use of commissions of inquiry by governments and the widespread use of the investigative powers of the Australian Securities and Investments Commission (**ASIC**) and the Australian Prudential Regulation Authority (**APRA**) also demonstrate the benefit to directors and officers of ensuring that their D&O insurance extends to cover them for the cost of such inquiries and investigations. Such inquiries can gain considerable media attention as they run their sometimes lengthy courses and the cost of arranging representation at an inquiry or the cost of responding to an investigation can be dramatic. It is not surprising, then, that there has been in the last few years a significant focus on the issue of whether insurers are prepared to meet such costs in advance of the final outcome of the investigation or inquiry.

Another focus in recent times has been on the personal exposure of directors and officers. In particular, such exposure arises in the area of occupational health and safety, where State legislation imposes a direct personal liability on directors where an offence committed by a corporation is attributable to an officer of the corporation failing to take reasonable care. In such circumstances, the responsible officer is also guilty of an offence and is exposed to personal liability.

To counter the exposure of individual directors and officers, a company's constitution may include indemnities in favour of directors and officers, which are typically conferred by the corporation by means of a deed of indemnity. However there are important restrictions imposed by statute on the liabilities that may be indemnified by the corporation.<sup>1</sup> A company, or related body corporate, is prohibited from providing an indemnity, other than for legal costs, in a number of circumstances.

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<sup>1</sup> See s199A(2) *Corporations Act 2001 (Cth)*.

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 (including the insolvent trading provisions); or
- owed to someone other than the company (or related body corporate) and arose out of bad faith.

This explains the reliance on D&O insurance. Given the increasingly onerous duties placed on directors and officers and their vulnerability to proceedings and financial exposure, the role of D&O insurance is becoming ever more important.

A typical Australian D&O insurance policy contains two separate insurance components. The first usually consists of a direct cover component which provides indemnification to directors and officers where the company itself is unable or unwilling to do so. The second 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 articles, to indemnify its directors and officers. These are the principle insuring clauses common to D&O insurance policies in Australia although D&O policies commonly offer a number of extensions of cover such as cover for spouses of directors and officers or defence costs relating to prosecutions under environmental or occupational health and safety laws.

There are however 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 (separate prospectus specific cover may be available as a stand alone product);
- **professional indemnity exclusion** which excludes cover for claims alleging a breach of duty other than the duties owed by a director in that capacity;
- **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 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. The reason for the exclusion is self-evident: it 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. Many D&O policies contain an exception to the insured versus insured exclusion. D&O policies normally include an exclusion to extend cover to claims brought in the name of the company:
  - (i) as a shareholder derivative action;
  - (ii) by ASIC; or
  - (iii) at the instigation of a receiver, administrator or liquidator.

In the absence of a write-back of cover, a D&O Policy which contains an insured versus insured exclusion 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.

Sections 199B and 199C of the *Corporations Act 2001* 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 of the *Corporations Act 2001* (which relate to directors' use of position and use of information).

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

The current market for D&O insurance is again soft. This means that there is downward pressure on premiums as a number of local and international insurers compete for premium insurance in the limited Australian market. No doubt given the potential exposures, for example the trend toward extending personal liability below board level which may result in greater exposures for insurers under existing wordings and definitions of 'officer', there will be a correction in due course. In the meantime, insurance brokers can use the opportunity to negotiate not only the best possible premiums from underwriters but also expanded policy wordings and extended coverage. Our experience is that corporations with support from the brokers are actively comparing available D&O policies and the investigations focus not only on price. Insureds are wise to the fact that differences in wordings and the exclusion or inclusion of optional extensions can result in very different outcomes for the company and its directors and officers and directors down the line.

## 2. What are the latest judicial developments?

To summarise what effect the latest judicial decisions have had on the D&O landscape, it can be observed that the cases highlight the emergence of gaps between the liabilities for which directors may expect to be indemnified and the actual scope of the indemnities conferred by the corporations for which they act and the extent of D&O insurance coverage conferred by their insurers.

### 2.1 *Intergraph Best (Vic) Pty Limited & Ors v QBE Insurance (Australia) Limited*

*Intergraph*<sup>2</sup> is an important case in the current Australian environment because it is a case about the extent of cover provided by the D&O policy in relation to a Royal Commission. As noted earlier the need to ensure that appropriate and adequate cover is in place in relation to such costs is becoming more and more apparent.

Intergraph was responsible for the call system for the Metropolitan Ambulance Service in the State of Victoria. That system was the subject of an investigation by a Royal Commission amid allegations of improper or unlawful conduct by Intergraph in winning the call-system contract.

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<sup>2</sup> (2005) 13 ANZ Ins Cas ¶161-653; [2005] VSCA 180.

Current and former directors and staff of Intergraph were compelled to give evidence. Intergraph incurred more than \$5 million in legal costs in connection with the Royal Commission and later sought to claim these costs from its insurer under its D&O policy.

The wording of the insuring clauses was fairly typical of D&O policies, and provided coverage:

1. to insured persons in respect of their personal liability; and
2. to the company in respect of any obligation to indemnify the insured persons.

The policy covered 'defence costs', defined to include costs incurred in relation to any legally compellable attendance by an insured person at an official investigation, examination or inquiry under extension 2.3. Again a common wording of such provisions.

