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Emilios Kyrou

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Abstract
In the last twenty years as a result of increased liability on directors the focus has been on director protection devices. These include indemnities and insurance where Australia has been influenced to some extent by US, Canadian and New Zealand law and practice. The detailed comparison has been carried out elsewhere and this paper concentrates on the resulting Australian law and the corporate governance dangers which lurk behind the emerging practice.

Keywords
corporate governance, deeds of indemnity, access, insurance, liability of directors

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DEEDS OF INDEMNITY, ACCESS AND INSURANCE - THE LURKING CORPORATE GOVERNANCE DANGERS

*Emilios Kyrou**

Introduction

In the last twenty years as a result of increased liability on directors the focus has been on director protection devices. These include indemnities and insurance where Australia has been influenced to some extent by US, Canadian and New Zealand law and practice. The detailed comparison has been carried out elsewhere and this paper concentrates on the resulting Australian law and the corporate governance dangers which lurk behind the emerging practice.[1]

The two key propositions I will be advocating in this paper are:

(a) the greater the success directors have in forcing their company to agree to generous benefits under a deed of indemnity, access and insurance, the more they run the risk of not being able to enjoy those benefits; and

(b) the dramatic changes to the corporate governance and insurance environment since 1 July 2001 necessitate a close review of any deed of indemnity, access and insurance that was executed before that time.

In the current situation where many directors are perceived to have pursued self-interest over the interests of their companies, directors are better off agreeing to a deed of indemnity, access and insurance that strikes a fair balance between the interests of directors and the interests of their company, rather than forcing the company to make unreasonable concessions. Restraint and moderation are necessary because success in negotiating a completely one-sided deed will become a pyrrhic victory if a court grants an injunction preventing any payments being made under the deed.

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* Partner, Mallesons Stephen Jaques. Presented at the LexisNexis Corporate Governance Summit in Sydney on 28 October 2002.

1 For detailed comparison see S. Ansell, 'Directors' and Officers' Liability Insurance – Recent Reforms and Developments in Australia and New Zealand (1995) 23 ABLR 164; American Law Institute, *Principles of Corporate Governance* (1994), Vol 2, Chap 3 Indemnification and Insurance; Ontario Business Corporations Act, section136.

I will develop these themes using the following headings:

- Historical development of deeds.
- Conflict of interest by directors.
- Dangers of uncapped and permanent indemnities.
- Inconsistency between deed and constitution.
- Shareholder approval.
- Unfavourable environment for judicial scrutiny.
- D&O insurance as a risk transfer device.
- Access rights.
- Insurance obligations.
- Payment of premium.
- Ideal deed and ideal way of negotiating it.
- Conclusion.

In dealing with the above issues, I will adopt a practical rather than a legalistic approach.

Historical Development of Deeds

Deeds of indemnity became popular after the amendment to section 241 of the *Corporations Law* on 15 April 1994 which expanded the power of companies to indemnify officers. Prior to this amendment, companies could only indemnify officers for legal costs where the officers were successful in court proceedings. The *AWA*[2] case, which was decided in 1995, caused alarm amongst some directors about potential personal liability for negligence and this spurred greater use of deeds of indemnity.

Deeds of access became popular in 1996 after the *Barrett*[3] and *Kriewaldt*[4] cases. The first case confirmed that a director does not have a right of access to company documents once they cease being a director and held that a company could assert legal professional privilege in a document and thus deprive a former director of access to it even if it would assist the former director to defend themselves in litigation over a transaction which is the subject of the legal advice. The second case decided that it is lawful for a company to undertake to give former directors access to company documents.

Initially, deeds of indemnity and deeds of access tended to be separate documents. Gradually, rights of indemnity and rights of access were combined in one deed.

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2 *Daniels v Anderson* (1995) 37 NSWLR 438.
3 *South Australia v Barrett* (1995) 64 SASR 73.
4 *Kriewaldt v Independent Directors Ltd* (1996) 14 ACLC 73.

