

COMPANIES  
AND  
SECURITIES  
LAW REVIEW COMMITTEE

COMPANY DIRECTORS  
AND OFFICERS:  
INDEMNIFICATION, RELIEF  
AND INSURANCE

DISCUSSION PAPER No. 9

APRIL 1989

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**COMPANIES AND SECURITIES LAW REVIEW COMMITTEE**

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INSURANCE**

**Preface**

**Membership and Functions of the Committee**

The Companies and Securities Law Review Committee was established late in 1983 by the Ministerial Council for Companies and Securities pursuant to the inter-governmental agreement between the Commonwealth and the States of 22nd December 1978.

The Committee's function is to assist the Ministerial Council by carrying out research and advising on law reform in relation to legislation concerning companies and the regulation of the securities industry.

The Committee consists of five part-time members, namely:

Mr Geoffrey W Charlton  
Mr David A Crawford  
Professor H A J Ford (Chairman)  
Mr Anthony B Greenwood  
Mr Donald R Magarey

The full-time director is Mr Colin Sayer.

The Committee's office is at the office of:

National Companies and Securities Commission  
17th Floor  
31 Queen Street  
MELBOURNE VIC 3000

GPO Box 5179AA, Melbourne 3001

Telephone: (03) 616 1811

Telex: 37764

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**General Aims of the Committee**

To develop improvements of substance and form in such parts of companies and securities law as are referred to the Committee by the Ministerial Council and for that purpose to develop proposals for laws:

- \* which are practical in the field of company law and securities regulation;
- \* which facilitate, consistently with the public interest, the activities of persons who operate companies, invest in companies or deal with companies and of persons who have dealings in securities; and
- \* which do not increase regulation beyond the level needed for the proper protection of persons who have dealings with companies or in relation to securities.

In the identification of defects and the development of proposals to have regard to the need for appropriate consultation with interested persons, organisations and governments.

### **The Reference from the Ministerial Council**

The Ministerial Council for Companies and Securities has referred to the Committee "for inquiry and review the following questions relating to directors and officers of companies:

(a) standards relating to their conduct and performance".

### **The Scope of this Paper**

This Discussion Paper deals with the possible need for amendment of the Companies Act 1981 (Cth) sections 237 and 535.

Section 237 invalidates provisions in articles of association or contracts which exclude liability of directors and others for breach of duty in relation to a company. It poses difficult questions as to its interpretation and as to its effect.<sup>(1)</sup>

Section 535 is a cognate provision which ameliorates the effect of section 237 by giving courts power to relieve directors and others from liability in certain circumstances.

Both sections are acknowledged to have obscurities which call for legislative attention. Those obscurities will be referred to later. Consideration of reform of section 237 and section 535 requires reference to the duty of care and diligence of a director at common law and under section 229(2). This paper is concerned with conduct of directors, officers and employees that is negligent but not dishonest.

Legislation in North America on indemnification of directors and officers may prompt a reconsideration of section 237's wide ban on indemnification.

*(1) A provision in the United Kingdom's Companies Act 1985 section 310 in like terms has been described as giving rise to similar difficulties in the discussion paper of the Law Society's Standing Committee on Company Law concerning Section 310 Companies Act 1985 of July 1986.*

Some of the problems encountered with section 237 are related to insurance in respect of loss caused by a breach of the duty of care and diligence on the part of directors and officers.

Section 237 deals with the liability of not only directors and employees of a company but also that of auditors and certain other independent persons. In this enquiry the Committee is concerned with the liability of directors and employees only. The Committee distinguishes between the liability of participants in the enterprise and the liability of independent professional persons. The questions raised in this paper may not be appropriate for those professional persons. So far as the liability of auditors is concerned the Committee addressed the operation of section 237 in relation to auditors in its Report on the Civil Liability of Company Auditors (September 1986).

The paper does not canvass generally the formulation of duties of directors, officers and employees. The Committee is proceeding on the basis that, in general, questions of indemnification and relief can be dealt with as a distinct issue.

The paper deals not only with questions of law but also some matters of insurance practice. The Committee will need additional information to be provided in responses to the paper when making its recommendations. Accordingly, intending respondents are asked to provide any information that they consider relevant to the scope of the paper and to assist the Committee in making its recommendations. See in particular Chapter 6, Issues 19 and 20.

### **Responses Invited**

The Committee invites written submissions on the matters dealt with in this discussion paper.

The Committee will assume that it is free to publish any submission, in whole or in part, unless the respondent indicates that the submission is confidential. All respondents will, in any event, be listed in any report made by the Committee to the Ministerial Council.

Submissions should be sent to:

Companies and Securities Law Review Committee  
GPO Box 5179AA  
MELBOURNE VIC 3001

by 7 July 1989.

## CHAPTER 1 THE DUTIES OF DIRECTORS WITH WHICH SECTION 237 IS CONCERNED

### Introduction

[1] The Companies Act 1981 (Cth) section 237 declares void any provision in the articles of a company or in a contract that mitigates the liability of certain persons connected with a company for any wrongful act on their part in relation to the company. Section 237 is as follows:

'237(1) Any provision, whether contained in the articles or in a contract with a company or otherwise, for exempting any officer or auditor of the company from, or indemnifying him against, any liability that by law would otherwise attach to him 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.

(2) Notwithstanding anything in this section, a company may, pursuant to its articles or otherwise, indemnify an officer or auditor against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted or in connection with any application in relation to any such proceedings in which relief is under this Act granted to him by the Court.

(3) Sub-section (1) does not apply in relation to a contract of insurance, not being a contract of insurance the premiums in respect of which are paid by the company or by a related corporation.

(4) For the purposes of this section, "officer", in relation to a company, means:

(a) a director, secretary, executive officer or employee of the company;

(b) a receiver, or receiver and manager, of property of the company;

(c) an official manager or deputy official manager of the company;

(d) a liquidator of the company; and

(e) a trustee or other person administering a compromise or arrangement made between the company and another person or other persons.'

[2] Section 237(1) modifies the common law. At common law a provision in a legal instrument exempting a person from liability for loss caused by his negligent but honest act can be effective. However, liability for dishonesty cannot be excluded in that way. A provision excluding liability for loss caused by want of care might be found in many forms of contract. Examples are contracts of bailment and contracts of carriage of persons. The freedom to include wide exclusion clauses in contracts has been reduced by legislation.<sup>(2)</sup>

[3] Section 237 is concerned with exclusion of liability in the relationship between a company and various persons who act for it. That relationship is similar to the relationship between principal and agent.