Extension 2.3 provided cover for such defence costs where the investigation, examination or inquiry may lead to a recommendation for civil or criminal proceedings and which would be the subject of a claim under the policy.

The insurer denied liability to indemnify on the basis that the policy required it to indemnify Intergraph for legal costs incurred by the directors or employees of Intergraph but not by Intergraph itself. The trial judge found that the wording of extension 2.3 was broad enough to cover defence costs incurred by Intergraph itself, provided the other conditions of that provision are satisfied. On appeal the Court of Appeal of Victoria held that the object of the extension was to provide cover anterior to a claim against the directors and officers by covering the costs of preliminary official inquiries. The Court of Appeal held the extension was clearly subject to the insuring clauses and operated within the framework of those clauses. The position remained that the policy only provided direct cover for claims against the directors arising out of the performance of their duties and to the company if it was required to indemnify the directors and officers for such a claim. The extension did not transform the policy into one which offered an entirely new category of cover, namely cover to the company in circumstances where it was not indemnifying the directors and officers.

The case emphasises the importance of the interaction between D&O insurance and any indemnity which a company might give to its directors. The company would have been covered if Intergraph's constitution had provided for an indemnity in favour of the directors (which is common practice) and where the directors had incurred and then sought reimbursement of the costs.

## **2.2 *Whitlam v National Roads and Motorists' Association***

A further illustration of the importance of the interaction between D&O insurance and any indemnity which a company might give to its directors is the recent decision of the New South Wales Supreme Court in *Whitlam*<sup>3</sup>.

Nicholas Whitlam was director of National Roads and Motorists' Association Limited (**NRMA**) from 1995 to 2002 and was its president from 1996 to 2002. He was also chairman of its subsidiary, NRMA Insurance Limited, which is now known as Insurance Australia Group Limited. These two companies were, prior to 2000, mutual organisations that together comprised the NRMA Group.

Between 1994 and 2000 the NRMA Group considered various proposals to demutualise. In March 2001, Mr Whitlam was interviewed by the Nine Network's *Sunday* program in relation to the

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<sup>3</sup> [2006] NSW SC 766 3 August 2006

demutualisation. Mr Whitlam consulted with NRMA in relation to the question of whether to provide the interview and ultimately took part in the interview with NRMA's consent. On several occasions between March and December 2001, Nine broadcast excerpts of that interview in broadcasts that were capable of conveying defamatory imputations of Mr Whitlam. In March 2001, a *Sunday* reporter was interviewed by Sydney radio station 2GB about the first of these broadcasts and that interview conveyed defamatory imputations of Mr Whitlam.

Mr Whitlam did not immediately commence defamation proceedings against Nine but was kept informed of the status of proceedings that were commenced by NRMA Limited in July 2001. However Mr Whitlam did immediately commence defamation proceedings against 2GB and these proceedings were settled in May 2002 by the radio station apologising to Mr Whitlam and paying almost all of his costs of the proceedings. Mr Whitlam eventually commenced defamation proceedings against Nine in December 2002 but those proceedings were discontinued four months later.

In November 1999, Mr Whitlam and NRMA had executed a deed by which NRMA confirmed the basis upon which Mr Whitlam was entitled to indemnity, insurance and access to documents while serving as an officer of NRMA Group companies. The parties executed a second deed in August 2002 to reflect the demutualisation of NRMA Group and the enactment of the *Corporations Act 2001*.

In August 2002, Mr Whitlam requested that NRMA reimburse him for legal costs that he had incurred in defending proceedings commenced by the Australian Securities and Investments Commission (**ASIC**) for alleged breaches of director's duties (in which ASIC had been successful at first instance but in which Mr Whitlam had successfully appealed to the New South Wales Court of Appeal). At the same time, Mr Whitlam sought from NRMA an indemnity for compensation and legal costs incurred 'in respect of causes of action in defamation arising as a consequence of numerous defamatory publications' concerning his role as director and president of NRMA. The claim for compensation was later described by his solicitors as being a claim for indemnity for 'damage to his reputation and consequential loss of earning capacity, which would otherwise be compensable from those directly responsible for it.'

Despite this and several further requests, in December 2004 NRMA eventually declined to indemnify Mr Whitlam.

Mr Whitlam commenced proceedings against NRMA, in which the issues were limited so that the only relief sought was a declaration and orders that NRMA was liable to indemnify him for:

- (a) the costs reasonably incurred in the proceedings against 2GB;
- (b) the costs reasonably incurred in the discontinued proceedings against Nine; and
- (c) the costs he may reasonably incur in bringing defamation proceedings against Nine.

NRMA denied that it was liable to Mr Whitlam because the indemnities sought are not liabilities that arose from a third party claim against Mr Whitlam for his acts or omissions as an officer of NRMA and the deeds of indemnity were obviously intended to respond only to such liabilities.

Bergin J, in the Supreme Court of New South Wales, handed down her decision on 3 August 2006.

The deeds executed by Mr Whitlam and NRMA in 1999 and 2002 conferred a 'full indemnity' to Mr Whitlam for all liabilities incurred by Mr Whitlam as an officer of an NRMA Group company,

including costs incurred in defending proceedings in which judgment was given in Mr Whitlam's favour and in which the court grants relief to Mr Whitlam under the corporations legislation.