Prior to 1994, section 241 of the *Corporations Law* prohibited companies from paying the premium for insurance policies covering directors. Section 241A was inserted on 15 April 1994 to permit companies to pay the premium except for cover for certain liabilities. This amendment and concerns arising from the *AWA* case resulted in greater reliance on directors' and officers' ("D&O") insurance as a means of protecting directors. Once the "claims made" nature of D&O insurance was understood, directors realised that they could be exposed unless they continued to have D&O cover for at least six years after they ceased to hold office to deal with any claims that might be made within the statute of limitations period for acts or omissions occurring while the director held office. The mechanism adopted to ensure the continuation of D&O insurance was the insertion of an obligation in a deed of indemnity or a deed of access requiring the company to maintain D&O insurance while the director held office and for seven years after the director ceased holding office.

In time, all three rights, the right of indemnity, the right of access and the right to be covered by D&O insurance, were consolidated into one deed of indemnity, access and insurance.

The use of these deeds became widespread in the late 1990s. It is now almost standard practice for a person invited to join the board of a public company to insist on a deed being signed before accepting the appointment.

Over the years, directors have sought to maximise the benefits available to them under these deeds. Given that the contents of the deeds have been determined largely by the directors themselves, some forms of these deeds have become completely one-sided.

Conflict of Interest by Directors

In my opinion, deeds of indemnity, access and insurance represent a classic conflict of interest scenario for directors. This is because it is in a director's interest to maximise the benefits to the director under such a deed, whereas it is in the company's interest to limit the exposure of the company's assets to liabilities under the deed.

That is not to say that it is not in the company's interest to enter a deed of indemnity, access and insurance. It is generally accepted now that in order to attract and retain skilled and experienced individuals on the boards of companies, it is necessary for those companies to offer protection to directors in the form of a deed of indemnity, access and insurance. The most significant conflict of interest arises not on the threshold issue of whether a deed should be executed, but in relation to the contents of the deed.

It is beyond doubt that a director who is a party to a deed of indemnity, access and insurance has a material personal interest in the deed. Until 13 March 2000, it was clear that a director of a public company had to declare their interest in such a deed and exclude themselves from any deliberation or decision relating to the deed, pursuant to section 232A of the *Corporations Law*. For reasons which are not entirely clear, the amendments that were made to the *Corporations Law* on 13 March 2000 replaced section 232A with sections 191 and 195, which arguably have the effect that such a deed need not be disclosed by a director and the director need not excuse themselves from decision-making in relation to the deed.

The relevant provision is section 191(2)(a) which states that a director need not give notice of an interest which:

(vi) relates to a contract that insures, or would insure, the director against liabilities the director incurs as an officer of the company …; or

(vii) relates to any payment by the company or a related body corporate in respect of an indemnity permitted under section 199A or any contract relating to such an indemnity.

While the effect of this provision has not been the subject of a judicial interpretation, and it lends itself to competing interpretations, the prevailing view appears to be that section 191(2)(a) takes deeds of indemnity, access and insurance outside the disclosure provisions of section 191(1) and the disqualification provisions of section 195.

Prior to the 13 March 2000 amendments, directors were often not able to form a quorum when a multi party deed of indemnity, access and insurance was being considered by the board, and this required the company to obtain a dispensation from ASIC under the then section 232B (which is now section 196) or shareholder approval, for execution of the deed. On the prevailing view of section 191(2)(a), neither step is now required.

Notwithstanding this, because of the obvious conflict of interest, it is my view that a director who is a party to a deed of indemnity, access and insurance should abstain from any decision-making in relation to that deed. This is because directors continue to be subject to their general duties to the company in relation to the deed, such as the duty of care and diligence (section 180 of the *Corporations Act*), the duty to act in good faith and in the best interests of the company (section 181 of the *Corporations Act*) and the duty not to improperly use their position (section 182 of the *Corporations Act*).

In the recent *Adler*[5] case, it was held that causing a company to enter into an agreement which confers unreasonable personal benefits on a director is in breach of sections 180, 181 and 182 of the *Corporations Act*.

