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Dear Jeremy

Directors' and Officers' Liability – AIG Gold Complete Policy Wording

We have been requested by AIG Australia Limited to advise on the operation of the Directors' and Officers' Liability Section of the Gold Complete Policy Wording (10/14). This involves in part a consideration of how the Management Liability Cover (the **Cover**) provided in that Section operates in comparison to the more traditional approach taken in other similar policies that provide separate covers for directors' and officers' liability (commonly called Side A or 'Directors' and Officers' Liability') and the loss incurred by a company where it is entitled to and does indemnify a director or officer for a liability (commonly called Side B or 'Company Reimbursement').

In addition we make some observations in relation to the operation and importance of the cover for Investigations (**Investigations Cover**) and the Directors' and Officers' Liability Lifetime Run-off cover (**Lifetime Run-off**).

This advice is provided to AIG who we understand may make it available to brokers and other persons who may be interested in the manner in which the policy operates. If a broker or other person reads this legal advice then the broker or other person accepts the terms on which that advice is provided which are set out at the end of this advice.

Preliminary

It is useful to commence with some background:

- Directors' and officers' liability policies are provided with the intent of protecting directors, officers and certain other employees from liabilities that they may incur in exercising their respective responsibilities for or on behalf of a company of which they are a director, officer or employee.
- Other than covering the company for its liability to indemnify a director, officer or employee, the policy normally does not provide cover to the company itself except where there is a specific extension. So modern policies may provide for extensions of cover to the company for Company Securities Claims (sometimes called Side C), Employment Practices Liability or certain other liabilities. In Gold Complete these are found in other Sections of the policy.

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- One matter of great concern today is regulatory action, which may result in claims being made against the company or its directors and officers or both. This often involves extensive investigations by the regulator. The costs of responding to requests for information and documents and in appearing before the regulator can be extremely large.
- The Australian *Corporations Act 2001* prohibits a company or a related body corporate from indemnifying or exempting from liability a director or officer in certain circumstances.
- Where a director, officer or employee incurs a liability in a circumstance where the company:
 - indemnifies the person for the liability, then the policy will in turn meet the liability of the company or reimburse it for the amount which is paid; or
 - does not indemnify the person, then the policy will provide cover to the director, officer and employee for that liability,
 in circumstances where the loss is covered by the policy. Whether or not a company is entitled to or does meet investigation costs can be very important to individual directors or officers who may have limited resources.

The Cover

The Cover combines the traditional Side A and Side B covers in the following sentence:

*The **Insurer** shall pay the **Loss** for, or on behalf of, any **Insured** for any **Management Liability**, irrespective of any other indemnification available to the **Insured**.*

The terms in **bold** are defined elsewhere in the policy.

The full definitions of the other terms are set out in the policy but in summary they are as follows:

- The **Insurer** is AIG Australia Limited.
- **Loss** is the amount which an Insured is legally liable to pay and includes Defence Costs. However, it does not include certain amounts which are set out in the definition¹.
- The **Insured** is a composite term covering:
 - any **Insured Entity** (the company that holds the policy, any subsidiary or a Plan such as a an employee benefit or superannuation plan);
 - any **Manager** which term is used to describe a director or officer of an Insured Entity, an employee of an Insured Entity and certain other persons described in the policy.
- A **Management Liability** is any claim against a Manager:
 - for any Wrongful Act of a Manager, which covers acts, errors omissions, breaches of duty, breaches of trust, misleading statements and the like;
 - arising solely because of a person's status as a Manager;
 - for Employment Practices Liability of a Manager arising from the employment or prospective employment of a person; or
 - for Third Party Liability of a Manager, which covers certain acts of harassment or discrimination against a person who is not themselves a Manager.

¹ Loss does not include certain taxes, certain remuneration and overheads of an Insured and other matters more particularly set out in the definition.

Defence Costs

Under the policy Defence Costs are payable as they are incurred by or on behalf of either the company or the director, officer or employee. Defence costs are the reasonable fees, costs and expenses that are incurred in the investigation, defence, settlement or appeal of an actual Claim². We discuss below how investigation costs are covered where there is no Claim as such.