Both deeds excluded any indemnity for a liability arising from 'a lack of good faith, wilful misconduct, gross negligence, reckless misbehaviour or fraud'. Both deeds also excluded any indemnity for a liability to the NRMA Group except one that was permitted by s241(3) of the *Corporations Law* (under the 1999 deed) or one that was permitted by ss199A(2) or 199A(3) of the *Corporations Act 2001* (under the 2002 deed).

NRMA argued that Mr Whitlam's entitlement to indemnity should be construed by reference to the 1999 deed only and that the indemnity being sought was prohibited by s241(3) of the *Corporations Law*. Mr Whitlam argued that even if the indemnity was prohibited under the 1999 deed, the 2002 deed should apply and the claim for indemnity was not prohibited by that deed.

Bergin J found that, as a matter of construction, the 2002 deed was intended to replace the 1999 deed and therefore the question was whether the indemnity being sought was prohibited by that deed.

Bergin J found that by incurring costs in bringing defamation proceedings against Nine, Mr Whitlam had taken steps in defending a claim and that this was a liability for which the 2002 deed provided an indemnity.

Her Honour found that nothing in s199A of the *Corporations Act 2001* prohibited an indemnity for costs incurred in pursuing a defamation action. Further, Mr Whitlam was found to have been defamed in the performance of his duties as an officer of NRMA, being his authorised interview with Nine. The indemnity conferred by the 2002 deed was very broad and the Court found that the only pre-requisite to indemnification by NRMA was that Mr Whitlam have incurred 'loss, liability, cost, charge or expense ... as an officer' of NRMA. This pre-requisite was satisfied because Mr Whitlam incurred a liability by giving an interview to Nine with NRMA's authority and in his capacity as an officer of Nine (not in his personal capacity).

The indemnity for those costs was to be limited to cases in which Mr Whitlam was vindicated by obtaining an apology, a settlement or verdict and judgment. Here, Mr Whitlam had discontinued his action against Nine and obtained an apology from 2GB. Bergin J found that Mr Whitlam was entitled to indemnity in respect of the costs incurred in the 2GB proceedings and also for the Nine proceedings because Mr Whitlam's discontinuance was reasonable in the circumstances. However, Mr Whitlam's ultimate entitlement to indemnity for costs incurred in the proceedings against Nine could not be determined until the outcome of Mr Whitlam's proposed further proceedings against Nine (the conduct of which NRMA would be entitled to assume).

It has been suggested that this case has ramifications for companies, their insurers and their shareholders. This is true but it is important to recognise that this decision ultimately turned on the wording of very broad indemnities provided by a company to its officer through deeds of indemnity, insurance and access. The indemnities were broader than the company intended because the Court found that they included not only actions brought against the officer but also actions commenced by the officer when defending allegations (in this case, defamatory imputations) made against them in their capacity as an officer.

The important issue highlighted by this case is the need for companies to ensure that the indemnities that they provide to their officers are aligned with their own D&O insurance.

Alternatively, companies must at least be aware of the existence of any gaps between their D&O insurance cover and the indemnities given to their officers.

Conventional D&O policies provide two types of cover: firstly to, or on behalf of, the company in respect of liabilities that the company incurs when indemnifying a director or officer, when permitted or required to do so by law; and secondly to, or on behalf of, the insured director or officer for all liabilities for which the insured person is not indemnified by the company. Typically, a D&O insurance policy will not provide cover for actions commenced by an officer against a third party because such policies are generally expressed as providing cover for claims made by third parties against officers in their capacity as officers of the company. However this may not be true in all cases and regard must be had to the particular terms and cover provided by of each policy to identify what gaps, if any, exist between the insurance policy and the indemnity provided by the company to its officers.

Gaps in cover may exist for a number of reasons, for example because the officers are not prepared to carry out their functions without very broad indemnities to which the insurance may not respond. However if companies are not at least aware of those gaps in their D&O insurance cover then they expose themselves to the risk of liabilities to officers and directors which are not covered by insurance, something illustrated also by the next case.

### 2.3 *Vero Insurance Limited v Baycorp Advantage Limited*

In *Baycorp*<sup>4</sup> the Court of Appeal of the Supreme Court of New South Wales held that an insurer was not obliged to indemnify the insured company under a D&O policy for a sum paid in settlement of proceedings against itself and its officers but was liable for common defence costs incurred in those proceedings (despite the fact that a non-insured entity also benefited from those costs).

The insurer refused to indemnify Baycorp under its D&O policy. Baycorp had sought:

- \$10 million paid to settle proceedings against Baycorp and a number of its officers; and
- Defence Costs (as defined in the Policy) incurred in connection with the proceedings that had benefited both Baycorp and its officers.

Clause 2.1 of the deed of settlement (the **Deed**) provided that:

Baycorp ... on behalf of itself and each of the other defendants in the proceedings ... will pay [the plaintiffs a total of \$10 million in respect of the claims in the Proceedings] in full and final settlement of the Proceedings ... inclusive of costs...

'Loss' was defined in the policy as:

1. The amount (whether determined by judgment or settlement) which [a Baycorp Officer] is legally liable to pay in respect of a Claim and includes damages, interest and claimant's costs and expenses;
2. Defence Costs.