[4] At common law an agent is entitled to be indemnified by his principal against losses and liabilities incurred by the agent in good faith in the execution of the agent's authority.<sup>(3)</sup>

[5] But an agent is not as a matter of general law entitled to indemnity from the principal against loss arising from the agent's negligence.<sup>(4)</sup> Indeed, at common law, the contract of employment between an employer and an

(2) *E.g. Trade Practices Act 1974 (Cth) ss 68, 68A Motor Vehicles (Third Party Insurance) Act 1942 (NSW) s 19(2).*

(3) *Bowstead on Agency 15th ed 1985 page 246; Re Famatina Development Corporation Ltd [1914] 2 Ch 271.*

(4) *Bowstead on Agency page 252; Thacker v Hardy (1878) 4 QBD 685, 687 per Lindley J (as he then was).*

employee contains an implied warranty by the employee that he will exercise reasonable care and skill in the performance of his duties. In effect, the employee is liable to indemnify the employer against loss caused by the employee's negligence.<sup>(4)</sup>

[6] But in New South Wales the employer's right to that indemnity has been taken away by legislation because it has been thought more appropriate that the enterprise, rather than the negligent employee, should bear the burden of negligence causing harm to third persons where that negligence is in the course of the employment.<sup>(6)</sup>

[7] At common law there is no prohibition on the principal and the agent making a bargain that any loss caused by the agent's honest but negligent behaviour will be borne by the principal.

[8] Earlier in this century it became common to include in the articles of association a provision indemnifying directors in respect of costs, losses and expenses incurred by them in or about the discharge of their respective duties 'except such as may happen from their own respective wilful or wrongful act or default'.<sup>(7)</sup> Such provisions posed questions as to the

(5) *Lister v Romford Ice and Cold Storage Co Ltd* [1957] AC 555..

(6) *Employee's Liability (Indemnification of Employer) Act 1982 (NSW) s2(3):*

'Where:

(a) a person suffers damage as a result of the fault of an employee; and

(b) but for this Act, the employee would be liable to indemnify the employer against whom proceedings for damages may be taken as a result of the fault against any liability of the employer arising out of those proceedings,

the employee is not so liable, whether the cause of action against the employer arose before, or arises after, the commencement of this Act.' *McGrath v Fairfield Municipal Council* (1985) 59 ALR 19.

"Employee" is not defined. It seems that it could include executives.

(7) For example, *Re City of London Insurance Company Limited* (1925) 41 TLR 521.



meaning of the expression 'wilful default'.<sup>(8)</sup> In some companies articles were more explicit and exempted directors from liability so long as they were not dishonest.

[9] Section 237 invalidates such provisions. Before embarking on a detailed examination of section 237 it is necessary to note the duties owed by a director, officer or employee with which section 237 is concerned.

[10] This paper is concerned only with persons who are part of the corporate enterprise : directors, officers and employees. The paper will refer to those three categories. The meaning of 'officer' used in this paper is narrower than the definition in section 237(4). It excludes the persons covered by items (b) to (e) of the definition and distinguishes between officers and employees. In this paper 'officer' refers to executive officers and the company secretary.

[11] In the context of indemnification by a company of its directors, officers and employees and their duties it is necessary to consider:

- \* their personal liability to third persons when acting for the company;
- \* their liability to the company for indirectly causing loss to the company by their wrongs to third persons which make the company vicariously liable to the third persons; and
- \* their liability to the company for directly causing loss to the company.

(8) *For example, Gould v The Mount Oxide Mines Limited (1916)*  
22 CLR 490

**The duties of directors, officers and employees which, when broken, cannot be excused because of section 237.**

[12] Section 237 refers to 'negligence, default, breach of duty or breach of trust'.

[13] Those words are all embracing. The word 'negligence' today conjures

up thoughts of the common law duty of care of the kind established by *Donoghue v Stevenson* [1932] AC 562, breach of which can lead to liability to pay common law damages. When 'negligence' is understood in that sense, section 237 could, for example, invalidate a provision indemnifying an employee against liability to pay common law damages for the tort of negligence. There is a conflict between the policy of section 237 in its application to employees (in the broad sense of executives and other employees) and the policy of the legislation referred to in note 6 above.

[14] It could also invalidate a provision in a contract of employment between the company and a director, officer or employee against liability for negligence when using company equipment. If section 237 can apply to a contract of insurance entered into by a company (a question considered later), section 237 would invalidate a provision indemnifying a director, officer or employee against liability for negligence when, say, driving a company vehicle.

[15] But 'negligence' was used before *Donoghue v Stevenson* in relation to company directors to refer to failure to perform the equitable fiduciary duty of acting up to a required degree of care and diligence in the conduct of a company's affairs. As long ago as 1906 the Reid Committee recommended for the United Kingdom<sup>(9)</sup> a provision from which section 535 is derived. The Committee referred to "an action for negligence or breach of trust". The liability in equity of a fiduciary for 'negligence' was not a liability to pay common law damages but to pay equitable compensation. Equitable

compensation has differed from damages.<sup>(10)</sup> The liability to pay equitable compensation is not affected by considerations of causation, foreseeability or remoteness such as in liability for damages in contract or tort.<sup>(11)</sup>

(9) See later paras [ 94 ] and [ 95 ].

[16] When 'negligence' in section 237 is read in that sense, section 237 invalidates provisions indemnifying a director, officer or employee against liability for breach of the fiduciary duty of care and diligence. There is a question whether the legislation should indicate more clearly what is meant by 'negligence'.

[17] The meaning of the word 'default' can be seen by reference to the legislative history of the related provision in section 535. The word 'default' was introduced into the United Kingdom equivalent of section 535 in 1929 at the same time as the United Kingdom Companies Act was amended by the introduction of new provisions creating offences by directors. In *Customs and Excise Commissioners v Hedon Alpha Ltd* [1981] 2 All ER 697 it was considered that the insertion of the word 'default' allowed the Court to relieve a director in respect of a liability to perform a statutory obligation.<sup>(12)</sup>

[18] The expression 'breach of duty' can be taken as referring to the duties owed to the company both under case law and under statute. 'Breach of trust' is consistent with the treatment of directors as fiduciaries and as

(10) *Davidson, I. E., 'The Equitable Remedy of Compensation'* (1982) 13 MULR 349 at 352-3.