Benefits of a Unified Insuring Clause

The unification of Side A and Side B under this single cover has an important consequence. In some cases, it may be that it is either:

- The Insured Entity refuses to indemnify;
- The Insured Entity places conditions upon such an indemnification; or
- a Manager does not wish to seek indemnification from the Insured Entity.

Rather than navigate between a more traditional 'Side A' and 'Side B' policy, AIG's obligation is not dependent on any determination as to whether the company may indemnify the Manager or whether it in fact does so.

Secondly the obligation to pay is not dependent on the payment by the Insured Entity of a retention or deductible. A Nil retention is specified for the Cover and no retention is applied where the company is in fact entitled to indemnify the Manager. This should reduce potential disputes about the scope of the insurer's obligation to make payment.

Thirdly one may ask about Defence Costs which are included in the definition of Loss. The legal costs recoverable by a successful claimant are included as part of the covered Loss by the general words of the definition of Loss. The separately defined Defence Costs are those incurred or which may need to be incurred in defending a claim. This is a very important issue for directors and officers where a major risk for them in the event of a claim is the ability to actually defend themselves in situations where the costs of legal representation can be very high.

The Defence Costs covered are those properly referable to a claim in respect of Management Liability. As the definition of Defence Costs makes clear it does not matter if they are incurred by the Insured Entity or the Manager so long as they are characterised as being incurred 'in the investigation, defence, settlement or appeal of a Claim covered' under the policy which is the claim in respect of a Management Liability. In addition it is made clear that certain experts reports are covered by Defence Costs.

It should be noted that unless they are incurred in an emergency, the Insurer's prior written consent is required.

Settlement

AIG is also liable to pay for, or on behalf of, the party liable the amount of the Loss, which will ordinarily occur on final settlement or adjudication of the Claim.

In some cases both the Insured Entity and a Manager will have a liability to a claimant for damages and the claimant's legal costs³ where the Management Liability is covered by the policy but not the liability of the Insured Entity. For the purposes of a settlement an apportionment may need to be agreed but if the matter proceeds to court and a Manager and an Insured Entity is found to be jointly and severally liable for a Loss

² But see the definition for full details of what is included or excluded.

³ The claimant's costs that are recoverable from a liable party are included in the general words of the definition of Loss and the principles discussed here apply to them in a way similar to any damages that may be agreed to be paid or which are awarded by adjudication. The term Defence Costs when used in the policy is defined to describe the costs that are incurred by the Manager and are discussed further below.

then, unless the Insured Entity actually meets some or all of the Loss, the Insurer is liable to meet the whole of the Loss on behalf of the Manager and the insurer will be subrogated to the rights of recovery of the Manager against the Insured Entity.

If the claim is brought against a Manager and an Insured Entity there will be issues as to the characterisation of the costs and whether they are reasonably incurred by either the Insured Entity or the Manager in dealing with the claim against the Manager. So in seeking agreement from the Insurer the Insurer could refuse agreement in relation to costs solely for the benefit of defending the Insured Entity (e.g costs of a lawyer separately representing the Insured Entity). Other cases will depend on the facts but there may be situations where the costs should be apportioned. However if costs are reasonably needed to defend a Manager, the fact that the Insured Entity may benefit from that, is not of itself a basis for the Insurer to refuse consent.

Management Investigation Costs

The important aspect of this cover is that it does not depend on the Company or a director, officer or employee being subject to a claim under the policy. They may have separate representation and be protected in respect of the expense of responding to a regulatory investigation. Before incurring costs they require the Insurer's written consent which ought be forthcoming where the expense is reasonable and is for the principal purpose of preparing for, responding to or attending an investigation.

An investigation is broadly defined but it must be by an Official Body into the affairs of the Insured i.e. the company or another director, officer or employee under the policy. The term Official Body is likewise broadly defined and includes regulators and others having legal authority to conduct an investigation.

Two things are notable; firstly the investigation itself does not have to be official, so it will cover circumstances where a regulator or other Official Body seeks the voluntary production of documents or information without the provision of a formal order; and secondly the definition of Official Body may extend to self-regulatory bodies such as industry associations with powers under their constituent documents to conduct an investigation.

