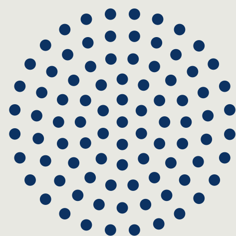


Australian Institute of Company Directors

INDIVIDUAL

D&O insurance for non-executive directors

Directors' and Officers' Liability insurance (D&O insurance) is designed to protect directors and personnel involved in the management of a company from claims arising from decisions and actions taken in performing their duties on behalf of the company. It is fairly typical for D&O insurance cover to group directors and management together,[1] despite differing roles and responsibilities and involvement in day-to-day decision making.

Directors face a broad scope of potential liabilities, including under the *Corporations Act 2001* (Cth) (Corporations Act), the State Associations Incorporation Acts and the *Australian Charities and Not-for-profits Commission Act 2012* (Cth) (ACNC Act); occupational health and safety laws (including industrial manslaughter); employment laws (including anti-discrimination and harassment and defamation); tax (such as unpaid PAYE and GST); consumer protection legislation (such as anti-competitive behaviour); and sector specific regulation. New risks continue to emerge such as cyber, modern slavery and climate change.

It is important that directors have appropriate arrangements in place to mitigate any liabilities and meet any legal costs incurred in defending claims. These arrangements will typically comprise:

- D&O insurance – insuring both the director and the company in respect of that liability; and
- an indemnity granted to the director by the company – for example, by way of a Deed of Indemnity.

Though these arrangements are useful tools for managing risk, there are some risks that directors must accept personally and D&O insurance and deeds of indemnity should be viewed as complementary to other risk management measures. These include being actively committed to adhering to good governance practices and ensuring governance structures are effective and well-executed.

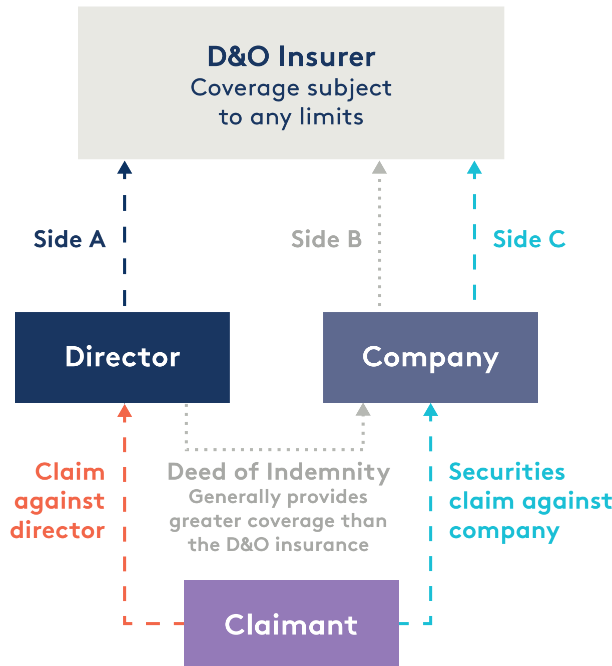
1. This bundling approach (often even labelled as "management liability" in the not-for-profit sector) can lead to a distortion of responsibilities and conflict of interest between directors and management, and emphasises the advantage of an order of payment provision in D&O insurance policy wording.

The interaction between D&O insurance and a Deed of Indemnity

At a high level, a deed of indemnity is an agreement between a company and a company director, where the company indemnifies a director against liabilities or legal costs incurred in their capacity as a director. The deed itself may cover a number of other matters, such as access to documents. At times, the indemnity may be contained in a different document, for example a company's constitution, or board charter or equivalent, or in a parent company's policy document.

There is no requirement for a company to give an indemnity, nor specific requirements for the terms on which any indemnity is given. The existence and scope of the indemnity will vary from company to company. Subject to certain statutory prohibitions, the indemnity granted by a company often contains broader terms than any applicable D&O insurance. As such, generally speaking, it will be a director's first point of reference in addressing potential liability and legal costs if a claim is made against the director. However, because of statutory limits on the scope of an indemnity (see further below), D&O insurance remains important in bridging some of the gaps.

