

The right protection

Directors and officers of AFSL licensees need to be able to conduct their duties without worrying about their personal liability. So what protection can companies offer? **JUNE SMITH** explains.

We are seeing an increasing trend to impose personal liability on directors and officers for the shortcomings of companies. This has been coupled with greater responsibilities imposed by the CLERP reforms, and the growing confidence of consumers and other stakeholders in exerting their legal rights.

It is therefore very timely to review the protection your organisation has in place for its directors and officers.

Why all the fuss?

Directors and officers of Australian financial services (AFS) licensees have numerous responsibilities and duties at common law and within relevant legislation. Given the risk that a breach of one of these duties will occur, each director or officer faces the real prospect of incurring personal financial liability.

The Corporations Act alone contains numerous provisions under which directors and officers have a personal liability, including section 180 on care and diligence, section 181 in relation to acting in good faith, and sections 182 and 183 for improper use of position and information.

There are also those sections relating to the provision of financial services under which personal liability can occur, including parts of sections 1041A to 1041S and 1043A(2) relating to market misconduct and other prohibited conduct in financial products and financial services and section 1041H on misleading or deceptive conduct.

These provisions can also lead to general civil liability, pecuniary penalties and compensation orders and, in some instances, criminal liability.

Add to this mix the fact that claims against directors and officers can be brought by a wide range of stakeholders – including creditors, shareholders/members, consumers, liquidators and numerous regulators – and you have a recipe for significant risk.

What protections are available?

There are numerous things to consider including:

- the rights of access and indemnity for directors and officers provided in the Corporations Act;
- the rights in favour of the directors (or officers) contained in the constitution of the company itself;
- their terms of appointment or engagement (which will vary depending on whether the individual is an executive director or non-executive director);
- the terms of any insurance held by the company (which could include directors' and officers' insurance); and
- an agreement (usually in the form of a deed) of access and indemnity with the company (and, if appropriate, with its parent).

Why use a deed of access and indemnity?

It has become common practice in Australia for listed public and large unlisted public or proprietary companies to enter into a deed of access and indemnity with their directors and officers. No two deeds ever seem to be alike, yet they usually have common elements. The first is to provide the individual with access to company documents and records should a claim ever be made against them relating to their office.

The second element is incorporating a right for these individuals to be indemnified in



respect of costs or other expenses or losses incurred as a result of the performance of their role.

The third element that is often included is the right to be covered by directors and officers (D&O) insurance.

It is generally considered that an arrangement containing all three elements has mutual benefits for the directors and officers, as well as the company. A deed usually enhances and clarifies the parties' agreement in respect of these issues, supplementing the protection for directors and officers found at either common law, within the company constitution or the Corporations Act.

Further, companies need the director/officer to exercise his or her duties for the proper benefit of the company without concern for personal liability, if those duties are performed properly and in good faith. Equally, the director/officer wants to avoid the risk of personal liability arising despite the proper performance of duties.

What might need to be negotiated?

Not all companies are prepared to include all three elements in a



deed. Some prefer to limit the obligations under the deed in some way. For example, some companies prefer to restrict access to documents.

Given that common law gives no right of access to a former director at all and the Corporations Act provides for only limited access, including the right of access only for the purpose of court proceedings, it is worth giving some thought to what is in the best interests of the parties involved.

The Corporations Act does not require the company to maintain a complete set of documents, which are readily available if the need for access arises and the statutory right to access only lasts for a limited time. Again, the parties should carefully consider whether the deed will extend these rights

and the obligations this will then impose on the company, for example, in relation to storage and access demands.

Indemnities provided by the company against liability for actions brought by third parties against directors and officers must be done within the confines of the law, which continues to impose some limitations on the extent of indemnity given.

For example, section 199A(1) of the Corporations Act states that a company or a related body corporate must not exempt a person from a liability to the company incurred as an officer.

