COMPANIES AND SECURITIES
ADVISORY COMMITTEE

REPORT
ON

COMPANY DIRECTORS AND OFFICERS: INDEMNIFICATION, RELIEF AND INSURANCE

1992

CONTENTS

A. BACKGROUND

The Ministerial Council referred to the Advisory Committee for comment the contents of Report No 10 of the Companies and Securities Law Review Committee, (CSLRC) entitled *Company Directors and Officers: Indemnification, Relief and Insurance* (1990).

The Advisory Committee referred this Report to its Legal Sub-Committee (the Legal Committee) for advice. This Report represents the views of the Legal Committee on this matter. The Advisory Committee, at its meeting of 17 February 1992, considered these views and supported them in full.

The Legal Committee was concerned primarily with the CSLRC recommendations on s 241 of the Corporations Law (previously s 237 of the Companies Code). In essence, this provision prohibits companies from indemnifying, insuring or limiting the liability of their directors or officers. A number of criticisms have been levelled at this section[1], including the following:

- The section may operate to render invalid the standard commercial practice of parent companies providing indemnities to the directors of subsidiary companies.[2]

- The section prohibits a company paying the premiums on a contract of insurance concerning acts and omissions of the company's directors and officers. It has been argued by a number of commentators that the policy underlying this prohibition is wrong and that companies should be permitted to take out insurance policies of this nature.

- Section 241 defines officer to include not only a director, secretary and executive officer but also an employee of the company. It has been argued that, in consequence, the application of the section is too broad.

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1 See generally, I Ramsay "Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance" (1987) 5 Company and Securities Law Journal 129; R John "Relieving Directors from the Liabilities of Office: The Case for Reform of Section 241" (1992) 10 Company and Securities Law Journal 6.

2 B Gibson and I Ramsay, "Indemnification of Company Directors and Officers and s 237 of the Companies Code" (1989) Company Law Bulletin No. 25, para 390.

- Section 241 states that a provision that exempts an officer from any liability in respect of "any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company" is void. If negligence is interpreted to mean the common law duty of care, s 241 could invalidate an indemnity given by an employer to an employee in respect of any liability to pay common law damages for negligence in the course of the employee's duties. Such indemnities are a common practice, and reflect a social policy that the company rather than the individual should bear this liability. Section 241 should not undercut this social policy.

- It is common for companies to have articles which impact on certain duties of directors. For example, under common law principles, a director must not place himself in a position where his personal interest conflicts with his duty to the company. However, most companies will have an article that allows a director to have an interest in, and profit from, a transaction in which the company is interested, provided that the director discloses his interest to the other directors or shareholders. Some commentators have argued that it is difficult to reconcile the existence of these common provisions in articles of association with s 241, which operates to void any provision which exempts an officer from any liability in respect of a breach of duty.

B. THE PURPOSE OF SECTION 241

The origin of s 241 can be traced to the well-known decision of the English Court of Appeal in Re City Equitable Fire Insurance Co Ltd [3] where a company article that exempted directors from loss except when resulting from "wilful neglect or default" was held to be unobjectionable. The Greene Committee Report considered:

> "... that this type of article gives a quite unjustifiable protection to directors. Under it a director may with impunity be guilty of the grossest negligence provided that he does not consciously do anything which he recognises to be improper... To attempt by statute to define the duties of directors would be a hopeless task and the proper course in our view is to prohibit articles and contracts directed to relieving directors and other officers of a company from their liability under the general law for negligence and breach of duty or breach of trust."[4] .

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3 [1925] Ch 407.

4 Company Law Amendment Committee Report (Cmd 2657, 1926) para 46.

As is stated by the Greene Committee, it is important that directors not be given total immunity from liability. This is of course an important policy underlying s 241. At the same time, there are additional policy considerations, including the following:

- Provisions such as s 241 need to achieve a balance between encouraging directors to engage in good faith risks for profits while at the same time effectively deterring mismanagement. The former could be jeopardised if directors face the prospect of severe personal liability, while the latter may not be achieved if regulation of company management is inadequate.

- The need to establish who, as between the director or the company, most efficiently bears the risk of liability. As a related point, provisions such as s 241 may apply to circumstances where an insurer otherwise would more effectively bear the risk of liability.