Furthermore, the business judgment rule would not apply to a director who participated in a decision relating to a deed of indemnity, access and insurance of which the director is a party, because one of the requirements of the business judgment rule is that the director does not have a material personal interest in the relevant decision (section 180(2)(b)).[6]

Dangers of Uncapped and Permanent Indemnities

Most deeds of indemnity, access and insurance provide rights of indemnity which are commensurate with the maximum indemnities permitted by section 199A of the *Corporations Act*. This means that under such a deed, a director is indemnified in respect of all liabilities incurred in the capacity of a director, other than:

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

(b) a liability for a pecuniary penalty order or a compensation order made under sections 1317G and 1317H, respectively; and

(c) a liability to a third party that did not arise out of conduct in good faith.

Such a deed also provides indemnity for all legal costs incurred in the capacity of a director, other than costs incurred:

(a) in defending proceedings in which the director is found to have a liability for which they cannot be indemnified;

(b) in defending criminal proceedings in which they are found guilty;

(c) in defending proceedings brought by ASIC or a liquidator where the grounds for an order in favour of ASIC or the liquidator are established;

(d) in connection with proceedings for relief in favour of the director, where the relief is refused.

Where a deed of indemnity, access and insurance simply replicates the provisions of section 199A, it is said that the company is indemnifying the director to the

5 *Australian Securities and Investments Commission v Adler* (2002) 41 ACSR 72, 185.

6 The business judgment rule is only a defence to a breach of section 180 and does not apply to a breach of any other provisions of the Corporations Act.

maximum extent permitted by law. What is often overlooked in relation to such an indemnity is that the indemnity is not limited to particular types of causes of action and there is no monetary cap on the company's exposure. By entering into such a deed, the company is undertaking contingent liabilities of unknown amounts which may arise in unknown circumstances.

Further, many deeds do not reserve a right in the company to revoke the indemnity or to amend it without the director's consent. They are thus permanent obligations which will bind the company irrespective of changes in its circumstances. They impose financial obligations which the company may not be able to afford in the future. The key question, to which I will return, is whether such an indemnity is reasonable and in the best interests of the company as distinct from the best interests of the director.

Inconsistency Between Deed and Constitution

As indemnities and payment of a premium on behalf of a director involve a financial benefit for the director, they must be authorised by the company's constitution or be approved by shareholders in general meeting, as well as comply with any applicable law. It is usual for constitutions to contain a provision indemnifying directors. This provision is enforceable by the director because the constitution is deemed to be a contract between the company and the director pursuant to section 140 of the *Corporations Act*.

Notwithstanding that constitutions provide an indemnity, it is common for deeds of indemnity, access and insurance to be signed. The key reason for this is that the indemnity provision in the constitution may not be enforceable once a director ceases to hold office. The deed thus protects former directors, as well as current directors, from adverse changes to the constitution.

It is thus not unusual for directors to have the benefit of an indemnity both in the constitution and in a deed. As both the constitution and the deed constitute a contract, it is vital that there not be any inconsistency between the two contracts.

Unfortunately, the constitution and the deed are sometimes inconsistent. Sometimes the constitution is more generous than the deed and sometimes the reverse is true. Either way, serious legal and governance issues arise. If the constitution is wider than the deed, complex issues arise as to which contract applies. It is likely that the director will seek to enforce only the constitution, thus negating any restrictions in the deed. On the other hand, if the deed is wider, the constitution will probably prevail to the extent of any inconsistency with the deed.

From a governance perspective, it is clearly undesirable that there be two inconsistent contracts conferring benefits on directors. A good way of avoiding the difficulties is for the constitution to authorise the company to enter into a contract indemnifying directors, rather than granting an indemnity itself. The deed could then be the sole contract providing an indemnity, consistent with the authority granted by the constitution. In this way, the constitution and the deed are complementary and the deed will be the operative document.

Shareholder Approval

As discussed already, due to sections 191 and 195 of the *Corporations Act*, inability by directors to form a quorum is no longer a common reason for seeking shareholder approval for a deed of indemnity, access and insurance. Nevertheless, because these deeds involve related party benefits, shareholder approval is required for public companies under Part 2E.1 of the *Corporations Act* unless an exemption in that Part applies.

The most relevant exemption is section 212(1) which provides that shareholder approval is not needed to give a financial benefit if:

(a) the benefit is either an indemnity or insurance premium in respect of a liability incurred as an officer of the public company, or an agreement to give an indemnity or to pay an insurance premium of that kind; and

(b) to give the benefit would be reasonable in the circumstances of the public company giving the benefit.