In addition, section 199A(2) of the Act states that an indemnity will not be available where the liability to the third party does not arise out of conduct

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to carry that insurance from the deed. Alternatively, the deed may carry a clause that gives the company discretion not to obtain the insurance if it reaches the view that the premiums are too high and it would cause a financial burden to the company's operations.

This may be commercially sound from the company's perspective and the individuals may also agree if they believe that the monies would be better spent on the business rather than on insurance premiums.

But it does mean the officers end up running the risk and it may be better for the effective running of the business for the premiums to be paid. The individuals can then undertake their role without concern for personal liability, subject to the matters raised in this article under the heading 'What about other terms'. Without cover they will be left to rely on their contract with the company (usually an executive contract) or rights under the Corporations Act or any indemnities provided under the company constitution.

What to look out for

Organisations should understand exactly which officers they want covered by such a policy. Once this decision is made, you need to check that the policy will in fact cover them. To do this, start with the definitions within the policy of 'director' and 'officer' and 'senior manager'.

A lot of people may not be aware that responsible officers for example, could be deemed to be an officer for the purposes of D&O cover. This is on the basis that the definition of 'officer' under the Corporations Act means a director or secretary of a corporation or a person who is essentially a senior manager.

'Senior manager' is defined as a person who makes or participates in making decisions that affect the whole or a substantial part of the business of the corporation, or has a capacity to affect significantly the corporation's financial standing. Given this describes the role of the responsible officer in relation to the provision of financial services, it is very arguable that these officers will

be covered by a D&O policy without anything else being done.

If the relevant officer is not covered by the policy, you need to determine what type of policy would cover them or you may want to consider having specific individuals named on the D&O policy as insured persons to ensure cover.

What about other terms?

D&O insurance will typically cover any 'loss' arising out of claims made against the insured person as a result of any actual or alleged wrongful act. A wrongful act is generally an act or alleged breach of duty, breach of trust, neglect, error, misstatement, misleading statement, omission or breach of warranty of authority.

However, the types of events that won't be covered by a D&O policy are numerous. For example, sections 199B and 199C of the Act prohibit a company providing D&O insurance in cases of:

- wilful breach of duty;
- misuse of directors' information or position; and
- wilful breach of good faith.

So, remember to read the terms of the policy as:

■ not all risks or liabilities are covered either in the policy terms, or because of their action or inaction and by the operation of law; and

■ in addition to the common exclusions listed above, there may be specific exclusions for other activities that may directly impact on the core business of the AFS licensee.

Protecting your officers

Given the increasing responsibilities placed on directors and officers in today's corporate environment, it seems timely for both companies and officers to review how those officers are protected should they be exposed to a claim arising from the performance of their duties.

Companies need the director/officer to exercise their duties for the proper benefit of the company without concern for personal liability, if those duties are performed properly and in good faith. Equally, the director/officer wants to avoid the risk of personal liability arising despite the proper performance of duties.

Without the added protection that a deed of access and indemnity can provide, they will be left to rely on their contract with the company (usually an executive contract) or rights under the Corporations Act or any indemnities provided under the company constitution, which may not prove adequate.

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in good faith. Further, section 199A(3) prohibits the granting of an indemnity by a company to a director or officer for legal costs and expenses where there is a finding of liability or guilt; or relief from liability is denied.

Individuals will obviously want indemnities to be as wide as possible so that they have access to both an indemnity and insurance cover under a D&O policy. Companies, however, may wish to restrict their indemnity to only apply in so far as the D&O policy doesn't cover the claim. Again, this will need to be the subject of negotiation and consideration, taking into account of all the circumstances.

You will also need to consider whether the deed includes reference to claims made against the person during both

their time with the company and for some time after they have left.

Directors' and officers' insurance

D&O insurance is intended to protect a company and its insured directors and officers from both liability and the associated legal costs and

expenses that result from a wrongful act or omission committed, or allegedly committed, by an insured director or officer as a result of the management of the company's affairs.

Some companies may take the view that D&O insurance premiums are prohibitive given the size of their business and seek to strike the requirement

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