- The need for those involved in commercial transactions to know that the law in this area has an application that is certain. Clearly, this is not achieved at the moment by the operation of s 241.

C. RECOMMENDATIONS

Introduction

There are three main areas of recommendation that result from the Legal Committee's consideration of CSLRC Report No 10. These are:

- the scope of s 241;
- the scope of shareholder ratification of actions of directors or officers otherwise in breach of their duties to the company; and
- allowing companies to pay the premiums on directors' and officers' insurance policies.

In addition, there are a number of miscellaneous matters that will be considered separately.

1. The Scope of Section 241

The CSLRC stated that s 241 is "a broad provision capable of upsetting various indemnifying provisions and susceptible to frustratingly varied interpretations".[5] The CSLRC made three recommendations directly on s 241, namely:

- that the definition of "officer" in s 241 be identical to the definition of "officer" in s 232;

- that the uncertainty concerning the phrase "articles, contract *or otherwise*" be removed by making it clear that s 241(1) is concerned with any provision, whether oral or in writing, which purports to bind the company but which is not authorised by the Corporations Law;

- that directors and officers be given a statutory right to indemnity for the costs of a successful defence.

The response of the Legal Committee to the general scope of s 241 and to these recommendations is outlined below.

(a) Breach of duty to the company

The Legal Committee believes that a company should not be able to indemnify its directors or officers for breaches of their common law or statutory fiduciary duty to the company. Without that prohibition, a company might succeed in a legal action against one of its directors for breach of duty, yet subsequently be required to indemnify the defendant for the damages that he was otherwise required to pay to the company. The CSLRC did not make any specific recommendation in this regard, though its support for this prohibition may be implied from the tenor of its Report.

The Legal Committee has considered whether the prohibition against indemnification should also apply in a wider range of circumstances eg where a director breaches a contract which has been entered into with his company, or where a company indemnifies its directors and officers for liability to third parties. Section 241 (1) may well prohibit indemnification in these circumstances, given its general reference to "any negligence, default, breach of duty or breach of trust" by a director or officer.

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5 Companies and Securities Law Review Committee, Company Directors and Officers: Indemnification, Relief and Insurance, Report No. 10 (1990) para 13.

The Legal Committee recommends that the prohibition in s 241 be limited to situations where a director or officer breaches his common law or statutory fiduciary duty to the company. Other situations should be excluded from s 241 and be left to the general law. The Legal Committee believes that this will provide the necessary precision to the operation of the section.

This recommendation does not effect the scope of shareholder ratification of conduct otherwise constituting a breach of fiduciary duty (see post).

(b) The definition of "officer"

As presently drafted, s 241 defines "officer" to include a director, secretary, executive officer or employee of the company and also certain other persons. The CSLRC recommended that the definition of officer in s 241 be consistent with the definition of officer in s 232, which does not include an employee. The Legal Committee believes that this would be an appropriate amendment. Employees would not, other than in exceptional circumstances, owe fiduciary duties to their company. In addition, excluding employees from the prohibition contained in s 241 will alleviate problems concerning standard indemnification procedures for employees (for example, indemnifying employees for the negligent driving of company vehicles).

(c) The meaning of the words "or otherwise"

It has been argued that the vague language in s 241 operates to prohibit third party indemnities.[6] In principle, the application of s 241 to these indemnities must be severely limited. Otherwise, the section could operate in unintended ways. For example, it could operate to void an indemnity from a government authority given to a director in a matter concerning a criminal prosecution. If, for instance, the Australian Securities Commission or the Director of Public Prosecutions, in the course of an investigation or prosecution, wishes to give an indemnity to a company officer or director in return for testimony, s 241 should not inhibit this process.

The solution proposed by the CSLRC is to amend s 241 to provide that it applies only to any provision, whether oral or in writing, which purports to bind the company but which is not authorised by the Corporations Law. This may resolve the general problem of third party indemnities.

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6 Supra note 2.

An important issue which is not addressed by the CSLRC concerns indemnities from related companies (as defined under s 50 of the Corporations Law). The recommendation of the CSLRC, if enacted, would permit all third party indemnities. The question is whether there is potential for abuse in the case of related companies. The Legal Committee considers that abuse may occur if a subsidiary is permitted to indemnify the officers of its holding company. In contrast, a holding company should be entitled to indemnify the officers of a subsidiary company. The latter is a common commercial practice and is not open to the same potential for abuse that exists in consequence of the capacity of a holding company to control the decisions of a subsidiary.