'Defence Costs' was defined in the policy as:

...all reasonable legal and experts' fees, costs, charges and expenses...incurred by [RSA] or with its prior written consent in defending, investigating, monitoring or settling any Claim...

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<sup>4</sup> (2005) 13 ANZ Ins Cas 61-630; [2004] NSWCA 390

Automatic Extension 1(a) contained in the policy provided:

Where [RSA] has confirmed in writing that a Claim against [a Baycorp officer] is covered under this Policy but elects not to exercise its entitlement to take over or conduct the defence or settlement of that Claim ... then [RSA] will pay Defence Costs, on behalf of [a Baycorp officer] or [Baycorp] ... as they are incurred and prior to finalisation of the Claim.

Claims Condition 6 contained in the policy provided:

In the event that ... both [Baycorp's officers] and others (including [Baycorp]) are a party to the Proceedings ... then [Baycorp] and [RSA] will agree on a fair and proper allocation of damages, interest, claimant's costs and expenses and Defence Costs between Loss covered by this Policy and Loss not covered by this Policy.

The questions for the Court were:

1. whether, by reason of the execution of the Deed, and on the proper construction of Clause 2.1, the settlement sum was an amount which Baycorp's officers were legally liable to pay in respect of the claims in the proceedings;
2. whether the insurer would therefore be liable under the policy to indemnify Baycorp for the amount of the settlement sum;
3. whether, it would be unconscionable for Baycorp to rely on the construction of Clause 2.1 of the Deed as establishing a 'Loss' for the amount of the settlement sum;
4. whether the insurer had to pay defence costs, even though another uninsured person (Baycorp) received a benefit (being defence of the claims) from those defence costs being incurred (the definition of 'Claim' restricts defence costs to costs incurred in relation to a claim against Baycorp's officers and not Baycorp itself); and
5. whether Claims Condition 6 was enforceable.

The Court of Appeal held that the officers of Baycorp were not legally liable to pay the settlement sum. The Court considered the words '*Baycorp on behalf of itself and each of the defendants ... will pay*' in clause 2.1 indicated that although payment would discharge the liabilities of its officers, the promise to pay was confined to Baycorp.

Although unnecessary (given the negative answer to question 1), the Court of Appeal held that even if the Baycorp officers were legally liable for the settlement sum, that did not automatically require the insurer to indemnify Baycorp. Although the definition of 'Loss' in the policy contained the words '*whether determined by judgment or settlement*', those words were held to merely clarify that a settlement payment could be a 'Loss', and did not remove the requirement (where a settlement has been reached without the insurer's consent) that in order to be indemnified the insured establish the settlement was for a reasonable amount and was bona fide.

The Court of Appeal held that the insurer was required to indemnify Baycorp for common defence costs that benefited both the insured (the officers) and a non-insured party (Baycorp). In the absence of express words such as '*solely and exclusively*' in the policy, the Court was not prepared to restrict 'Defence Costs' to only those costs that exclusively benefited the insured officers.

This decision illustrates the way a court will construe settlement deeds to determine whether an insurer is liable to indemnify an insured (in circumstances where the insurer is not a party to the settlement) and makes it clear that indemnities for defence costs incurred will not be confined to

costs incurred solely and exclusively in defending the insured entities, without express words to that effect in the policy.

#### 2.4 ***Wilkie v Gordian RunOff Ltd; Rich v CGU Insurance; Silbermann v CGU Insurance***

The issue of the advance payment of defence costs continues to be a topical subject in D&O insurance in Australia at the moment and it is worthwhile to consider again the cases that brought this issue to the fore: the claims by former directors of One.Tel and a former director of FAI against their D&O insurers for advance payment of costs. The former One.Tel directors, Messrs Rich and Silbermann remain locked in battle with ASIC defending compensation claims based on alleged breach of duty. Mr Wilkie, a former director of FAI, was charged with failing to act honestly in the exercise of his duties as a director of FAI following the collapse of insurance giant HIH. *Wilkie*<sup>5</sup> went all the way to the High Court, which very carefully analysed the words used in the policy. *Wilkie* and the *Rich* and *Silbermann* decision<sup>6</sup> highlight the need for both insureds and insurers to choose their wordings very carefully and provide practical guidance for the industry and purchasers of D&O insurance going forward.

The New South Wales Supreme Court in *Wilkie*<sup>7</sup> and the New South Wales Court of Appeal in the *Rich and Silbermann* matter<sup>8</sup> held that insurers were entitled to refuse to advance defence costs to insureds under D&O policies that excluded loss arising from dishonest or fraudulent conduct of the insureds. Even though the relevant exclusions were expressed to apply where there was a judgment or final adjudication on the issue of dishonesty, the insurers were held to be able to refuse advance payment of defence costs before that judgment or adjudication had taken place.

In *Rich and Silbermann*, the New South Wales Court of Appeal held that the discretion to refuse to pay defence costs was subject only to the duty of utmost good faith. In other words, so long as the insurers acted reasonably, they could exercise their discretion to refuse to pay defence costs until there had been an adjudication of the issue by a court.

At first instance, Justice Nicholas relied on the reasoning of the New South Wales Court of Appeal in the *Silbermann* proceedings in his decision to refuse to make the orders sought by Mr Wilkie. The High Court unusually granted special leave to Mr Wilkie to directly appeal the decision of Justice Nicholas to the High Court.