The key consideration, in determining whether shareholder approval is necessary, is whether the giving of the indemnity or payment of the premium on behalf of a director "would be reasonable in the circumstances of the public company".[7]

Section 212(3) provides that in working out whether giving the benefit in the form of a deed would be reasonable in the circumstances, an assessment must be made on the basis of the circumstances existing at the time the deed is made. In the absence of shareholder approval, the decision as to whether the entering into of a deed of indemnity, access and insurance would be reasonable in the circumstances of the company, is made by the directors. The requirement of reasonableness involves an objective test. This means that the mere fact that directors subjectively believe the entering into a deed is reasonable is not sufficient. Their belief must be supported by objective facts.

7 Section 212(2) imposes a similar requirement in relation to a benefit constituted by "the making of, or an agreement to make, a payment (whether by way of advance, loan or otherwise) in respect of legal costs incurred by the officer in defending an action for a liability incurred as an officer of the public company".

The effect of section 212 is that the contents of the deed of indemnity, access and insurance must be reasonable insofar as they relate to indemnity and payment of insurance premiums by the company. In a situation where a director asserts their authority and insists on a deed which confers maximum benefits to the director without any obligations (such as immediately reporting claims, complying with the company's reasonable directions and not making admissions) on the director's part, and the other directors simply give in to the director's demands, a court may ultimately hold that the entering into of the deed was not reasonable in the circumstances of the company, which means that shareholder approval was required. If shareholder approval was not given, the consequences are:

(a) the directors may be liable to a civil penalty (section 209(2)); and

(b) the court may make an order prohibiting any payments being made under the deed (section 1324).

While shareholder approval is not a general legal requirement, it is usually a prudent step to take. In order for shareholder approval to be meaningful, however, an adequate explanation of the effect of the deed must be provided to the shareholders.

If one looks at past notices of shareholder meetings seeking approval of a deed of indemnity, access and insurance which were used by public companies, one will find that in many cases, the information in the notice was very brief and very general and did not enable shareholders to gain a proper understanding of the risks for the company in entering into such a deed. In many cases, the information amounted to no more than saying that a deed of indemnity, access and insurance is being entered into to bring the company in line with the current provisions of the corporations legislation and prevailing market practice.

Given the inherent conflict of interest involved in a deed of indemnity, access and insurance and the dangers for the company associated with uncapped, widely worded and permanent indemnities, this type of disclosure would clearly not meet proper standards of shareholder disclosure or proper principles of corporate governance.

Unfavourable Environment for Judicial Scrutiny

Although deeds of indemnity, access and insurance have been part of the corporate landscape since the mid 1990s, they have not yet been the subject of any judicial scrutiny. The current environment of high profile corporate collapses and high profile directors being fined and disqualified from being a director, lends itself to a dispute over entitlements under such a deed coming before the courts.

From the point of view of upholding the efficacy of these deeds, now is the worst time for the courts to be looking at the deeds, as judges are likely to be influenced, at least indirectly, by community outrage over the excesses of some directors. Further, if the dispute over entitlements under a deed involves a director who has been the subject of adverse findings in previous court proceedings which have resulted in the director being fined and disqualified from being a director, the judge hearing the dispute is unlikely to be sympathetic to the position of that director.

The simple point I am making is that a deed of indemnity, access and insurance is more likely to survive close judicial scrutiny if a case involves a reputable director acting in good faith, rather than a director who has been adjudged as breaching their duties and as warranting disqualification from being a director of a company for a period of years. Unfortunately, it is more likely that the first cases about these deeds will involve directors in the latter category.

D&O Insurance as a Risk Transfer Device

A factor which would count in favour of the reasonableness of a deed of indemnity, access and insurance is the existence of substantial D&O insurance. As I have mentioned earlier, typical deeds of indemnity, access and insurance involve uncapped and permanent contingent liabilities which have the potential to place the company's assets at risk. If the company has substantial D&O insurance which would enable it to seek reimbursement from the insurer for any liabilities that are the subject of the indemnity, then there is an effective risk transfer to the insurer which would assist in establishing the reasonableness of the deed.