The Legal Committee therefore recommends that in respect of related company indemnities:

- a holding company should be permitted to indemnify the officers of its subsidiaries. Any decision by the directors of the holding company to provide such indemnification would of course be subject to the fiduciary duty of the directors to act in the best interests of the holding company; and
- a company should not otherwise be permitted to indemnify the officers of related companies.

(d) Mandatory indemnification

In paragraph 161 of its Report, the CSLRC recommended that directors and officers be given a statutory right to indemnity for the costs of a successful defence. It is to be noted that a similar provision is contained in both the Canadian and Delaware legislation. The policy underlying this recommendation is the belief that indemnifying a director or officer for costs incurred in legal proceedings which are successfully defended should not be at the whim of the board of directors of the company (para 160 of the Report).

The opposing view is that the board should retain a discretion not to indemnify a director for costs, for instance where a defendant director has been successful in defending legal proceedings because of a technicality. Moreover, where a court has not awarded costs to a director who has successfully defended legal proceedings because of reservations that this is appropriate, it can be argued that the company should not be under a legal obligation to indemnify the director for these costs.

The Legal Committee recommends that the issue of indemnification for the costs of a successful defence should be left to the discretion of the directors or should be dealt with by the shareholders by means of the Articles (for example, Table A Article 98). There should not be mandatory indemnification for the costs of a successful defence.

2. The Scope of Shareholder Ratification

In paragraphs 57-67 and 104-108 of its Report, the CSLRC recommended that the Corporations Law be amended to provide that the shareholders of a company can give specific advance authority to a director or officer for conduct which would otherwise be a breach of duty. Furthermore, the shareholders should be able to give protection after a breach of duty by a director or officer. It is important to note that it is well established under common law principles that shareholders can, subject to certain limitations, relieve a director or officer from breach of duty to the company.[7] Additional protections are recommended by the CSLRC and these include detailed disclosure requirements and provisions that interested directors, their associates and relatives, are not able to vote.

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[7] J Corkery, Directors' Powers and Duties (1987), p. 156.

The CSLRC also noted that when shareholders relieve a director or officer from a breach of duty, this can adversely affect the interests of creditors. The solution proposed by the CSLRC is to recommend that if the company goes into liquidation within 12 months after the authority is given, the Court may order that the director or officer in question should be considered to be in the same position as if the authority had not been given.

The difficulty with this recommendation is that, although not acknowledged by the CSLRC, it severely weakens the existing common law protections given to creditors. In the case of Kinsela v Russell Kinsela Pty Ltd [8] it was held that shareholders of a company cannot relieve directors or officers of a breach of their duty to the company where the company is insolvent *or near insolvent*. In other words, this common law principle prevents the shareholders passing the resolution in the first place. However, the recommendation of the CSLRC allows the resolution to be passed and places sole reliance for the protection of creditors on subsequent court action. Furthermore, this court action is only permissible where the company actually goes into liquidation. There may be resolutions of shareholders which jeopardise the interests of creditors, but will not necessarily result in the company immediately going into liquidation.

In view of the above, the Legal Committee recommends that the subject of shareholder ratification not be codified but remain as part of the common law.

3. Insurance

Under the existing law, insurance of directors and officers does not breach s 241, provided that the premiums on such insurance are not paid by the company or a related company.

The CSLRC referred to the following reasons which support the proposition that companies be authorised to purchase and maintain insurance in respect of their directors and officers.

- It is in the interests of the company, its shareholders and the community that directors and officers be insured because:

  (a) there will be a fund to compensate a plaintiff for loss caused by the director or officer;

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8 (1986) 10 ACLR 395.

(b) directors will be less likely to be discouraged from taking good faith business risks where they are covered by insurance.

- It is not possible to achieve the aim of s 241(3) in seeking to prevent use of the company's resources to provide insurance cover. Companies may circumvent the prohibition by including in the amount of remuneration to directors or officers, a sum of money to pay for the premium on their own insurance policies.

- It would be more efficient for the company to obtain insurance rather than the directors and officers.