(11) *Re Dawson* [1966] 2 NSW 211 per Street J at 215,6: '[A defaulting] trustee is liable to place the trust estate in the same position as it would have been in if no breach had been committed. Considerations of causation, foreseeability and remoteness do not readily enter into the matter .... [T]he obligation to make restitution, which courts of equity have from very early times imposed on defaulting trustees and other fiduciaries is of more absolute nature than the common law obligation to pay damages for tort or breach of contract.'

(12) See para [ 102 ].

being comparable with trustees so attracting case law about duties in regard to company property. The duties referred to will now be considered.

### **Non-statutory duties of directors to companies**

[19] Broadly speaking, a director's duties to the company which were developed in equity are two-fold: (1) to act in good faith; and (2) to act with a required degree of care and diligence. This paper is primarily concerned with the duty of care and diligence, since most, but not all<sup>(13)</sup> of the content of the duty to act in good faith, being a requirement of honesty, could not be excluded by provision in the articles or otherwise, even if section 237 did not exist.

[20] At the beginning of the 20th century the standard of care and diligence required of a director of a commercial company would not have been accurately expressed by saying that he was bound to take the care which an objectively reasonable person would take in the circumstances. At that time a non-executive director would be liable for loss caused by his want of care or diligence only where that deficiency amounted to, at least, gross negligence. There had to be some moral obloquy evidenced by recklessness or gross negligence.<sup>(14)</sup>

*(13) The fiduciary duty to act in good faith would be broken not only where there is dishonesty involving moral turpitude but also where a fiduciary power is used for a purpose outside the purposes contemplated when the power was conferred. There would then be a breach regardless of whether the fiduciary had a dishonest intention. Insofar as section 237 prevents exclusion of liability for breach of duty it extends to attempts to exclude liability for innocent misuse of a fiduciary power.*

*(14) Lagunas Nitrate Co v Lagunas Syndicate [1899] 2 Ch 392 at 435. '...it is plain that directors are not liable for all the mistakes they may make, although if they had taken more care they might have avoided them ... Their negligence must be not the omission to take all possible care; it must be more blamable than that: it must be in a business sense culpable or gross'. Although it has been said that 'gross negligence' is the same thing as 'negligence' with the addition of a vituperative epithet (Wilson v Brett (1843) 11 M & W 113 at 115-6 per Rolfe B) the adjective can serve a useful purpose when it is necessary to think in terms of a scale of culpability consisting of degrees of care. For example, the common law crime of manslaughter in driving a car consisted in driving with*



[21] That was a more lenient standard of care than the standard applicable to a person who contracted to serve another in a recognised calling or trade. Such a person would be deemed to have warranted that he would take reasonable care. The standard against which his efforts would be measured would be that of a reasonably competent practitioner in that calling or trade, as deposed to by experts drawn from the same calling or trader

[22] One of the reasons for the lower standard applicable to a director may lie in the theory that a company is an association of members who elect persons, usually fellow members, who have volunteered to assume the task of seeing that the association's purposes are carried out. Under that view of a company, directors elected from the membership may be seen to be doing a service to other members rather than being outsiders hired in the way that contractors and employees are hired. Now although the theory that a company is an association of members and that the directors are persons prevailed upon by their fellow members to assume burdensome office may be reflected in the legislation, it is departed from in practice in commercial companies with a large membership. In such companies the promoters assemble a board by invitation from among people the promoters believe to be suitable. The board co-opts persons thought satisfactory to fill casual vacancies. Appointees to casual vacancies hold office until the next annual general meeting when they come up for election by members. The concept of an association choosing from its members persons willing to assume special burdens is so far departed from that in many companies directors are not

*gross or reckless negligence. 'Ordinary negligence does not make a man liable for manslaughter. No one has been able to define where the dividing line is to be drawn, but every one agrees that it requires a high degree of negligence to make the offence manslaughter.'*- *Tinline v White Cross Insurance Association Limited [1921] 3 KB 327 at 330 per Bailhache J. See also Crimes Act 1958 (Vic) section 318 defining the statutory offence of culpable driving of a vehicle by reference to (inter alia) driving 'negligently, that is to say, if he fails unjustifiably and to a gross degree to observe the standard of care which a reasonable man would have observed in all the circumstances of the case'.*

required to be members.<sup>(15)</sup> The Committee is not concerned to make any judgment about that way of constituting public company boards; the Committee's point is that there is a distinction between the mode of selection in listed companies as against other companies.

[23] The legal model of a board of directors elected by the members from the membership persists in many non-commercial companies formed for some purpose other than direct pecuniary gain to the members. In such a company the board of directors may be little different from a group of unpaid volunteers rather like the committee of an unincorporated association. It is not unrealistic to contemplate a person becoming a director of such a non-commercial company on terms that the members accept that person with all such faults and failings as he might possess. There is a question whether the legal obligations of an unremunerated director of such a company should not be put more highly than that he promises to be honest and not to be reckless or grossly negligent in handling the affairs of the company. Another approach would be to allow that standard, instead of the standard of reasonable care, to apply where a special contract had been made between the appointee and the company with the approval of the company in general meeting.

[24] Reverting to commercial companies, it has been widely assumed that the question of standards for directors cannot be answered by treating the directing of companies as an established calling such that the law could refer to a model of the reasonable company director and apply an objective test of reasonable skill, care and diligence.