Figure 1: The interaction between D&O insurance and a Deed of Indemnity



For example, if a claimant commences a $2 million claim against a director, the director may claim from either: (1) the company (pursuant to the Deed of Indemnity); or (2) the D&O insurer under Side A. (See further below for D&O insurance Side A, B and C cover)

If the director pursues option 1, the director would make a claim for the entire $2 million from the company, who in turn would make a claim under the Side B cover. The company would be subject to any deductibles and limits of liability under the Side B cover and therefore may not recover the full $2 million, depending on the terms of Side B.

If the director pursues option 2, assuming that the Side A cover had a limit of $1.5 million (but no deductible), there would be a $500,000 shortfall not covered by the D&O insurance policy. The director would then need to make a claim in respect of that shortfall from the company pursuant to the deed of indemnity, and the company would make a claim under Side B (subject to its terms and the remaining available limits).

Subject to differences in exclusions and statutory limits in cover (see further below), it is generally easier for a director to simply claim from the company under the deed of indemnity. However, if the company is unable to indemnify the director (for example, in the event of insolvency), the director has the ability to bring a claim directly against the D&O insurer.

It is important for directors to familiarise themselves with the existence and terms of any indemnification granted by the company, and if necessary seek professional advice.

More information about Deeds of Indemnity can be found in the AICD director tool ***Deed of Indemnity***.[2]

Key issues to consider when reviewing an indemnity

Given the bespoke nature of indemnities, a director should consider the following questions when reviewing an indemnity:

- Does the indemnity apply to claims brought against directors after their term as a director ends (for events occurring during their time as a director)?
- Are there any onerous preconditions on the indemnity / does the indemnity only arise in specific circumstances?
- Are they any express carve outs placed on the indemnity?
- Does the indemnity provide cover for any or all legal costs? Is it limited to only necessary and/or reasonable costs?
- Does the coverage extend to legal costs incurred during a regulatory investigation?
- What is the trigger for the coverage for legal costs? Is a formal claim / notice required or are initial informal queries sufficient?
- Will legal costs be advanced or paid as they are incurred?
- Are there any monetary or temporal limits on the coverage?[3]
- Is the company obliged to maintain suitable cover for retired directors? And if so, for how long?

Statutory prohibitions in relation to indemnities

There are some statutory prohibitions on a company's ability to indemnify a director, including:

- under the Corporations Act, a company cannot indemnify a director for:
  - liability owed to the company (for example, for breaches of directors' duties of care and diligence and acting in good faith in the best interests of the company);
  - liability for pecuniary penalty and compensation orders under various sections of the Corporations Act;
  - liability arising out of conduct not in good faith;
  - defence costs in respect of the above liabilities, as well as criminal proceedings and proceedings brought by ASIC or a liquidator (where a final, non-appealable finding of liability has been made);
- under the *Competition and Consumer Act 2010* (Cth), a company must not indemnify their officers for liabilities for pecuniary penalties for breaches of the restrictive trade practices provisions of that Act and legal costs incurred in defending or resisting proceedings where that liability is established; and
- under the *Work Health and Safety Act* 2011 (NSW) (and equivalents in other states[4]), it is a strict liability offence to enter into a contract of insurance or other indemnity arrangement covering liability for monetary penalties imposed under the legislation.

It is important to be aware of the limits of the scope of the indemnity. D&O insurance can play a critical function in providing coverage in respect of the gaps.

2. A typical deed of indemnity includes insurance clauses that deal with the parties' rights and obligations in relation to D&O insurance, which can include the type and term of insurance cover to be maintained.
3. At times, the indemnity may be contained in a policy document (either at parent or group company level or, more commonly, at government level with government NFPs,) rather than in a contract or company constitution. Where this is the case, an additional consideration is whether the indemnity is actually legally enforceable against the indemnitor.
4. Australian Government, 2021, Work health and safety, business.gov.au, **https://business.gov.au/risk-managment/health-and-safety/work-health-and-safety**, accessed 26 July 2021.