- To allow the company to purchase and maintain insurance is appropriate because the company is in the best position to arrange distribution of loss by adding the cost of the premium to the expenses of the enterprise.[9]

It is clear that the international trend is to permit companies to pay the premiums on insurance policies covering their directors and officers. The recommendation of the CSLRC is in line with this trend. However, even if a decision is made to allow companies to pay the insurance premiums, there remain four policy issues.

(a) Should the company be permitted to pay the premiums on insurance policies that cover directors and officers for breaches of their duty to the company?

Insurance policies can potentially cover three situations where a director or officer can cause loss. First, the policy may provide cover where a third party brings an action against the company for loss to that party caused by the negligence of a director or officer. For example, a director may have caused loss to a third party because of negligence in driving a company motor vehicle. Most commentators would say that there is no difficulty with the company paying the premiums on these types of policies. Secondly, the company itself may take out insurance to cover its own vicarious liability for loss caused by the wrongs of its directors or officers. This is a well established practice. Thirdly, there is the issue of whether

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[9] Companies and Securities Law Review Committee, Company Directors and Officers: Indemnification Relief and Insurance Discussion Paper No. 9 (1989) para 175.

the company should be authorised to pay the premiums on policies which cover directors and officers for breaches of their common law or statutory fiduciary duties to the company. Regardless of its possible merits, the practice of insurers will determine whether such policies could ever be obtained. The CSLRC took the view that at the moment this liability of directors and officers would not be covered in standard policies because of the usual "insured v insured" exception.[10]

The CSLRC recommended that the company be authorised to pay the premiums in such circumstances. This is in line with developments in Canada and the United States. The Legal Committee supports this recommendation, noting that insurance practices may determine the likelihood of such practices occurring.

(b) As a means of enacting its recommendation concerning the payment of insurance premiums, the CSLRC in paragraph 139, recommended the adoption of a provision similar to s 124(4) of the Canada Business Corporations Act. This section provides as follows:

"A corporation may purchase and maintain insurance for the benefit of any person referred to in sub-section (1) against any liability incurred by him; (a) in his capacity as a director or officer of the corporation, except where the liability relates to his failure to act honestly and in good faith with a view to the best interests of the corporation; or (b) in his capacity as a director or officer of another body corporate where he acts or acted in that capacity at the corporation's request except where the liability relates to his failure to act honestly and in good faith with a view to the best interests of the body corporate."

The Legal Committee believes that this provision is not appropriate as it may limit the capacity of companies to establish and maintain insurance. Insurers, however, may be unwilling to insure against dishonesty.

(c) In paragraph 152 of its Report, the CSLRC recommended that any legislation authorising a company to establish and maintain insurance in respect of the liability of a director or officer should require that the insurance be on reasonable terms and should not involve the company

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[10] Supra, note 5, para 127.

itself carrying to any substantial extent the burden of liability of directors and officers for loss caused to the company by any of those people. In particular, the CSLRC was concerned about the amount of excess that a company may be required to bear. The CSLRC recommended that the legislation should provide that regulations may be made prescribing limits within which a policy of insurance in respect of the liability to the company of a director or officer may provide that the risk shall be carried by the company.

A further recommendation is that there should be a prohibition on the company obtaining or maintaining insurance from a company related to or associated with it unless there is re-insurance from an independent re-insurer.

The Legal Committee believes that most of these recommendations are better left to be negotiated between the insurer and the insured and reflected in the terms of insurance policies rather than be incorporated into the Corporations Law. However, the Committee does see merit in a recommendation that any insurance be obtained from an independent company.

(d) In paragraphs 145-6 of its Report, the CSLRC identified two statutory provisions which, it argues, show a legislative intention to impose personal liability on a director or officer which should not be shifted to the company or an insurer. These provisions are s 592 (reckless trading) and s 201 (restriction on payments of dividends). The CSLRC recommended that it should not be possible for a company to insure against the liability imposed by these two sections.

The Legal Committee has considered these sections and does not believe that any policy against insurance applies to them. The Legal Committee sees no reason why, should insurers be prepared to write such policies, insurance should not be able to be obtained for incorrect payment of dividends or trading while the company is technically insolvent. In fact, insurance may be highly desirable where the mistake is inadvertent.