Mr Wilkie was an officer of FAI. Criminal proceedings were commenced against Mr Wilkie in the local court in relation to the collapse of the HIH Insurance Group, of which FAI was a part. Mr Wilkie made a claim for advance payment of defence costs under an extension to the D&O insurance policy issued by GIO Insurance Ltd (now Gordian Run Off Limited).

As in the One.Tel cases, GIO relied on a term excluding liability for loss arising out of dishonest or fraudulent conduct of the claimant. However, in contrast to the *Silbermann* case, the insurer made no allegations of misrepresentation or non-disclosure against the claimant.

When it reached the High Court, the Court unanimously allowed Mr Wilkie's appeal.

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<sup>5</sup> (2005) 214 ALR 370

<sup>6</sup> (2005) 214 ALR 410

<sup>7</sup> [2003] NSWSC 1059 (18 December 2003)]

<sup>8</sup>(2003) 57 NSWLR 469.

The relevant terms of the GIO Policy considered by the High Court were as follows.

Extension 9 provided that:

If GIO elects not to take over and conduct the defence or settlement of any Claim, GIO will pay all reasonable Defence Costs associated with that Claim as and when they are incurred, provided that:

- (i) GIO has not denied indemnity for the Claim; and
- (ii) the written consent of GIO is obtained prior to the insured incurring such Defence Costs.

GIO reserves the right to recover any Defence Costs paid under this extension from the Insured or the Organisation severally according to their respective interests, in the event and to the extent that it is subsequently established by judgment or final adjudication, that they were not entitled to indemnity under this policy.

Exclusion 7 provided that:

This policy does not insure Loss arising out of any claim...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.

In turn, the words 'in fact' were defined to mean:

that the conduct referred to in those Exclusions is admitted by the Insured or is subsequently established to have occurred following the adjudication of any Court, tribunal or arbitrator.

The High Court rejected GIO's argument that its denial of indemnity in reliance on the dishonesty Exclusion was sufficient to relieve it of its obligation to advance defence costs. The dishonesty Exclusion had not been triggered as the alleged wrongful conduct had not 'in fact' occurred; that is, it had not been admitted by Mr Wilkie and no adjudication had been made in relation to his conduct. Of particular interest is that the majority noted that the adverse findings about Mr Wilkie's conduct by the HIH Royal Commission did not satisfy the requirement that the conduct be established 'in fact', that is established by adjudication of any court, tribunal or arbitrator.

The majority noted that the policy specifically contemplated the possibility of advancement of defence costs before all issues relevant to entitlement to indemnity are resolved. By reason of the defence costs Extension 9, GIO reserved its right to recover defence costs advanced to the insured if it was subsequently established that the insured was not entitled to be indemnified.

The majority took comfort that this construction was compatible with the apparent commercial purpose of the GIO Policy (that is, to provide advance funding for legal costs in the absence of a final adjudication of disqualifying conduct on the part of the insured) and observed that '[i]t would require clearer exclusionary language than appeared in the GIO Policy to deprive the Insured of the benefit of the Policy for which the premium has been paid'. The Court viewed the advance payment of defence costs until any relevant fraud or dishonesty was proven as an important benefit provided by the policy. Given the construction of the policy, it is the insurer that must run the risk that the insured may have insufficient funds for it to recover what it paid if fraud is ultimately proven.

In contrast to the policy wording in *Wilkie*, which stated that the insurer '*will* pay all reasonable Defence Costs', the policy wording in the One.Tel matters granted the insurer a *discretion* as to

whether to pay defence costs. However, the relevant exclusion for dishonesty was similarly expressed to apply 'to the extent that the subject conduct has been established by judgment or other final adjudication'.

The High Court ultimately decided the *One.Tel* cases on a very narrow point. It revoked the grant of special leave to appeal and did not consider questions of policy interpretation.

Justices Callinan and Kirby gave separate reasons in which they indicated that they favoured the insured's interpretation of the policy. In their view, having regard to the words used and the reality that directors against whom dishonesty is alleged may otherwise have no means of defending themselves adequately, the policy was intended to provide 'up front' cover for defence costs in such circumstances.

The *Wilkie* decision demonstrates that the courts will have regard to the policy wording as a whole and carefully analyse the words used. The difficulties associated with adducing evidence in proceedings of the commercial purpose of a policy mean that the policy wording must be chosen very carefully. Having said that, it is interesting to note that the court did not completely disregard evidence that the insured in *Wilkie* had sought to adduce as to how similarly worded policies had been construed in the United States. Those cases supported the commercial purpose as being to afford assistance with defence costs when an insured is faced with allegations of wrongdoing, including criminal wrongdoing.

### 3. New battlegrounds for directors – personal liability and class actions

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This section of the paper moves away from cases dealing purely with D&O policies and on to the broader environment in which directors and officers need to have regard to the increasing potential for incurring personal liability and for class action litigation.

#### 3.1 *Downey v Crawford*<sup>9</sup>

In *Downey v Crawford*, the liquidator claimed that the directors of the company breached their duties to the company by placing it into voluntary administration at a time when it was not insolvent or likely to become insolvent.