In an ideal world, there would be a close correlation between the liabilities that are the subject of the indemnity and the liabilities that are the subject of D&O insurance. In practice, it is impossible to have a direct match between a deed of indemnity and a D&O policy. For one thing, there is always a cap on cover available under any insurance policy. All insurers also have standard exclusions which are more extensive than the restrictions on indemnity in section 199A of the *Corporations Act*.

Furthermore, it is not possible to obtain a permanent D&O policy. D&O policies are usually written on an annual basis. Although it is sometimes possible to purchase a longer term policy, it is unlikely that the term will exceed three years. As we will see shortly, there is no guarantee that once a policy expires, the insurer would be prepared to renew it on exactly the same terms. It is therefore not possible to match perfectly the company's exposure under a deed of indemnity with cover available under a D&O policy.

Nevertheless, the scope of D&O cover available to a company should always be taken into account when the company is asked to sign a deed of indemnity, access and insurance. The closer the cover under the D&O policy is to the company's exposure under the indemnity provisions of the deed, the more likely it is that the deed will be held to be reasonable.

Access Rights

Since 13 March 2000, directors have had a statutory right of access to company documents by virtue of section 198F of the *Corporations Act*. This section, in conjunction with section 290, confers a right of access on directors during the time they hold office and for seven years after they cease to hold office. The statutory right of access in favour of former directors only applies for the purposes of actual or anticipated legal proceedings involving the director.

Some commentators have argued that in light of section 198F, it is no longer necessary to have access rights in a deed of indemnity, access and insurance. My own view is that it is still useful to deal with access rights in such a deed, as the statutory right of access is limited to one specific purpose. A former director may require company documents for other legitimate purposes, such as appearing before a Royal Commission or an ASIC investigation, and responding to an audit by the Australian Taxation Office.

Furthermore, section 198F does not impose an obligation on the company to keep company documents in any particular form or require that the documents be readily available. A deed can contain sensible machinery provisions to facilitate the right of access.

The actual practice of many companies has been to ignore the existence of section 198F and to set out the usual elaborate access rights and restrictions in a deed of indemnity, access and insurance. While it is possible for such a deed to confer access rights which are wider than section 198F (see section 198F(5)), any restrictions which are inconsistent with the section would be void.[8]

In my view, the most troublesome issue regarding the statutory right of access is the question of whether it extends to documents which are the subject of legal professional privilege. Having regard to the fact that the wide and unqualified language of section 198F does not distinguish between privileged and non-privileged documents, it may be argued that the statutory right of access extends to privileged documents.

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8 If the company refuses to comply with section 198F, a court order may be obtained under section 1303.

On the other hand, as the right to claim legal professional privilege is a fundamental common law right which Parliament is presumed not to abrogate unless it does so by express words or by necessary implication, it may be argued that section 198F does not expressly or impliedly abrogate a company's right to claim privilege, including against a former director.

This issue is very important in that if section 198F does not extend to privileged documents and a company provides privileged documents to a former director on the erroneous basis that section 198F does extend to privileged documents, the result may be a waiver of the privilege, which could cause prejudice to the company.

On 18 June 2002, the High Court heard an appeal in the case of *Daniels Corporation International Pty Ltd v Australian Competition and Consumer Commission*. This case dealt with abrogation of privilege in the context of section 155 of the *Trade Practices Act*. My expectation is that the High Court will decide that in order for privilege to be abrogated, very clear words must be used. If I am right, the result is likely to be that section 198F does not extend to privileged documents, as it does not use clear words to indicate that privilege is abrogated as between a company and a current or former director.[9]

Until this position is clarified, careful wording is required to minimise the risk that disclosure of a privileged document to a former director may result in privilege being waived.

Insurance Obligations

The insurance provisions in a deed of indemnity, access and insurance tend to be relatively brief. In essence, they require the company to maintain D&O insurance for the director during the time that the director holds office and for seven years after the director ceases to hold office. This is often referred to as the "Access Period". The provisions also oblige the company to pay the premium for the policy, to do everything necessary to maintain the policy and to provide a copy of the policy and evidence of payment of the premium at the request of the director.