Voting on a deed of indemnity

A director has a general obligation not to vote on matters in which they have a material personal interest. Although voting on deeds of indemnity are not expressly prohibited by the Corporations Act, it is also not expressly permitted. It is not uncommon for directors to vote on a form of deed which will be entered into with each director. Directors should take care, and if necessary seek legal advice, prior to voting on any Deed of Indemnity which relates to them – particularly where it relates solely to them.

What is generally covered by D&O insurance?

D&O insurance is intended to cover liability (including for judgments, settlements and defence costs) for wrongful acts by directors or officers. Policies will generally, but not exclusively, be arranged and purchased by the company with the directors as insureds able to make claims directly under the policy if required.

Policies will typically be renewed on an annual basis and will operate on a 'claims made and notified' basis. That is, the policy will provide coverage for claims made against directors (and notified to insurers) during the annual policy period, even if the act or omission on which the claim is based preceded the annual policy period (with some exceptions – see below).

Where a substantial limit of cover is purchased, it is common for multiple D&O policies to be arranged in layers (sometimes called a "tower"). The first layer is referred to as the primary policy. Once the limit of the primary policy is exhausted, the subsequent responsive policies are referred to as the excess policies, or excess layers. Typically, the terms of the excess policies will closely follow those of the primary policy.

What are the forms of coverage?

D&O insurance typically includes two main forms of cover, colloquially described as 'sides'. These sides of cover are capable of being purchased together or separately:

- **Side A cover** – provides cover directly to an insured director or officer in relation to liabilities incurred by them personally by reason of their role as a director or officer (including defence costs, damages or compensation awarded against the director or officer, interest or costs awarded against the director or officer). This cover is important where a director or officer is not indemnified by the company. This cover becomes critical if, notwithstanding a deed of indemnity, the company indemnitor is unable to meet its indemnity obligation (for example, due to insolvency).
- **Side B cover** – provides cover to the company for money spent in indemnifying directors or officers covered by a deed of indemnity.

In addition, many ASX-listed entities also purchase **Side C cover**, which provides cover to the company for liability for a "securities claim" (such as a shareholder class action).[5]

It is common for the limits of the Side A, B and C cover to be shared, at least to some extent. For example, the primary policy of, say, $20 million, may respond to claims against directors (Side A/B) and the company (Side C). This means that losses of the company, will reduce the limit subsequently available to the directors. Frequently, there are dedicated limits for Side A or Side A/B cover to ensure that there will always be some available limit in respect of claims against directors.

The policy may also contain specific extensions of coverage, for example express coverage for civil fines and penalties or occupational health and safety liability.

If a deed of indemnity exists, it is typically intended that the company would indemnify the director pursuant to the deed of indemnity, and the company would then bring a claim for reimbursement under the Side B cover. If the company does not indemnify the director, the director has the ability to claim under the Side A cover. Side A will generally be subject to either a small or no deductible (i.e. the amount the insured has to pay before the cover comes into effect), whereas Side B will have a more significant deductible. In other words, the director is protected but the company bears some financial risk in relation to any claim where it is permitted to indemnify the director.

5. The reason for including Side C as part of D&O insurance (despite it being a cover which benefits only the company) is largely practical and commercial. Historically, securities claims would name both the company and directors. The directors and companies would often appoint the same lawyers. Prior to the inclusion of Side C cover, this created an expensive process of allocating costs between those covered, and not covered, by the policy. As a result, the insurance market began offering optional Side C coverage in addition to Sides A and B.

Who is covered by D&O insurance?

For Sides B and C, the insured (who would receive the payment from the insurer) is the company.

For Side A, the definition of "insured" (or similar term) in the policy determines the persons covered by the insurance. The term "insured" could be defined to include executive directors, non-executive directors, the company secretary, executive officers and employees involved in the management of a company. If the definition of "insured" is broad, directors could consider the cost/benefit of procuring differential coverage for directors and management, including negotiating provisions dealing with the order of payment.

At a minimum, a Side A policy would generally cover directors and officers of the company (including shadow and de facto directors). These roles may be specifically defined in the policy or defined by reference to the Corporations Act.