*(15) Directors to fill vacancies are recruited by a variety of methods. The Korn/Ferry International/AGSM study for 1988 identifies the following methods and in respect of 28 public listed companies notes the following percentage of directors identified by each method:*

<i>By a standing board sub-committee</i>	<i>3 per cent</i>
<i>By an ad hoc committee</i>	<i>7 per cent</i>
<i>By informal input from Chairman/Directors</i>	<i>36 per cent</i>
<i>By executive search</i>	<i>11 per cent</i>
<i>Resulting from take-over/merger</i>	<i>18 per cent</i>
<i>By recommendation of major shareholder</i>	<i>25 per cent</i>

[25] The classic statement as to the legal standards for directors is that of Romer J in *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 at 427. Although uttered many years ago, his words provide a useful basis for discussion:

'In discharging the duties of his position thus ascertained a director must, of course, act honestly: but he must also exercise some degree of both skill and diligence. To the question of what is the particular degree of skill and diligence required of him, the authorities do not, I think, give any very clear answer. It has been laid down that so long as a director acts honestly he cannot be made responsible in damages unless guilty of gross or culpable negligence in a business sense. But as pointed out by Neville J in *In re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425, 427, one cannot say whether a man has been guilty of negligence, gross or otherwise, unless one can determine what is the extent of the duty which he is alleged to have neglected. For myself, I confess to feeling some difficulty in understanding the difference between negligence and gross negligence, except in so far as the expressions are used for the purpose of drawing a distinction between the duty that is owed in one case and the duty that is owed in another. If two men owe the same duty to a third person, and neglect to perform that duty, they are both guilty of negligence, and it is not altogether easy to understand how one can be guilty of gross negligence and the other of negligence only. But if it be said that of the two men one is only liable to a third person for gross negligence, and the other is liable for mere negligence, this, I think, means no more than that the duties of the two men are different. The one owes a duty to take a greater degree of care than does the other: see the observations of Willes J in *Grill v General Iron Screw Collier Co* (1866) LR 1CP 600, 612. If, therefore, a director is only liable for gross or culpable negligence, this means that he does not owe a duty to his company to take all possible care. It is some degree of care less than that. The care that he is bound to take has been described by Neville J in the case referred to above as "reasonable care" to be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf. In saying this Neville J was only following what was

laid down in *Overend & Gurney v Gibb* (1872) LR 5 HL 480, 486 as being the proper test to apply, namely:

"Whether or not the directors exceeded the powers entrusted to them, or whether if they did not so exceed their powers they were cognisant of circumstances of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into?"

There are, in addition, one or two other general propositions that seem to be warranted by the reported cases:

(1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. A director of a life insurance company, for instance, does not guarantee that he has the skill of an actuary or of a physician. In the words of Lindley M.R.: "If directors act within their powers, if they act with such care as is reasonably to be expected from them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company": see *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392, 535. It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment:

(2) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.

(3) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for

suspicion, justified in trusting that official to perform such duties honestly.'

**Non-statutory duties of officers and employees**

[26] The main non-statutory duty of an officer or other employee is the implied contractual duty to act with the care and skill that a reasonably competent occupant of the employee's position would bring to the job. In some circumstances an officer or employee could be in a fiduciary relationship to the company so as to owe duties of good faith. This paper is not concerned with the duty to act honestly in the narrow sense: that is, to refrain from fraudulent behaviour.

**Statutory statement of the duty of care and diligence owed by directors and officers: section 229(2)**

[27] The Companies Act 1981 (Cth) in section 229(2) provides:

'An officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his powers and the discharge of his duties.'

The expression 'officer' is defined in section 229(5) so as to include (among others)

'a director, secretary or executive officer of the corporation'.

Under section 5(1) 'executive officer' means:

'any person, by whatever name called and whether or not he is a director of the corporation, who is concerned, or takes part, in the management of the corporation;'

[28] There has been no clear indication that this provision changes the standard of care to be achieved by officers. Just as the common law standard has had to operate without there being a recognised calling of company directors so this provision is subject to the same impediment.

Hence it seems that in assessing a director's performance attention would have to be given to his own training and experience rather than some objective standard unless it can now be said that there is a recognised calling of company director. That is considered later.

[29] In relation to an earlier provision, section 107 of the Companies Act 1958 (Vie) which provided that '[A] director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office', the Victorian Full Court took the measure to be a legislative restatement of the common law as expounded by Romer J in *Re City Equitable Fire Insurance Co* [1925] Ch 407.

[30] Insofar as Romer J seemed to accept that the degree of negligence laid down in earlier cases as being necessary to make a director liable was gross negligence, it may be that section 107 required a similar degree of negligence. It may be also that section 229(2) requires proof of gross negligence.

#### **Liability for errors of business judgment**

[31] In considering liability for conducting a business enterprise it is necessary to notice the special position of errors of business judgment.

[32] A director's conduct unintentionally causing loss to a company can take various forms. Where loss is caused by neglect of duties, in the sense of abandonment of functions, the shortcoming is evident. Where loss is caused by making the wrong decision and the defect in the decision is one readily apparent to any observer, whether skilled in business or not, there is no problem in imposing liability for going wrong. Another decision may lead to loss and the defect in the decision may not be readily seen by a lay observer. Where loss is caused by persons exercising esoteric skills and the skills are those of a recognised calling, the question whether the person concerned should be liable for the loss is resolved by determining whether the loss-causing decision could have been taken by a reasonably competent practitioner in the particular calling. To aid the tribunal of fact in making that determination evidence will be taken from experts who

are cognisant of acceptable practice in the particular calling. Before that can be done the calling must be one whose practitioners share an interest in a discrete body of theoretical and practical knowledge.

[33] In the directing of companies by a board there are some functions that are common to all companies. An article in the Australian Director<sup>(16)</sup> contains a recent statement of perceived common functions by the British Institute of Directors:

(1) Setting the company's objectives and its strategy for achieving them by establishing the right balance between the interests of shareholders, employees, customers, suppliers and the community.

(2) Approving and taking responsibility for the plans for achieving the agreed objectives, and controlling the company's progress towards them and ensuring a commitment to legal and ethical business behaviour.

(3) Ensuring that the necessary organisation and human resources are available to implement the plans.

(4) Ensuring that the company has adequate information systems to monitor progress and performance.

(5) Accounting for the company's performance to those to whom any account is due.

(6) Performing certain executive tasks, for which only the board can be responsible.

[34] But such is the diversity of business activity that rules cannot be laid down as to the way a board should go in making a decision on many matters of business judgment: a decision to site a plant in a particular place; a decision to acquire an interest in another company. There may even be no consensus as to the six functions referred to above.

(16) *May/June 1988 page 58*

[35] One can ask whether the directors concerned exercised an active discretion; whether they informed themselves, allowing for time constraints and the level of risk in the company's disclosed activities; whether they were influenced by a conflict of interest and duty or an extraneous loyalty to someone outside the company. But there can be no review of the decision provided that it is one that a reasonable board of directors could have made.