As with indemnities, payment of a premium by the company on behalf of a director constitutes a financial benefit and must be either authorised by the company's constitution or be approved by shareholders. The payment must also not contravene the *Corporations Act*.

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9 On 7 November 2002 the High Court held unanimously that section 155 of the Trade Practices Act does not abrogate privilege: (2002) 192 ALR 561. It is submitted that based on the Court's reasoning, section 198F of the Corporations Act does not abrogate privilege.

Many deeds, particularly deeds executed in the 1990s, contain an absolute obligation on the company to maintain insurance during the Access Period which is not less favourable than the insurance in place at the time the deed was executed. An example of such a clause is as follows:

> *Throughout the Access Period, the Company must take out and maintain an insurance policy which provides cover for the Director against all liabilities incurred by the Director in the capacity as a director of the Company. Any policy resulting from the renewal of the policy in force at the date of this deed must provide no less cover for the Director than the latter policy. The Company must pay the premium for all policies taken out and maintained in accordance with this clause.*

In my view, a company which assumes an absolute obligation to maintain a particular type of insurance, irrespective of the commercial availability of that insurance or the premium payable to purchase such insurance, is acting irresponsibly. As recent events have confirmed, the insurance market is cyclical in nature and insurers alter the risks they insure as well as the premiums they charge, based on a combination of external events and changes in their underwriting criteria.

The key flaw in the above clause is that the company is undertaking a contractual obligation, the performance of which does not lie entirely within its own control. This is because even if the company is willing to comply with the obligation, it may not be able to do so because the insurers are not prepared to renew cover on the same basis as previously. The insurer may want to introduce new exclusions or the cost of retaining cover for certain types of liabilities may become prohibitive.

Other flaws with the above clause are:

(a) The clause obliges the company to provide insurance in respect of "all liabilities incurred by the Director in the capacity as a director". It is simply impossible to comply with this obligation because all D&O policies have exclusions.

(b) The clause requires the company to pay the entire premium for the policy irrespective of whether or not it is lawful for the company to do so. As we will see shortly, it is unlawful for the company to pay the premium for certain types of insurance cover.

Companies entering into deeds of indemnity, access and insurance since the recent difficulties in the insurance market became apparent, are entering into less onerous obligations. One example, based on my firm's standard deed, is as follows:

1 Without limiting the indemnity provisions of this deed:

(a) to the extent permitted by law;

(b) so far as is reasonably available at a reasonable cost;

(c) consistent with generally accepted insurance industry practices including as to applicable exclusions and conditions; and

(d) subject to clauses 2 and 3,

the Company undertakes to use its reasonable endeavours to ensure that throughout the Access Period it will:

(e) take out and maintain an insurance policy … insuring against liabilities incurred by the Director in the Director's capacity as an officer of the Company … except for an Excluded Liability;

…

2 The Director undertakes:

…

3 The Director acknowledges that the negotiation of the terms of the insurance policy may:

(a) involve the insurer varying the terms of the insurance policy offered which if accepted by the Company, may provide less coverage or less favourable coverage for the Director;

(b) involve a decision by the Company, acting reasonably, to balance the proposed level of premiums against the terms offered; or

(c) result in a decision by the Company to accept varied terms or to change insurers.

4 Excluded Liability means a liability in respect of which the Company cannot lawfully pay the premium under the insurance policy and includes a liability the subject of the prohibition in section 199B of the Corporations Act.

It can be seen that the company's obligations under the above provisions are much more balanced and, in contrast to the first clause, the provisions are unlikely to cause the company to be in breach of the deed if there are changes in the availability or price of insurance cover.

Payment of Premium

The key provision relating to payment of premium for insurance for the benefit of directors is section 199B of the *Corporations Act*. As a result of a recent amendment to the section, greater care is now required in relation to payment of the premium, as failure to take care may result in the commission of a criminal offence of strict liability.

When it was inserted into the *Corporations Law* on 13 March 2000, section 199B provided:

> *A company or a related body corporate must not pay, or agree to pay, a premium for a contract insuring a person who is or has been an officer … of the company against a liability (other than one for legal costs) arising out of:*
>
> *(a) conduct involving a willful breach of duty in relation to the company; or*
>
> *(b) a contravention of section 182 or 183.*[10]
>
> *This section applies to a premium whether it is paid directly or through an interposed entity.*

Section 199C(2) provides that anything that purports to insure a person against a liability is void to the extent that it contravenes section 199B.