It is also common for optional cover to exist for 'outside directors' (or similarly termed individuals). Essentially, this is coverage for persons who are directors of a non-insured entity where, for whatever reason, the insured company requests the individual serve as a director (or otherwise consents to that appointment). This may occur in relation to an entity where the company has a significant (but not controlling) interest – for example, a joint venture company.

When considering the coverage provided by the D&O insurance policy, directors should be mindful of the scope of who is insured and how much coverage is provided. For example, if the class of persons covered is broad, then the monetary limits of the coverage may need to be shared across a greater number of persons and an order of payment clause may need to be included so that the allocation of the available coverage limit is pre-determined.

What key terms should directors consider when reviewing the policy?

There is typically an insuring clause under the Sides A and B cover, which provides cover in respect of 'Claims' for 'Loss' made in the 'Policy Period' arising from a 'Wrongful Act' by the 'Director' or 'Officer'.

The specific defined terms may vary, but generally the scope of cover will be determined by reference to these concepts. It is important for directors to closely review both the insuring clause and the definitions of the terms used in that clause to understand the scope of cover provided by the policy.

Directors may wish to carefully consider the following matters when reviewing the policy (many of which may be addressed in the defined terms noted above):

- What is the scope of a 'Wrongful Act'?
- Are 'Claims' limited to only formal written demands? The broader the definition of claim the better, as it results in cover for legal costs being triggered earlier.
- Is coverage provided for regulatory investigations, inquests and commissions? And if so, what level of formality is required to trigger cover for legal costs?
- Will legal costs be advanced, paid as they are incurred, or deferred until resolution or determination of the claim?
- Are there limits to the incurring of legal costs? Must the insurer consent to any legal costs being incurred? Are all legal costs incurred or only 'reasonable' legal costs? And do insurers have a panel of lawyers they have pre-approved?
- What excesses or deductibles apply to claims?
- What limits of liability apply to claims?

What is not covered by D&O insurance?

Directors should closely review the exclusions that apply to the scope of cover.

Each insurer will tend to have different standard exclusions, and each policy may be subject to specific exclusions. Policies in the Australian D&O market commonly exclude claims:

- by 'Major Shareholders' – that is, those with a stated percentage of shareholding or control over the board;
- arising from circumstances known prior to the policy period – though as noted below, D&O policies often contain continuity clauses alleviating this exclusion where the same insurer was on risk at the time the policyholder became aware of the circumstances;
- arising from fraud, dishonesty or wilful default; and
- arising from insolvency[6].

There may be statutory prohibitions on certain risks being insured. For example, under the Corporations Act, a company cannot pay a premium to purchase insurance for conduct involving a wilful breach of a duty in relation to a company.

What further specific issues should be checked?

Directors should consider the risk profile of their specific company when reviewing the D&O insurance policy. For example, if a director is on the board of company that has significant exposure to environmental risks, then consider whether the policy provides sufficient coverage in respect of environmental risks.

Some further issues for directors to consider include:

- whether claims relating to employment practices (such as discrimination, underpayment of wages) are covered;
- whether there is coverage for capital raisings;
- whether there is coverage for fines and penalties;
- whether there is coverage for environmental damage;
- how the policy treats retired directors – that is, if a claim is brought against a director after they resign;
- whether there is an order of payment regime specifying that directors are paid in priority over reimbursing the company;
- whether directors can object to settlements of third-party claims being proposed by insurers; and
- whether there is a non-imputation clause – that is, is the coverage for one director prejudiced by the knowledge or actions of another director.

Note that, for insurance contracts entered into after 5 April 2021, the unfair contract terms (UCT) regime applies to certain standard form insurance contracts for consumer and small business insureds. It may be possible your D&O insurance policy falls with the scope of the UCT regime and, if so, may provide an avenue for challenging "unfair" terms.

6. Directors should be alert to this type of exclusion and, subject to cost/benefit assessment, be clear on when the exclusion is triggered: that is, that the exclusion applies to actions done while insolvent/liabilities arising from insolvency as opposed to applying simply because the company is insolvent. In the event of the latter, directors should be prepared to challenge it, as it disregards the central purpose of Side A cover (which is to indemnify the director or officer when the company can't indemnify them).