Andrew Crawford and his father, Gilbert Crawford, were directors of a company that reviewed financial advice given by other financial advisers. Gilbert Crawford had no daily interactions with the company's operations and relied almost solely on his son, who ran the company. Gilbert Crawford did provide finance to the company on various occasions.

Well after the company had ceased trading, the directors resolved on 4 August 1999 to place the company into voluntary administration and appointed Mr Downey as administrator. Subsequently, the creditors resolved to wind up the company, with Mr Downey appointed as liquidator. On 27 October 1999, Mr Downey appointed himself as administrator under section 436B(1) of the Corporations Act and the creditors agreed to execute a Deed of Company Arrangement, which was finalised on 27 November 1999. This deed was subsequently terminated and Mr Downey was appointed liquidator under s446A.

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<sup>9</sup> *Downey and ACN 075 004 643 Pty Ltd (in liquidation) v Andrew Crawford and Gilbert Crawford* [2004] FCA1264

Following his examination of the company's financial position, Mr Downey reached the view that the company was not insolvent, or likely to become insolvent. As such, the costs incurred by the company from the liquidation and administration were unnecessary. He commenced proceedings against the Crawfords, claiming general damages under s598 of the Corporations Act (which is a general provision allowing Courts to order compensation for breaches of duty to a company). In addition to general damages, Mr Downey also claimed against the directors that resolving to place the company into Voluntary Administration was without justification and made in breach of the statutory and fiduciary duties owed to the company.

In this particular case the records of the company were incomplete, it was difficult to assess the company's financial position and in making such a claim Mr Downey failed to discharge the onus of proving that its directors had breached their duty to the company.

The court found that the state of the company's financial records prevented an accurate assessment of its assets and liabilities and thus Mr Downey was unable to prove that the directors should have known that the company was solvent.

While this case has specific factual nuances, it highlights the difficulty in determining the financial position of a company where its records are incomplete. It also indicates the difficulty in seeking to prove on the balance of probability that a company placed into voluntary administration by directors was not in fact likely to become insolvent.

### **3.2 *Campbell's Cash & Carry Pty Ltd v Fostif Pty Ltd*<sup>10</sup>**

Historically, the common law in Australia has prohibited maintenance (supporting litigation, regardless of the reason) and champerty (supporting litigation in exchange for a share of the proceeds of that litigation), on the basis that they are contrary to public policy. However, maintenance and champerty have now been abolished as crimes and torts in most Australian jurisdictions and recent court decisions have made it plain that litigation funding is now a reality in Australia. Courts throughout the country have accepted, as a matter of public policy, that litigation funded by third parties may allow parties who would otherwise be denied access to justice to proceed with their claims. However, until the High Court of Australia decision in *Fostif*, there was some uncertainty as to what elements of a litigation funding agreement might render it contrary to public policy and an abuse of process.

A class action was brought by a number of tobacco retailers against licensed wholesalers for the recovery of state licence fees, following the High Court's declaration in *Ha v State of New South Wales* (1997) 189 CLR 465, that the tobacco licensing schemes of the states and territories were invalid. The proceeding was financed by a litigation funder, Firmstone, on the basis that it would take one-third of the proceeds if the case were successful.

At first instance, Justice Einstein of the New South Wales Supreme Court held that the proceeding was an abuse of process and fell outside the court rules permitting representative proceedings. The Court of Appeal allowed the appeal and ordered the proceedings to continue as representative proceedings. The Court of Appeal found that neither Firmstone's role in connection with the litigation nor the particular funding arrangements justified staying the proceeding. The Court of Appeal's findings included that:

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<sup>10</sup> [2006] HCA 41.

- champerty or third-party assistance per se does not amount to abuse of process;
- the court is not concerned with the arrangements between the funder and the plaintiff unless they have corrupted, or have a tendency to corrupt, the processes of the court;
- in circumstances where the plaintiff's claim is viable, as was held to be the case here, the standard of proof for a permanent stay is high, and the court will only dismiss the proceeding as a last resort means of eliminating the abuse; and
- some measure of control over the proceedings by a litigation funder is necessary if the funder is to manage the group litigation and protect its own interests, and is not a basis for finding abuse of process meriting an unconditional stay.

The High Court granted special leave to appeal in September 2005.

In *Campbell's Cash & Carry Pty Ltd v Fostif Pty Ltd*, the High Court upheld the wholesalers' appeal on the question of whether the proceedings should continue as representative proceedings. However, the appeal was dismissed on issues of public policy and abuse of process arising from the funding agreement between the retailers and Firmstone.

Justices Gummow, Hayne and Crennan, with whom Chief Justice Gleeson and Justice Kirby agreed on this issue, made the following points in concluding that the funding arrangements between Firmstone and the retailers did not constitute a ground to stay the proceedings.