[36] In the U.S.A. the American Law Institute in its Principles of Corporate Governance and Structure: Restatement and Recommendations (1982) page 143 noted the existence in American law of a 'business judgment' gloss on the director's duty of care and diligence which had been developed by the courts 'because of a desire to protect honest directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and because of a desire to refrain from stifling innovation and venturesome business activity.'

[37] The American Law Institute drafted a re-stating provision which qualifies the duty of care:

'A corporate director or officer shall not be subject to liability under the duty of care standards ... with respect to the consequences of a business judgment if he:

(1) informed himself and made reasonable inquiry with respect to the business judgment;

(2) acted in good faith and without a disabling conflict of interest; and

(3) had a rational basis for the business judgment.'

**Is there now a recognised calling of being a director of a public company?**

[38] Many of the problems associated with liability for errors of business judgment would be met if there now existed a recognised calling of being a director of a public company.

[39] For a calling to be significant in law there must be a body of special knowledge professed by members of that calling. Knowledge about management of companies in which ownership is separated from management is now the subject of formal study in business management courses. However, it is the Committee's understanding that there are differences of view as between different business schools and as between different countries as to the appropriate theories of management and as to emphasis.

[40] Even though management has become a subject of formal study, it may be doubted whether there is yet a concept of the reasonably competent company director comparable with the concept of, say, the reasonably competent surgeon. The hypothetical reasonably competent surgeon is a construct of opinions of representative members of the profession giving their views of what should have been done in a particular situation. The work of surgeons involves both routine processes and the making of decisions. If litigation ensues after a surgeon has made a decision, the court may have to decide whether in making the decision the surgeon was guilty of a want of care. The court will be assisted by evidence of expert surgeons as to what decision should have been made. There may be cases where the decision could have gone either way and, in the circumstances, either decision would have been the right one. For many cases, however, there will be a recognised right way which should have been followed.

[41] In the directing of public companies it cannot yet be assumed that all directors on a board will share a common body of special knowledge about directing companies that corresponds to the knowledge shared by members of a profession. It may suit a company to have on its board persons with different professional backgrounds and with varied experience. The reason for recruiting a director may lie in his specialised knowledge which he is expected to bring to bear in the deliberations of the board and in the reaching of collegiate decisions. Hence, it remains true as Romer J said in the City Equitable case that in assessing the performance of a director as to whether he acted with the necessary degree of care and diligence his knowledge and experience are to be taken into account.

[42] But even though an entirely objective test of care and diligence is not feasible, there are certain aspects of the process of directing a commercial company's fortunes that are common to all boards.

[43] In this Committee's report on Nominee Directors and Alternate Directors it was recommended that the legislation should state a duty of a director to exercise an active discretion.<sup>(17)</sup>

[44] Later in this paper<sup>(18)</sup> there will be consideration of whether legislation should provide that directors are not to be held liable for a mistaken business judgment in certain circumstances. Rather than state a positive duty to be informed, an alternative approach may be to withhold the benefit of a business judgment rule from a director who has failed to inform himself.

[45] Consideration needs to be given to whether there should be any legal requirement as to how a person should prepare to become a company director. Nowadays there may be more specific expectations in the community as to the matters on which would-be directors should be informed than those stated by Mr Justice Romer in 1925 in *Re City Equitable Fire Insurance Co Ltd* (see para [25]). In 1959 Sir Douglas Menzies of the High Court of Australia, speaking extra-judicially, referred to the example of a director of a life insurance company used by Mr Justice Romer. Sir Douglas acknowledged that it was still the case that such a director did not guarantee that he had the skill of an actuary or of a physician, but even so,

'[I]t can properly be demanded that he should have or obtain at least a general understanding of the business of life assurance, that he should know or learn something about the investment of large sums of money in a changing economy, that he should concern himself with important staff problems and that he should bring an informed and

(17) *Report No 8, 2 March 1989, para [ 91 ]*.

(18) *Para [ 112 ]*.

independent judgment to bear upon the various matters that come to the board for decision. Any life insurance company appointing a director would expect all this of him; any person accepting office as director would expect to do as much and ... what is expected is the best indication of the content of the duty of care that rests upon an office holder.'<sup>(19)</sup>

[46] It is noteworthy that The Company Directors' Association of Australia sponsors a Company Directors' course in association with the University of New England. The contents of the course are:

Company Law - with special reference to:

- \* the structure of companies
- \* directors' duties
- \* the regulatory authorities
- \* stock exchange regulations and requirements
- \* securities industry legislation
- \* takeovers
- \* meetings

Relevant contract law, trade practices law, income tax law  
Financial and accounting knowledge  
Corporate Planning  
The Company's Human Resources  
Wider Aspects of Company Direction

[47] Obviously, the directing of companies calls for business skills and aptitudes not all of which can be acquired by formal study, But there is a question whether there should be a legal requirement that before being eligible for appointment as a director a person shall either:

(a) have participated to a significant level in a course of study designed to inform about basic responsibilities involved in directing a company, or

(19) (1959) 33 *Australian Law Journal* 156 at 163.

(b) be a member of a professional body which sets standards for the directing of companies.

[48] The mischief to be guarded against is that funds will be raised from the investing public by persons ignorant of their responsibilities. Accordingly, it may be that any requirement of participation in a course should not apply to directors of proprietary companies.

[49] The problem of absence of an objective reasonably competent director as a standard is not mirrored in the liability of some other persons referred to in section 237. Receivers, administrators of schemes of arrangement, professional liquidators, auditors and employees of the company would be subjected to the test of the standard drawn from their profession in relation to many of their judgments.

[50] Having examined the question of legal standards for directing companies, detailed consideration can now be given to section 237.

## CHAPTER 2 STATUTORY LIMITS ON INDEMNIFICATION

### ANALYSIS OF SECTION 237

[51] Section 237 is derived from United Kingdom legislation which was passed after the Greene Committee in 1926 expressed disquiet about provisions in articles which sought to relieve directors from liability for all but dishonesty. The text of section 237 is set out in para [ 1 ].

