The practicalities of D&O insurance

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- *What are the typical features of D&O policies?*
- *Issues to consider when purchasing D&O insurance*
- *D&O insurance not a substitute for compliance with directors' responsibilities*

Directors' and officers' (D&O) insurance is the insurance payable to the directors and officers of a company to cover damages or defence costs in the event that they are sued unless the director or officer has been indemnified by the company for that loss. Company reimbursement coverage provides for the company to be reimbursed in respect of indemnities it has lawfully provided to its directors and officers.

Insurance and indemnities

To counter the exposure of individual directors and officers, a company's constitution may provide for the corporation to indemnify them. Some might question the need for D&O insurance when an indemnity is available. However, there are restrictions on liabilities indemnified by a corporation. Sections 199A and 199B of the *Corporations Act 2001* govern the granting of indemnities by the company in favour of its directors and officers. A company or a related body corporate must not exempt a person from a liability to the company incurred as an officer (or auditor) of the company. This means that a company cannot release a director from a liability incurred to it as a director. A company is prohibited from granting an indemnity against certain kinds of liability incurred as an officer (or auditor) of a company specifically:

(a) a liability owed to the company itself, or to a related body corporate

(b) a liability owed to someone else, which does not arise out of conduct in good faith and

(c) a liability for a pecuniary penalty under s 1317G of the Corporations Act or a compensation order under ss 1317H and 1317HA of the Corporations Act.

The granting of an indemnity by a company to a director for legal costs and expenses is also prohibited where they cannot be indemnified for the liability in question by the company or there is a finding of liability or guilt on the part of the director or relief from liability is denied. There are also restrictions on the company paying the premium for a policy that insures certain risks — which is why some adopt the policy of asking the directors to pay all or part of the premium.

There may also be practical restrictions on a company's indemnity. An indemnity will be useless if the company is insolvent.

Features of D&O policies

An insurance policy is simply a species of contract and, like all contracts, the terms differ. However, there are some features that are typically found in most D&O policies.

Most D&O policies feature 'claims made' cover and provide insurance in respect of claims made against an insured during the policy period. Section 40(3) of the *Insurance Contracts Act 1984* gives an insured the right to notify circumstances that may give rise to a claim, and if a claim is subsequently made it is deemed to have been made in the policy period. This is an important right, because subsequent policies may exclude claims arising from known circumstances.

'Insured persons' under D&O policies are typically any person who is a past, present or future director, secretary or officer of the company or its subsidiaries. 'Officer' generally includes anyone who is responsible for or involved in important decision-making for the corporation.

A D&O policy will typically provide cover for wrongful acts in the insured's capacity as a director or officer. The 'wrongful acts' covered in D&O policies vary from insurer to insurer and from industry to industry. However, a typical definition includes any actual or alleged breach of duty, the breach of trust, neglect, error, misstatement, misleading statement, omission, breach of warranty or authority or other acts done by any insured person or any liability asserted against them solely because of their status as directors or officers of a company.

Typical exclusions in D&O policies

Most D&O policies include a professional indemnity exclusion which excludes cover for claims alleging the breach of duty other than duties owed by a director in that capacity. Directors who are also professionals will need to insure these obligations under a separate professional indemnity policy.

Most D&O policies also include an insured v insured exclusion which excludes claims bought 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 brought by the company are thus a significant potential source of liability. Many policies contain a carve-out to the exclusion and extend cover to claims bought in the name of the company such as a shareholder derivative action, an action by ASIC (under s 50 of the *Australian Securities and Investments Commission Act 2001*) or an action brought at the instigation of a receiver/administrator or liquidator.

Most D&O policies also include an exclusion for wilful breach of duty, misuse of position and misuse of information by directors and officers.

Issues to consider when purchasing D&O insurance

Advance payment of defence costs

Defence costs can be considerable. Directors should consider if the policy provides for advancement of defence costs in claims where it may be unclear whether the policy will or will not apply. Much will turn on the particular wording of the policy. This was illustrated in the cases of *Wilkie v Gordian Runoff Limited*[1], and *Rich v CGU Insurance Limited; Silbermann v CGU Insurance Limited*[2]. In similar, circumstances the High Court found that Mr Wilkie was entitled to advance payment of his defence costs but Messrs Rich and Silbermann were not. These different results arose primarily because of the different policy wordings in question.

Costs of proceedings before an inquiry

Directors should also be aware of the increasing use of commissions of inquiry by government and the widespread use of the investigative powers of ASIC and APRA which demonstrate the need for D&O insurance to extend cover to legal costs of representation of such inquiries and investigations. Some D&O policies limit costs of representation to circumstances where 'a wrongful act' is alleged against the 'insured person', other policies agree to pay defence costs regardless of whether a wrongful act is alleged. Directors must take care to ensure that their insuring clauses cover other types of inquiries and investigations.