4. Miscellaneous Recommendations

The CSLRC took the opportunity in Report No 10 to recommend a series of further amendments to the Corporations Law. Some of these recommendations (which derive from recommendations made in the Senate Standing Committee Report Company Directors' Duties, 1989), have been considered by the Advisory Committee as part of its review of the Senate Report[11] and are therefore not repeated here. However various other recommendations have been reviewed by the Legal Committee.

(a) In paragraph 44 of its Report the CSLRC recommended that the legislation should provide that it is not possible for the memorandum and articles of a company to reduce the duties of care and diligence which a director and officer owe to their company. The Legal Committee does not believe that the case for statutory intervention has been made out and recommends that this matter is better left to the common law.

(b) In paragraph 51 the CSLRC recommended that the legislation should recognise that there should be scope for a company, by its memorandum and articles, to define the limits of the duty of good faith in relation to the exercise of the discretions by directors and officers, by stating the specific purposes for which discretions are conferred. The CSLRC further recommended that there should be no possibility of the articles conferring a general power to disregard the duty to consider the benefit of the company as a whole except in the circumstances referred to in the Committee's Report No. 8 on Nominee Directors and Alternate Directors.

This is a complex area and is rendered more complex by the fact that the recommendations of the CSLRC's Report No. 8 have not been enacted. In addition, the ASC has rejected the recommendations contained in that Report.[12] For these reasons, the Legal Committee recommends that this matter be left to the common law.

(c) In paragraph 55 the CSLRC recommended that the Corporations Law allow company articles to contain a provision permitting a director to be interested in a transaction of the company so long as the provision would only operate if

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11 Companies and Securities Advisory Committee, Report on Directors' Duty of Care and Consequences of Breaches of Directors' Duties (September 1991). This includes the extensive discussion in CSLRC Report No 10 on a statutory business judgment rule.

12 Australian Securities Commission, Submission to the Inquiry by the House of Representatives Standing Committee on Legal and Constitutional Affairs into Corporate Practices and the Rights of Shareholders (1990) p. 57.

and when the director has made prior disclosure. This subject has now been considered by the Advisory Committee in its debates on loans to directors and related party transactions and therefore this recommendation of the CSLRC has been superseded by the recommendations of the Advisory Committee.[13]

(d) In paragraphs 96 and 97 the CSLRC recommended that the rights which a director has to obtain information from the company be strengthened and that there be imposed on the principal executive officer of a company an obligation to take reasonable steps to provide to each director such information about the company's affairs as is reasonably necessary to enable the director to exercise powers and discharge duties. The Legal Committee recommends that this should not be the subject of statutory intervention at this stage and believes that developments in this area are better left to the courts operating under common law principles.[14]

(e) The CSLRC has also made a number of recommendations concerning the operation of s 1318. This section allows the court to relieve a director or officer from liability in civil proceedings provided certain requirements are met. The first recommendation of the CSLRC (contained in paragraph 112) is that should a suitable drafting opportunity occur, s 1318 should be re-located near s 232. This would be in recognition of the relevance of the two sections to each other and their historical inter-relationship as disclosed by the Greene Committee Report. Secondly, the CSLRC recommends in paragraph 114 that an additional requirement be added to sections 1318 and also 1322(6)(b) - that the court be satisfied that the person concerned acted with no intent to deceive or defraud. Thirdly, the CSLRC recommends in paragraphs 115 and 116 that a court should be able to relieve a director or officer from not only civil liability but also criminal liability that may be imposed under the Corporations Law, provided that the requirements of s 1318 are satisfied and that an additional requirement be inserted in this section; namely, that the court be satisfied that the person concerned acted reasonably. The Legal Committee supports these recommendations, but suggests that the second recommendation may not be required because the court, in determining an application under s 1318, must have regard to all the circumstances of the

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13 Companies and Securities Advisory Committee, Report on Reform of the Law Governing Corporate Financial Transactions (July 1991).

14 See, for instance, Deluge Holdings Pty Ltd v Bowlay (1991) 6 ACSR 36.

case. This would include consideration of whether the applicant acted with intent to deceive or defraud.

Finally, the CSLRC recommends in paragraph 118, that s 1318 be amended to authorise the court to take into account efforts made by the person seeking relief to inform himself about the legal responsibilities of his office and about the company's business operations. The Legal Committee believes that this recommendation should not be adopted because the court already has this discretion given that, as presently drafted, s 1318 requires the court to "have regard to all the circumstances of the case".