- (a) Section 6 of the legislation abolishing the offences of maintenance and champerty in New South Wales, the *Maintenance, Champerty and Barratry Abolition Act 1993* (NSW) (the **Abolition Act**), made it clear that questions of maintenance and champerty were not to be regarded as always legally irrelevant. That section preserved any 'rule of law as to the cases in which a contract is to be treated as contrary to public policy or as otherwise illegal'. However, the Abolition Act neither stated explicitly whether questions of maintenance and champerty are relevant to issues of abuse of process nor addressed the scope of public policy or doctrines of illegality concerning those questions.
- (b) In their Honour's view, the wholesalers' proposition that for the maintainer to institute and continue proceedings in the name of, or on behalf of, the maintained plaintiffs was an abuse of process which could be avoided only by a stay assumed that maintenance and champerty give rise to public policy questions beyond those relevant when considering whether the funding agreement is enforceable between the parties. However, in jurisdictions where legislation like the Abolition Act has been enacted, that assumption is not valid, for several reasons:
  - (i) when the crimes and torts of maintenance and champerty were abolished, any wider rule of public policy, beyond the rules preserved by s6, lost any basis that it previously had; and
  - (ii) the asserted rule of public policy would not yield any certain rule, because the content and basis of the public policy asserted was identified only by the use of terms such as 'trafficking' or 'intermeddling'.
- (c) The particular complaints by the wholesalers that Firmstone had sought out claimants, exercised a great degree of control over the proceedings and bought the

rights to litigation to obtain profit were not, either alone or in combination, contrary to public policy or resulting in an abuse of process. Their Honours held that many people seek to profit from assisting in litigation, and seeking out and encouraging litigation could only be contrary to public policy if there were still a rule against maintaining actions. In the absence of such a rule, either in crime or in tort, there was no foundation to conclude that maintaining an action could be contrary to public policy.

- (d) Moreover, fears concerning the adverse effects on the processes of litigation and the fairness of the agreement between the funder and the plaintiff are not sufficient to justify an 'overarching rule of public policy' that would prohibit funded actions or require funding agreements to meet particular standards concerning the funder's degree of control or reward. Such a rule 'would take too broad an axe to the problems that may be seen to lie behind the fears'. Similarly, fears for the administration of justice (for example, that the funder might inflame the damages or suppress evidence) can be adequately met by existing doctrines of abuse of process, and fears that lawyers might find themselves in positions of conflict are also adequately addressed by the existing rules regulating their duties to the court and clients.
- (e) Importantly, their Honours considered it neither necessary or appropriate to consider the position in jurisdictions where maintenance and champerty continue to be torts or crimes.

Justices Callinan and Heydon dissented on this point. Their Honours found that the Court of Appeal's decision on this issue should be overturned. Their Honours found that a combination of factors rendered the proceedings an abuse of process, including Firmstone's motive of profiting from the litigation of others, the fact that Firmstone sought out and encouraged persons to sue who would not otherwise have done so, the large gains hoped for by Firmstone, Firmstone's control of the litigation and the subservience of the retailers' interests to those of Firmstone.

The High Court's decision is likely to encourage the number of litigation funders and funded cases, particularly for class actions which through economies of scale may be seen to offer the best chance of a large return for funders. Previously, it was difficult to predict whether a particular litigation funding agreement would be stayed on public policy grounds. That uncertainty has now been largely removed, at least in New South Wales, Victoria, South Australia and the ACT, where the torts of maintenance and champerty have been abolished. The position remains unclear in the remaining jurisdictions.

The decision is of concern to insurers, defendant corporations and their directors. The majority judgment appears to dismiss many of the public policy considerations that have been identified in lower courts as significant. Those considerations include the importance of protecting plaintiffs where their interests might conflict with those of the funder and the need to discourage unmeritorious litigation to ensure an appropriate balance in the civil justice system. The decision of the majority of the High Court suggests that courts should be slow in staying proceedings as an abuse of process on the basis of funding agreements.

The decision may also affect what, if any, regulation of litigation funding is considered by the Standing Committee of Attorneys-General (**SCAG**). The Discussion Paper released by SCAG in

late May on the issue of litigation funding notes the lack of legislative uniformity across Australia on this issue. That lack of uniformity has been highlighted by the High Court's decision in *Fostif* and may encourage action on the part of SCAG. Further, the need to protect vulnerable plaintiffs who enter into funding agreements has also been highlighted by SCAG, and may be given further consideration in light of the High Court's judgment. It is unclear whether other aspects of the decision will influence the outcome of SCAG's review.

### 3.3 Personal liability for corporate fault

In the HIH Royal Commission Report, Justice Owen made the observation that many of the practices found to be undesirable within HIH were undertaken by middle managers, but that the provisions of the *Corporations Act 2001* on the liability of middle managers is unclear. In September 2002, the Parliamentary Secretary to the Treasurer announced that the Federal Government had asked the Corporations and Markets Advisory Committee (**CAMAC**) to identify any inconsistencies and compliance cost overlaps in existing laws relating to directors' liability. CAMAC was asked to investigate the personal liability of directors at common law and under Federal, State and Territory statute and to consider whether potential personal liability under the various requirements were disincentives to anyone considering board positions.

CAMAC was established in 1989<sup>11</sup> to advise the Federal Government on issues relating to corporations and financial markets law and practice. CAMAC members are appointed on the basis of their knowledge and experience in business, financial markets, law, economics or accounting. They are assisted by the Legal Committee, whose members have expertise in corporate law.

CAMAC produced its first report *Directors and Officers Insurance* in June 2004 and its follow-up report, *Personal Liability for Corporate Fault* was produced on 8 September 2006. This second report, which follows a discussion paper from May 2005,<sup>12</sup> was released to the public last week. Its findings and recommendations are summarised below.