#### **The recommendations of the Greene Committee that led to provisions like section 237**

[52] The Greene Committee said in its report (Cmd 2657 paras 46-7):

'We consider 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. The evidence satisfies us that in the great majority of companies in this country directors conscientiously endeavour to do their duty. The public interest excited when exceptions are brought to light is perhaps the best proof of their rarity. But the position is one which in our opinion calls for an alteration of the law. 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. We are satisfied that such an enactment would not cause any hardship to a conscientious director or make his position more onerous and, in our view, there is no foundation whatever for the suggestion that it would discourage many otherwise desirable persons from accepting office. A director who accepts office does not do so upon the footing that he may be as negligent as he pleases without incurring liability. It is only when he has been negligent and the company have suffered a loss, that he is content to take shelter behind the article. It is, moreover, in our opinion fallacious to say that the shareholders must be taken to have agreed

that their directors should be placed in this remarkable position. The articles are drafted on the instructions of those concerned in the formation of the company, and it is obviously a matter of great difficulty and delicacy for shareholders to attempt to alter such an article as that under consideration.

On the other hand it has been forcibly brought to our notice that under the modern conditions of company administration it is in many cases quite impossible for every director to have an intimate knowledge of or to exercise more than a quite general supervision over the company's business. Moreover, it often happens that a director is appointed owing to some special knowledge of a particular branch or aspect of the company's affairs or because he is in a position to obtain business for the company. It is not to be expected that such a director should be bound to have so close an acquaintance with the general business of the company as other members of the board. We are of opinion that the general law of negligence is sufficient to deal with such a case but in order to remove any possible hardship we recommend that the Court in exercising its power to grant relief should give attention to considerations of the nature indicated.'<sup>(20)</sup>

[53] The Greene Committee then recommended

'that any contract or provision (whether contained in the company's articles or otherwise) whereby a director, manager or other officer is to be excused from or indemnified against his liability under the general law for negligence or breach of duty or breach of trust should be declared void. This should extend to contracts or provisions existing at the date when the amending Act comes into force, but as regards such contracts or provisions it should not take effect until (say) six months from that date.'

(20) See later, para [98].

It is noteworthy that the Greene Committee made its recommendation without any reference to insurance against liability.

**The persons with whose liability section 237 is concerned**

[54] Section 237 invalidates provisions excluding liability on the part of only certain persons related to a company. They include persons within the company, not only the directors and executives but also all employees. They also include some persons who are outside the company but who provide services for it such as auditors. Also included are certain persons who may take over property or administration of the company: receivers, receivers and managers, official managers, deputy official managers, administrators of schemes of arrangement and liquidators.

**For whose protection does section 237 invalidate indemnification provisions?**

[55] It is evident from the extract in para [52] above that the Greene Committee was concerned that the company should be protected.

[56] To the extent that the Greene Committee was concerned about the interests of companies the committee did not distinguish between public and private companies. Nor is it apparent that the Greene Committee specially adverted to the interests of non-commercial companies.

**Does section 237 extend to wrongs to persons other than the company?**

[57] This is one of the many obscurities in section 237. It will be noted that the wording of the section follows very closely the recommendation of the Greene Committee although that committee did not purport to draft.

[58] Although the tenor of the Greene Committee's consideration of exculpatory provisions suggests that the committee was concerned only with loss suffered by the company, the terms of the recommendation do not explicitly contain any such limitation. Under section 237 the limitation as to liability is that it must be liability for negligence etc of which the relevant person 'may be guilty in relation to the company'.

[59] Guilt through negligence can be 'in relation to the company' even though it causes loss to a third person; a breach of a duty owed to a third person by an employee of a company can make the company vicariously liable if the breach occurs in the course of the employment.

[60] But it is possible to read section 237 as being impliedly confined to liability in respect of breaches of duty owed to the company. The reference to 'exempting' is consistent with that since, apart from the Legislature or a Court, the only person who can exempt another person from liability is the person in whose favour the liability exists. At first sight the word 'indemnifying' is consistent with the company saving from liability to third persons. But section 237(2) indicates that there can be an indemnity against the costs of defending criminal proceedings. They could be criminal proceedings for a breach of duty in relation to the company. When section 237(1) speaks of 'indemnifying' it can be read as referring to an attempted indemnity against liability to pay a fine. Section 237(2) refers not only to indemnity against costs of criminal proceedings but also costs of civil proceedings. Does this mean that section 237 is also concerned with civil proceedings brought by some one other than the company for breach of a duty owed to them? The answer can be 'no'. It is possible for a member to bring civil proceedings on behalf of the company by way of derivative proceedings to vindicate a right of the company. Section 237(1) can thus be read as being confined to wrongs which represent a breach of duty owed to the company.

[61] It will be noted from the extract from the Greene Committee's report<sup>(21)</sup> that the United Kingdom provision comparable with section 535 empowering the Court to give relief was seen to be related to the legislation the Committee was proposing. The older provision was seen as mitigating the impact of what the Greene Committee proposed. It has been held in the United Kingdom that the equivalent of section 535 did not apply

(21) See para [ 52 ].

to proceedings brought against a director by a third person.<sup>(22)</sup> That provides some support for the view that section 237 is concerned only with liability of a director etc. to the company.

[62] If section 237 is, as suggested, concerned only with breaches of duty as against the company, it means that many other duties imposed by legislation on directors which could give rise to statutory liability to persons other than the company are outside the purview of section 237. A list of some of the liabilities imposed by companies and securities legislation on directors and officers appears in Appendix A. As a matter of statutory interpretation many of those liabilities can be seen to be imposed on directors and officers with the implied legislative intention that the liability should rest with them. But on occasion there is an expression of that intention: see section 556(4). It may be an improvement to the legislation for the intention to be expressed where appropriate in relation to each statutory imposition rather than by relying on section 237.

[63] In addition to the liabilities imposed by companies and securities legislation there are further statutory liabilities in other legislation. They are penal liabilities of a kind in respect of which the director or officer could not be given indemnity. Examples are:

the Environment Protection Act 1970 (Vic)

s 66B making a director or other person who is concerned in management of an offending corporation also guilty of the offence unless he can prove certain defences.

the Mining Act 1973 (NSW)

s 194 making a director, manager, secretary or other officer of an offending corporation also guilty of the offence where the corporation's offence is attributable to his neglect.