On 15 December 2001, section 199B became subsection 199B(1) and a new subsection (2) was inserted, which states:

> *An offence based on subsection (1) is an offence of strict liability.*

The effect of section 199B(2) is that a breach of section 199B(1) constituted by a company paying a premium for a contract insuring the liabilities referred to in section 199B(1) (which I will refer to as "the prohibited liabilities") not only renders the policy void to the extent that it provides cover for the prohibited liabilities, but also results in the company committing a criminal offence of strict liability. The penalty is a minor fine of $550.[11]

The conventional wisdom in respect of section 199B and its predecessor, the former section 241A, is that in respect of the prohibited liabilities, directors have two choices. First, if the directors want the company to pay the entire premium, they have to ensure that the policy contains an exclusion in respect of the

10 Section 182 deals with misuse of position and section 183 deals with misuse of information.

11 Item 34 of schedule 3 of the *Corporations Act*.

prohibited liabilities. Second, if the directors want cover for the prohibited liabilities (and an insurer is prepared to provide such cover), part of the premium has to be apportioned to the cover for the prohibited liabilities and the directors must pay that part of the premium.

A dominant market practice did not emerge in respect of the two options referred to above. Some directors did not want to pay any part of the premium and were therefore content to have the policy contain an exclusion in respect of the prohibited liabilities. Other directors, however, have sought to maximise the cover available to them and have paid part of the premium in return for having some cover for the prohibited liabilities. In the latter situation, insurers provide two invoices for the premium, the first payable by the directors and the second payable by the company. The market practice has been for the directors to pay 1% of the premium and for the company to pay 99% of the premium. The appropriateness of this split in the premium has never been the subject of any judicial consideration.

It is arguable that the practice of allocating 1% of the premium to directors is not, in itself, sufficient to prevent a breach of section 199B. The basis for the argument is as follows:

(a) Section 199B(1) prohibits a company from paying "a premium for a contract" which provides cover for the prohibited liabilities.

(b) An insurance policy constitutes a single indivisible contract.

(c) If a company pays any part of the premium for a contract which provides cover for the prohibited liabilities, irrespective of whether someone else pays another part of the premium, the company, literally, has paid "a premium for a contract" which provides cover for the prohibited liabilities. Accordingly, the company contravenes section 199B(1).

Under this argument, as the contract of insurance is "indivisible", any part of the premium relates to the entire cover under the contract and cannot be attributed to only some of the cover. In other words, the covers are not severable.

In my view, while this indivisible contract argument has some merit based on a very literal reading of section 199B(1), it is unlikely to be adopted by the courts. The key reason for this is that the argument focuses on the contract, rather than the premium and the cover. The mischief sought to be addressed by section 199B is not the taking out of cover for the prohibited liabilities, but companies using their assets to pay for such cover. Accordingly, if a policy makes it clear that the 99% of the premium being paid by the company does not include cover for the prohibited liabilities, then section 199B is not infringed. On this basis, the fact

that the prohibited cover is included in a single contract of insurance which also covers other liabilities, is not to the point.

Notwithstanding the view I have expressed above, because breach of section 199B(1) constitutes a criminal offence, it is important for companies to take prudent steps to reduce the risk of breaching section 199B(1). Accordingly, insofar as the indivisible contract argument has some merit, it would be prudent to seek to overcome the argument by having two separate contracts of insurance, the first in respect of the prohibited liabilities and the second in respect of all other liabilities. These separate contracts can be two separate policies or they can be in a single policy. The latter result can be achieved by an endorsement to the policy which separates the policy into two contracts.

At this stage, it is not clear what the attitude of insurers is to the indivisible contract argument and whether they are prepared to accept two separate policies or an endorsement which deems the policy to comprise two separate contracts. From the directors' perspective, the endorsement option is preferable.