What is the process for obtaining D&O insurance?

D&O insurance is obtained through a commercial insurance broker, acting as the agent of the company.[7] The broker acts for the company in obtaining quotations from insurers and negotiating terms of the D&O policies, including price. Once the broker has received instructions, it will 'place' the policies and obtain final policy documents form the insurers.

Responsibility for procuring D&O insurance varies from company to company. Procurement may be conducted by the CFO or company secretary, a specific risk and insurance function, the audit and risk committee or another sub-committee of the board. In some circumstances, D&O insurance options may be considered by the full board.

As part of the insurance procurement process, the company (and the directors) have a statutory duty to disclose material information which may affect the insurer's decision (including in relation to the amount of premium to be charged). This information is usually obtained through a 'proposal form' (essentially a questionnaire) and the company should have an internal process for gathering potentially relevant information (particularly in relation to actual or potential claims). The company may also be required to present to the insurers on the company's risk profile.

Once this information has been provided, the broker will obtain quotations from insurers, with different options around aspects, such as limits, deductibles, terms and pricing and present these to the company. Once the company has determined its preferred option, it provides instructions to the broker who will finalise the placement of the policies and provide the final policy wording.

In addition, prior to a board procuring or renewing D&O insurance cover, directors should test the responsiveness of the intended policy terms against some scenarios around potential claims.

Voting on the purchase of D&O insurance

Directors are permitted to participate in and vote on decisions about D&O insurance, notwithstanding the personal interest that they have in the decision. This is expressly recognised in the Corporations Act (sections 195(1A) and 191(2)(a)(vi)) and may also be addressed in the company's constitution.

What happens if a notification and/or a claim needs to be made?

If you have not already done so, you should obtain a copy of both the deed of indemnity and the D&O insurance policy (or a detailed summary).

There are generally two broad types of events notifiable under a 'claims made' D&O insurance policy:

- a claim (as defined under the policy, which may include an investigation, or some pre-claim step); and
- a factual circumstance which might result in a claim – the factual circumstance has to raise a real possibility (but not a probability) that a claim may be made.

Some, but not all, policies have a specific contractual right to notify factual circumstances. If not, there is a statutory right to notify such circumstances. Notifying circumstances once you become aware of them is important because it means that subsequent claims arising from those circumstances will be deemed to be claims made during the policy period you notify in and will be covered (even if the claims arise after the policy period has expired). If they are not notified, there is a risk that cover will not be provided under a subsequent policy when the claim occurs.

You would generally seek indemnity from the company in the first instance pursuant to any deed of indemnity, as the terms of the indemnity are generally broader. The company would then progress a reimbursement claim against the insurer. The company will also usually make a notification under the D&O insurance policy, but it is prudent for you to confirm that this has occurred. You may be required to notify insurers under a deed of indemnity in any event.

7. There is an inherent tension between the interests of the company and the interests of the directors when procuring D&O insurance cover. This is why some boards of larger companies have separate insurance brokers, respectively advising them on D&O insurance and insurance for the company (including management).

If you need to make a claim against the insurer, there are a number of matters to bear in mind:

- You should closely consider what is required under your policy before coverage is triggered – that is, is a formal or written claim required or is knowledge of circumstances sufficient?
- You should notify the insurer of the claim or circumstances as soon as reasonably possible.
- You should consider whether and in what circumstances you are able to appoint your own lawyer.
- Similarly, you should consider what limits apply to the recovery of legal costs – for example, if costs are limited to 'reasonable' legal costs, insurers may insist that only the heavily discounted rates of their panel firms are reasonable.
- Be mindful of your obligations to co-operate with the insurer.

All of these are matters on which you can seek legal advice.

What happens once a claim is made?

Subject to the terms of the policy, most D&O policies provide that it is the duty of the insured to defend any claims. Typically, insurers retain a right to be associated with, or involved in, the claim. Effectively, this means insurers have the right to be kept up to date and be consulted on decisions.