[64] There is a view that legislation of this nature, which attaches liabilities on directors for operational matters, often seems to be founded

on a misconception of the role of a director. A director, when acting in that capacity, is involved with fellow directors in collectively directing the overall activities of a company. Where a director becomes involved in operational matters, that is generally in the capacity of an executive, and there is a view that it should often be in that capacity, and not as a director, that legislative liability for operational matters should be attracted.

(22) See para [ 100 ]

**Section 237 affects 'provisions' contained in certain statements of rights.' what are those statements?**

[65] Section 237 applies to 'any provision, whether contained in the articles or in a contract with a company or otherwise'. This raises the question as to what other statement of rights could there be apart from the articles or a contract. The expression 'or otherwise' does not attract any settled canon of statutory interpretation which could assist. According to Windeyer J in *Crowe v Graham* (1969) 121 CLR 375 at 388 the expression should not be read as 'likewise'. See also *Purdom v Dirtmar* [1962] 1 NSWLR 94 following that view. But see Pearce, *Statutory Interpretation in Australia* 2nd ed (1981) para 53 citing other decisions that suggest that similar expressions such as 'other person whatsoever' should be construed as meaning 'other like persons'.

**Could a contract to which the company is not a party be within section 237?**

[66] In section 237 does the expression 'or otherwise' relate to 'contract with a company' so that provisions in contracts with persons other than the company can be caught? Or do the words 'or otherwise' relate to the whole phrase 'contained in the articles or in a contract' so that one looks for something other the articles or a contract with the company as the repository of the offensive provision? On the latter interpretation, section 237's operation in relation to contracts can be confined to contracts made by the company. Accordingly, the other repositories apart from the articles and company contracts would have to be something associated with the company. That would leave untouched a case where a third person indemnifies an officer of a company against liability arising from activity as an officer of a company. Examples in the Australian practice are indemnification of a receiver or receiver and manager by a

private appointor (one other than the Court); indemnification by a parent company of an executive officer or other person appointed as director of a wholly-owned subsidiary; indemnification by the Government of a Government officer appointed to the board of a company that has received Government finance.

[67] The original recommendation of the Greene Committee referred to 'any contract or provision (whether contained in the company's articles or otherwise)'. That formula, unlike the wording in section 237, could be read as limiting the application of the recommendation, so far as contracts are concerned to contracts made by the company. The Greene Committee was also concerned to ensure that provisions in articles were covered. In 1926 the United Kingdom companies legislation had provisions which treated the memorandum and articles as having some of the features of a contract but did not go so far as to deem them to be a contract.<sup>(23)</sup> Hence the proposed legislation would need to cover articles. The terms of the Greene Committee's recommendation suggest the possibility of something other than articles or a company contract as the repository of the indemnifying provision but still something connected with the company.

[68] One such possibility is a resolution of either the company in general meeting or of the board of directors providing that no director etc. should be liable for negligence etc. There is a question to be considered later as to whether section 237 means that the company in general meeting cannot authorise a particular act of a director etc. on terms that he is not to be liable for negligence etc. But, at least, a resolution that provided in general terms that a director etc. should never be liable for any negligence etc. in the future would be void under section 237. In other words, the genus of provisions caught by section 237 would be established by a provision in articles, a necessarily general provision, unrelated to

*(23) Section 14 of the Companies Act 1908 (UK) provided that 'the memorandum and articles shall, when registered, bind the company and members thereof to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member...to observe all the provisions of the memorandum and of the articles, subject to the provisions of this Act.'*

particular transactions.

[69] A further possibility of a statement of rights containing an offending provision could be a scheme of arrangement to which the company is a party: *Re Price Mitchell Pty Ltd* (1984) 9 ACLR 1.

[70] It thus seems possible to read section 237 as being confined to the articles of the company which has sustained the loss, contracts to which that company is a party and other statements of rights made on behalf of that company or to which the company is a party.

[71] Unless section 237 is limited in that way it could operate in ways that could hardly have been intended. For example, if it suited a competent authority to provide for an immunity from proceedings in favour of a director etc. in respect of conduct giving rise to liability for some act in relation to a company, section 237 might invalidate the immunity.

**If section 237, in its application to contracts, is confined to contracts to which the company is a party, which such contracts are comprehended?**

[72] There are many company contracts which are clearly comprehended. The obvious example is a service agreement with a director or executive. So also a contract of employment with any employee is caught. An arrangement with a union by which a company undertook that it would not seek to make employees liable under the implied term of reasonable competence would also be covered.<sup>(24)</sup>

[73] Without including an indemnifying provision in the service agreement a company might recognise that activities of its employees could possibly cause loss to it and the company might seek to cover that loss by taking out insurance against that loss. The company could take the view that the employee was not likely to be able to meet a judgment. The contract of insurance between the company and the insurer would not necessarily indemnify the employee and, if it did not, section 237 would not operate. Probably, the position is that section 237 is concerned with provisions

(24) *Para [ 5 ]*.

which would prevent the company from suing a director, officer or other employee for loss caused to it rather than contracts of the company which save employees from liability to third persons.

[74] As noted earlier, <sup>(25)</sup> although an employee is at common law bound to indemnify his employer against the consequences of the employee's negligent performance of duties, that common law indemnity has fallen out of favour. The legislation in New South Wales abolishing that indemnity (see note 6 above) appears to favour all employees, including executives. In the absence of legislation abolishing the right of indemnity, the employer and the insurer may agree that there is to be no duty on an employee to indemnify. It would be unfortunate if section 237 invalidated that agreement. By the same token, it would be unfortunate if section 237 invalidated a term of a contract of employment which excluded the employer's common law right to indemnity as against the employee.

[75] In another example, the company may sell a business or a subsidiary upon terms that all the liabilities up to the date of settlement shall be the responsibility of the seller and that all liabilities arising after that date shall be the responsibility of the buyer. Each party will often indemnify the other in respect of the liabilities for which it assumes responsibility. That indemnity usually extends to the directors, officers and employees of a corporate seller or buyer. Should section 237 apply to any such contract?

#### **Section 237 and prescription of duties**

[76] To what extent does section 237 reduce the power of framers of articles, contracts and resolutions to formulate duties of directors and officers?

(25) Para [ 5 ].