Continuous cover

Most D&O policies traditionally exclude liability for claims that arise out of circumstances known to the insured at the commencement of the policy period. Continuous cover clauses alleviate the effect of this by providing that the insurer will not rely on such exclusions where the insured has been continuously insured, either with the same insurer or sometimes with any insurer, for a specified period of time.

Defamation costs

Directors and officers are increasingly being asked to represent the company publicly and to give interviews with the media. However, sometimes public exposure can result in the director being defamed. A director's reputation is their greatest personal asset but bringing proceedings for defamation can be expensive. The issue arises who should fund those costs. This was considered in *Whitlam v National Roads and Motorists' Association*[3] where Mr Whitlam sought reimbursement from the NRMA in respect of his legal costs of bringing defamation proceedings. The NSW Court of Appeal held that Mr Whitlam was not entitled to indemnity under the relevant deed of indemnity which on its terms was limited to a payment actually made or liable to be made as a matter of legal obligation rather than pursuit costs.

Some D&O policies now provide cover for PR costs and it may be that an insurer might be prepared to provide an extension to a D&O policy to cover the costs of pursuing a claim for defamation.

Directors duties and climate change

A public company must in its annual reports give details of the entity's performance in relation to environmental regulation if the entity's operations are subject to any particular and significant environmental regulation under the law of the Commonwealth or of a state or territory.[4] With respect to listed public companies, the annual report must also contain certain information that members of the company would reasonably require to make an informed assessment of the

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operations of the entity, its financial position and its business strategies and prospects for future financial years.[5] In the context of this section, companies arguably may now be required to provide information about their past, present and future environmental performance to the extent that it is likely to affect their business strategies and future financial prospects.

The *ASX Corporate Governance Council Principles and Recommendations (Second Edition)* provide that a company should establish a sound system of risk oversight and management and internal control. The commentary specifically refers to risks to operational and environmental sustainability.

The increasing awareness and concern of the Australian public and government about climate change have highlighted this issue and the potential effect that it may have on director's liabilities.

Directors should also be aware of the increased reporting obligations introduced as a result of the commencement of the *National Greenhouse and Energy Reporting Act 2007*. The reporting obligations under this Act are expected to be released in July 2008. It is likely the reporting guidelines will impose fines for companies which do not comply with the reporting obligations and possibly fines on CEOs who knew or should have known that the corporation did not comply with the requirements of the Act. The Act sets out the reasonable steps that a CEO should take to prevent a contravention.

The increase in shareholder class actions

Shareholder class actions enable shareholders to aggregate their common claims and to prosecute them as a group, against the company and often also the directors. There have been many recent examples including cases against Multiplex, Telstra, AWB, Healthscope, Aristocrat, Westpoint and Centro.

Typical causes of action in shareholder class actions are for misleading or deceptive conduct and for breach of the company's continuous disclosure obligations. It is important to remember that a defendant can be liable for misleading or deceptive conduct even if the statement is made without negligence and without wrongful intent.

There are two principal factors influencing the recent increase in shareholder class actions — the availability of litigation funding and changing views on shareholder priorities.

In 2006 a majority of the High Court[6] found that there was no rule of public policy against funding agreements that provide money to a party to prosecute proceedings in return for a share of the proceeds of the litigation, or even for a funder to seek out claims which may be aggregated in class action proceedings and to control the funded litigation on behalf of the class.

In relation to shareholder priorities, traditionally it was the view that, in relation to wrongs done to a company, it is the company and not its shareholders who is the proper plaintiff in commencement of proceedings. However, following a decision in 2004[7], shareholders seeking remedies not dependent on their status as shareholders were able to bring actions in their own right.

Then, in January 2007 the High Court[8] ruled that a shareholder was to be treated as a creditor equally with other creditors of an insolvent company, and did not have to wait until those creditors had been paid out.

Insurance risk management

In the first part of this decade, the D&O insurance market contracted and market capacity declined. Insurers provided limited cover and premiums were on the increase.[9] By 2005 the cycle had turned and there is now a 'soft market' meaning that insureds have more opportunity to negotiate premiums and extended coverage under D&O policies. Remember that price isn't everything and it is important that the insurer will be around to pay claims if they arise.

Because of the changes in the insurance market, directors should review (either themselves or with the assistance of the company's insurance adviser) their D&O insurance policies annually to understand the cover provided and ensure it meets their requirements. They should also regularly review their deeds of indemnity from the company.

D&O insurance is only a safety net. It is not a substitute for compliance with a director's responsibilities. Directors should be familiar with their responsibilities and ensure that the company puts in place a compliance program that is regularly tested and reviewed.

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Notes

1 [2005] HCA 17
2 [2005] HCA 16
3 [2007] NSWCA 81
4 s 299(1)(f) Corporations Act
5 s 299A(1) Corporations Act
6 *Campbell's Cash and Carry Pty Ltd v Fostif Pty Ltd* [2006] HCA 41
7 *Johnstone v HIH* [2004] FCA 190
8 *Sons of Gwalia Ltd v Margaretic* [2007] HCA 1
9 CAMAC (2004) *Directors and Officers Insurance Report*