CAMAC identified two principal areas of concern relating to the potential liabilities that directors and officers may incur when directing and managing a corporation:

- the tendency of Australian legislation to impose personal criminal sanctions on individuals for corporate breach by reason of their role within the corporation and not their actual acts or omissions, except where available defences can be established; and
- differences in the way in which liability is imposed under the relevant statutes, thereby increasing complexity and decreasing clarity in relation to the compliance burden.

CAMAC's review focused on the liability provisions contained in legislation relating to environmental protection, occupational health and safety, hazardous goods and fair trading laws, although this is not the full complement of legislation that imposes personal liability on directors for the conduct of corporations. CAMAC identified and expressed concern about the marked differences in the way in which the various statutes impose liability on directors and officers personally. A variety of standards and defences apply to different aspects of a corporation's operations in different Australian States and Territories.

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<sup>11</sup> CAMAC is now constituted under the provisions of the *ASIC Act 2001*.

<sup>12</sup> CAMAC Discussion Paper: Corporate Duties Below Board Level (May 2005).

The liability with which CAMAC's review was concerned was not the liability that a director may incur by virtue of their own misconduct or by virtue of being an accessory to misconduct of another. Instead, CAMAC was concerned with legislation that deems an individual director to be responsible for the breach by a corporation of a statutory obligation.

In CAMAC's view, these legislative provisions discriminate unfairly against corporate personnel compared with the way in which other people are treated under the law. Although laws should encourage corporate compliance, CAMAC considers that this does not justify the abrogation of the rights of individuals. Where directors and officers could not reasonably have influenced or prevented particular corporate conduct, CAMAC considers that while this may be rough justice for single directors companies, it does not appropriately reflect the realities and complexities of corporate governance of large corporations.

CAMAC made the following recommendations in its report:

- as a general principle, legislation should not penalise individuals for corporate misconduct except where it can be shown that they have been accessories to that conduct either by personally assisting the misconduct or by being personally aware of the misconduct;
- the way in which organisational fault results in personal liability should be consistent across all corporate and non-corporate organisations – no unique liability should accrue to directors and officers of companies incorporated under the *Corporations Act 2001* that would not accrue to their counterparts in other organisations;
- in order to achieve corporate compliance, there may need to be some particular exceptions to these general rules – for example, a designated officer approach might be appropriate where an individual corporate officer is required to perform specific 'on the spot' operational or administrative tasks on behalf of a company – another option considered by CAMAC is the principle of extended accessorial liability, by which a greater duty of care may be imposed on individual directors and officers in appropriate circumstances but with the availability of the defence that all reasonable steps were taken to prevent the contravening conduct; and
- more consistency is required between the laws of the Commonwealth, States and Territories relating to personal liability, in order to reduce complexity and aid understanding.

To achieve this last recommendation, CAMAC suggests that the Federal Government publish a policy on imposing criminal liability on individuals for corporate fault in Commonwealth legislation. This would achieve consistency at the Commonwealth level. Then, in relation to the States and Territories, CAMAC recommends that an inter-governmental body such as a Ministerial council adopt similar principles and model provisions. CAMAC also recommends the Commonwealth consider an umbrella provision in Commonwealth legislation that covers all personal liability for corporate fault on a generic basis.

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The recent report of the Regulation Taskforce 2006, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burden on Business*, recommended that the Council of Australian Governments seek to achieve more nationally consistent regulation of matters, including the personal liability of directors and officers for corporate fault, after completion of the CAMAC review. The Federal Government responded to that report by stating that it would consider the CAMAC report and make appropriate recommendations to the Ministerial Council for Corporations.<sup>13</sup> Last week, in an address to the Australian Institute of Company Directors, the Parliamentary Secretary to the Treasurer described CAMAC's recommendations as 'useful' and stated that he looked forward to discussing them with his State and Territory counterparts in the near future.

#### 4. Conclusion

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The insurance and liability landscape for directors and officers of Australian corporations is changing. Issues that came to the fore in previous years, such as the advance payment of defence costs, continue to attract close scrutiny from directors and officers and their brokers in the current environment of closely reported investigations and inquiries. At the same time, new areas of potential gaps in cover continue to come to light, so that it is as important as ever for directors to be aware of the extent to which the liabilities they may incur are matched by the indemnities and insurances provided to them. Likewise, companies themselves need to be aware of any indemnities that they have provided to their directors and officers, perhaps unwittingly, which are not backed up by their own corporate reimbursement insurance.

Given the current state of the market, there is an opportunity to do something about the gaps that may be identified. However experience suggests that that opportunity will not last indefinitely and that the cost of filling those gaps will ultimately rise. Legislative reform of the kind that has been recently recommended may provide relief for some individual directors and officers (and their insurers) but the tree of legislative reform can be slow to bear fruit and it is prudent for those awaiting reform to focus their attention in the meantime on recent developments in the personal liability of directors and officers and the scope of their indemnities.

**NOTE:** This document is intended only to provide a general review on matters of concern or interest to readers. The text of this document should not be relied upon as legal advice. Matters differ according to their facts. The law changes. You should seek legal advice on specific fact situations as they arise.

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<sup>13</sup> *Australian Government's Response* (August 2006) to Recommendation 5.28 of the Taskforce on Reducing Regulatory Burdens on Business.