You should pay close attention to the obligations of the insurers in advancing defence costs. Defending claims can be a very protracted process, extending over many months or even years. If the policy does not allow for defence costs to be advanced, you may be left in the interim with the task of having to fund these costs from your own resources.

Also, for example, the costs incurred in updating and consulting insurers may not be covered by the D&O insurance policy (although you may be reimbursed for such costs under an indemnity and the company may be able to seek reimbursement from the insurers under Side B).

You should also pay close attention to your obligations in relation to settlements and admissions. Most D&O insurance policies require an insured to seek the insurer's consent prior to settling a claim or making any admissions. Some policies may contain clauses which limit coverage to the amount of a reasonable settlement offer received but rejected by the insured.

As noted above, D&O policies impose obligations on insureds in relation to the defence of claims. Breach of those obligations may allow the insurer to reduce the amount it has to indemnify you for the claim. However, if delays by the insurer in providing input or consent are prejudicing your defence of the claim made by a third party, you should consider clearly communicating the prejudice you are suffering by reason of their delay and the steps you consider should be taken to protect your interests in the underlying claim. This can assist in resisting a later attempt by the insurer to reduce the amount of its indemnity under the D&O policy.

The Australian D&O insurance landscape

At the time of publication, the Australian D&O insurance market has been hardening for a number of years, resulting in increased costs in purchasing D&O insurance, increased retention limits and decreasing availability of providers offering D&O insurance.

Insurers point to securities class actions as the key driver behind the hardening of the D&O market. Until recently, insurers had not adequately priced the risk of securities class actions given the active litigation funding industry and Australia's strict liability disclosure laws.

Long-awaited reforms to continuous disclosure laws

On 9 August 2021, the Treasury Laws Amendment (2021 Measures No. 1) Bill 2021 was passed by Parliament, which includes the permanent re-introduction of a fault element in continuous disclosure laws. The amendments take effect from 14 August 2021, and will be subject to an independent review in two years' time (if this is not complied with, the continuous disclosure amendments will cease to have effect).

Listed entities will still need to comply with its continuous disclosure obligations under Listing Rule 3.1. However, under the reforms, corporations and their officers will only be liable for breaches of continuous disclosure laws where material information is negligently, recklessly or intentionally withheld from the market.

The negative impact of securities class actions has been widely felt, particularly on the cost and availability of directors and officers insurance. Key insurance players have highlighted the Government's reforms as a positive step towards rebalancing skyrocketing insurance premiums.

A complicating factor in assessing the cost of each type of cover is that the impact of the higher risk and cost of Side C actions has flowed through to Side A and B cover, including for non-listed entities. There is now only a relatively limited discount for only taking Side A and B cover. The single pool of insurance capital means that the losses attributable to Side C claims (brought only against listed companies) are effectively borne more broadly than that sector.

Indicators of a hardening D&O insurance market in Australia include:

- Increased premiums charged to companies – in particular, ASX-listed companies have seen the largest increases with some companies facing premium increases in the order of 400-500 percent.
- Increased retention limits (or deductibles/ excesses) – for large ASX-listed entities with Side C coverage, excesses are increasing to between $10m to $50m. Increases to Side A and B retentions (albeit at more modest levels) have also been observed.
- Unavailability of Side C cover – insurers have been increasingly unwilling to provide Side C coverage, or would only do so at higher limits.

In brief, it is increasingly difficult for companies and directors to obtain D&O Insurance for the price and on the terms they obtained in the past.

Further, COVID-19 has had both a direct and indirect impact on the D&O insurance market. D&O insurers perceive that COVID-19 and its impact on their insured's businesses has increased the D&O risk of those insureds (albeit that there has been some legislative relief from this aspect). In addition, many insurers who have been impacted by COVID-19 claims will be looking to increase revenue in other areas of the business, including D&O insurance.

About the authors

Christine Tran is an experienced commercial litigator, with specialist expertise in defending class actions, particularly securities claims. Regularly advising ASX 200 and multinational companies on managing class action risks, she has acted in several of the most high-profile class actions in Australia and has trial experience in both shareholder and product liability class actions.

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