It is my expectation that the indivisible contract argument will become more widely known within insurance and legal circles. Because the only sure means of totally overcoming any possible argument of a breach of section 199B(1) is to have an endorsement in the policy which expressly excludes cover for the prohibited liabilities, I expect that the more conservative companies and directors will abandon the previous practice of directors paying 1% of the premium and opt for such an endorsement.

Ideal Deed and Ideal Way of Negotiating It

As can be seen from the above discussion, deeds of indemnity, access and insurance give rise not only to complex legal issues, but if they are not drafted carefully, may contain time bombs which can cause severe financial or legal difficulties for the company in the future.

An ideal deed of indemnity, access and insurance is one that strikes a reasonable and fair balance between the interests of directors and the interests of the company.

There has been an accumulation of experience and learning on what is appropriate for deeds of indemnity, access and insurance, since the mid 1990s, when such deeds became popular.

In light of changes in sentiment and changes in the corporate governance and insurance environment, it is advisable that the contents of any deed that was executed prior to 1 July 2001 be reviewed with a view to determining whether its

contents are reasonable. If they are not, endeavours should be made to renegotiate the terms of the deed.

In view of the conflict of interest issues that I have discussed and the recent raising of the bar in relation to proper corporate governance standards, I recommend that any new deed of indemnity, access and insurance or any renegotiation of an existing deed be in accordance with the following procedure:

(a) The director and the company should not be represented by the same lawyers, whether they are inhouse or external.

(b) The company's normal lawyers should not represent the director. Those lawyers should represent the company. If the director requires separate legal representation, such representation should be provided by a firm that does not usually act for the company.

(c) The company's lawyers should produce a draft deed which the company and its lawyers believe is fair and reasonable. The draft should be submitted to the director. If the director wishes to amend any provisions of the deed to make it more favourable to the director, the onus should be placed on the directors to demonstrate why a deed containing those amendments is in the best interests of the company and is reasonable in the circumstances of the company.

(d) The entire negotiation should be on an arms length basis.

(e) Notwithstanding sections 191 and 195 of the *Corporations Act*, the director concerned should not participate in any discussions or voting in relation to the deed.

(f) Although shareholder approval is not required, it should be considered, in the interests of full disclosure to shareholders.

(g) If shareholder approval is sought, the notice of meeting seeking the approval should contain a full explanation of the provisions of the deed, the financial, legal and other implications for the company in entering into the deed and the extent to which any liability covered by the deed is the subject of cover under the company's D&O policy.

Serious consideration should be given to including a revocation clause in the deed, to enable the company to revoke the indemnity after giving at least 30 days' notice if it forms the view that it is in its interests to do so. The revocation should apply only in respect of liabilities arising from acts or omissions occurring after the revocation. The notice period will enable the director to resign if the director is not prepared to continue to hold office without the indemnity.

It is less appropriate for the company to be entitled to revoke the insurance obligations in the deed, as the absence of insurance in future years will expose the director to uninsured liabilities in respect of past acts or omissions, and thus cause unfair prejudice to the director. The absence of a right to revoke insurance obligations underlines the need for that obligation to be suitably qualified.

It is also less appropriate for the company to be entitled to revoke the right of access in the deed as it is reasonable for the director to have access to company documents to help the director defend proceedings brought in respect of acts or omissions occurring while the director held office. In any event, revocation of the access rights in the deed will not affect the statutory right of access conferred by section 198F of the *Corporations Act*.

Conclusion

For many companies, entering into a deed of indemnity, access and insurance has almost become a formality. Deeds are signed every time a new director joins the company and they tend to be updated when the law changes. The key objective tends to be to indemnify the director to the maximum extent permitted by law. There is less focus on what obligations should be imposed on the director and on whether the contents of the deed are, objectively, fair and reasonable. One sided deeds are now not uncommon.

In the current environment, there is a risk that a one-sided deed may come before a court and that such a deed may not survive judicial scrutiny.

The deeds that are at greatest risk are those executed before 1 July 2001, as they are more likely to contain onerous indemnities and absolute insurance obligations which the company cannot meet. It is therefore prudent for such deeds to be reviewed.

All deeds should seek to strike a fair balance between the interests of the company and the interests of directors and be negotiated in an arms length and transparent manner.