An Example

We illustrate this advice by an example of how these sections of the policy operate in a particular factual situation. Obviously the operation of the policy will depend on the particular facts and circumstances that may arise and so this example must be approached with caution. It is illustrative only.

Facts

Able Ltd has 5 directors. None of the directors are executives but one, Bradley holds 15% of the issued capital of Able. Able purchases a property for \$75 million from Valley Ltd, a company controlled by associates of Bradley. The directors approve the purchase by a majority of 3-1 with Norman dissenting. Bradley declares his interest and does not attend or vote at the meeting. No shareholders' approval is sought as the majority believes the price is an arm's length price. The majority rely on valuations provided by Valley Ltd and do not seek an independent valuation. The majority fail to realise that the valuation assumes the property is able to be rezoned from a rural use to an industrial use which is disclosed in the fine print of the valuation. Rezoning proves impossible and the land is then worth \$20 million. Able Ltd's share price drops significantly and the company faces severe financial difficulties.

Some shareholders then threaten action against the company and require the company to bring proceedings against the 3 majority directors to recover the loss. ASIC commences an investigation seeking information and documents from the company and each of the directors.

There is a Claim or prospective Claim against Able and the 3 directors which could be notified as a Claim under the AIG Gold Complete policy. Any loss arising from a liability of the 3 directors together with the defence costs will be covered under the Management Liability Cover (subject to no other exclusions applying). As there is no claim alleged against Norman or Bradley (or until such time as a Claim arises

against them) they will be able to rely on the policy for the Management Investigation Costs Cover to meet the costs of the ASIC investigation that they may be required to meet. They may require separate legal representation to protect their interests especially if Able is not able to honour its indemnity to them due to its financial stress.

Lifetime Run-off

Another innovation in this policy is Lifetime Run-off cover for management Liability. The policy provides a mechanism for this cover to be acquired if the company or a related body corporate is sold. If the Insured accepts the quote for the cover provided by the Insurer then this cover protects directors, officers and employees for any Management Liability arising from an act, error or omission that occurred prior to the Sale Date which will be specified in the Schedule to the policy.

You may ask why this is important. Often insurers will only provide a limited period of run-off cover, say 6 years and this is accepted because it is thought that the statutory limitation periods for claims will mean no claim can be brought after that time. That is often not true. Firstly the limitation periods may in fact be for periods greater than 6 years, such as where there are breaches of trust or fiduciary duties. Secondly in the simplest cases such as in relation to claims for negligence it may be incorrect.

An action for negligence does not arise until the claimant suffers a loss and so if the claimant has relied on a representation, and it is not until many years later that a loss is suffered, then only then does the limitation period commence to run.

An Example

We set out below an example of a scenario in which a claim might be brought against a company's directors and officers more than 6 years after the company is sold. Again, the example is illustrative only.

Stevens Ltd is a property development company that is building the Horizon apartments.

The Directors of Stevens Ltd put together a due diligence package to offer the company for sale, including a list of "off the plan" sale agreements for the Horizons apartments. After various offers are received, the CEO and the Directors recommend to their shareholders that they accept a takeover offer offered by Black Ltd. The sale subsequently completes in 2003.

In late 2007, Stevens Ltd, now a subsidiary of Black Ltd, completes the building of the Horizon apartments. When selling the apartments, Stevens Ltd finds that the contracts for a number of the "off the plan" sales were fraudulent. They put the apartments on the market for sale, but struggle to find buyers in the tough economic conditions.

In 2012, having sold the last of the apartments at a discount to the original "off the plan" prices, Black Ltd alleges that the former CEO (by entering into the fraudulent transactions) and the Directors (by failing to review the sales agreements when putting them into the due diligence package) failed to exercise reasonable care.

Disclaimer

This advice is by its nature general and does not deal with any particular factual situation. It is not intended to be relied upon by any person covered by, or seeking or advising on a Gold Complete policy and they should seek their own legal advice referable to their own particular circumstances.

Yours sincerely

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