Even if section 237 does not prevent reduction in respect of common law duties (a matter which is obscure) there are special problems in respect of duties imposed by statute. Where legislation spells out a duty the terms of the legislation may exclude any attempt at reduction by private instrument. But not all legislation imposing duties makes the matter clear. For example, could section 229(1) be read as leaving room for private provision to affect the content of the duty to act 'honestly' so that non-fraudulent action otherwise within section 229(1) would be taken outside it: cf *Marson v Pressbank Pty Ltd* (1987) 12 ACLR 465 at 472. Any attempt to exclude duties in terms allowing fraudulent conduct would be invalid at common law.

[77] The question here posed has been discussed more often in relation to the duty of good faith than the duty of care and diligence. It may be that section 229(2), on proper construction, states an irreducible test of liability for failure to act with care and diligence. But it is not entirely clear that (say) an attempt to establish a special test of causation between act and loss before there can be recovery would be excluded by section 229(2) if it is not excluded by section 237. A private provision purporting to prescribe a shorter time limit for legal proceedings against a director than that provided by the appropriate law on limitation of actions would also raise a question. Is it significant that section 237 is concerned with provisions 'exempting' or 'indemnifying' rather than provisions 'relieving'? Contrast the language of section 535 which also addresses the possibility of partial relief.

[78] So far as the duty of good faith statutorily stated in section 229(1) is concerned, there is tentative authority that articles may narrow down the range of a director's duty of good faith: *Levin v Clark* [1962] NSWLR 686 at 700-1. See also dicta in *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 at 291 70 ALR 251 at 255 related to the duty of good faith in the particular board function of issuing new shares. On the other hand, it has been held in England that the United Kingdom equivalent of section 237 does not allow relaxation of duties: *Motivex Ltd v Bulfeld* (1986) 2 BCC 99, 403. But the Court in that case saw a distinction between a duty and a disability (such as that affecting an officer in a situation of conflict of interest and duty) and considered that the United Kingdom section equivalent to section 237 does not preclude articles removing the disability. That

reasoning would accommodate articles which save from invalidity a transaction between a director and his company. Such articles are not uncommon. If Table A regulation 71 and Table B regulation 55 can be read as impliedly authorising a director to contract with the company, the reasoning of the Motivex case would accommodate that concession. Another view is that the provisions in Table A and Table B may simply be a legislative exception to section 237.(26)

### **Section 237 and the autonomy of the company in general meeting**

[79] Provided a company is not in financial difficulties so that the interests of creditors are at stake, a properly informed general meeting may have power to validate action of a director which would be a breach of duty, at least the duty of good faith: *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666; cf *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722.

[80] Whether that validation could have only civil effects so as not to impede a prosecution under section 229 is not clear.

[81] If post-action ratification is possible, is it also possible for the company in general meeting to act prospectively so as to give authority to do what would otherwise be a breach of duty? This matter is related to the question of reduction of normal duties considered in para [76] with the difference that authority may be sought in respect of a particular transaction rather than a blanket authority such as might be provided by articles. When the question arises in relation to a particular transaction there is scope for providing more specific information to the shareholders who are to vote.

[82] As noted in para [78] prior authority could, depending upon the proper construction of section 229(1), take action that would otherwise be a breach of the duty of good faith out of the section. On that basis prior authority could forestall any prosecution because the action would not

(26) *Cranston, 'Directors' Duties - Indemnity and Ratification' in 'The Modern Company Director', Sydney Law Review Conference (1987) (to be published).*

contravene section 229 whereas post-action ratification would not have that effect.

[83] The role of section 237 in relation to these questions is not at all clear.

#### **Section 237 and contracts of insurance**

[84] The Greene Committee in the passage cited in para [52] above referred to a director obtaining 'quite unjustifiable protection' from a provision in the articles. It said that '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'. But the mischief with which the Greene Committee was concerned can hardly have been the fact that a director could obtain protection. It is more likely that the mischief was loss to the company for which the company could obtain no recovery. It had earlier been accepted in English law that persons could protect themselves against the financial consequences of their own negligence, even if it involved the commission of a criminal act, by taking out insurance. But it would be against public policy to indemnify a person against the similar consequences of a crime committed wilfully and intentionally: *Tinline v. White Cross Insurance Association Limited* [1921] 3 KB 327. See also *James v British General Insurance Co* [1927] 2 KB 311.

[85] In the insurance setting section 237 would be attracted in theory:

(a) if the employment contract purported to exclude the company's right to an indemnity from its employee against any vicarious liability falling on the company as a result of the employee's negligence; or

(b) if the company took out a policy of insurance to insure a director, officer or other employee against his liability to the company for loss caused by his negligence etc. a transaction which the company is not likely to enter because it can insure itself against such a loss.

In practice a company takes out a policy covering its liability which indemnity is expressed to extend to its directors, officers and other employees.

[86] If then a contract of insurance taken out by the company to cover loss that a director, executive or other employee may cause to a third person is not within section 237, what is the force of section 237(3)? Providing:

'(3) Sub-section (1) does not apply in relation to a contract of insurance, not being a contract of insurance the premiums in respect of which are paid by the company or by a related corporation.'

[87] That provision was not in the forerunners to section 237 in earlier Acts. It was first enacted in 1981 in the Companies Act 1981 (Cth). The Explanatory Memoranda to the various versions of the Bill which became the Companies Act 1981 (Cth) do not indicate that what is now section 237(3) was a new provision. It originated as clause 96(3) of the National Companies Bill 1976 (Cth).

[88] It seems a rational explanation of section 237(3) that it was intended to remove any doubt that a director etc. can take out his own insurance against the liabilities referred to. But as seen above there is a strong argument that section 237(1) would never have affected any such contract to which the company was not a party. In the light of that, section 237(3) may be taken to have been enacted in an abundance of caution. There has been so much obscurity in section 237 and its earlier versions that even a well experienced draftsman might think it advisable to underline the fact that a director's own contract of insurance was not intended to be caught. Having gone that far, the draftsman could well consider it necessary to say that the company should not have to pay for any contracts of insurance against liability for breach of duties owed to it. Viewed in that light the latter part of section 237(3) about payment of premiums is really a provision about proper use of company resources.

[89] Section 273(3) could well have created a new insurance market for individual directors' and officers' insurance. The new insurance would not always be as economical as when the company's policy covered the directors

and officers because:

(a) there is a need for separate insurance, and

(b) companies which reduced premium costs by self-insuring for the first part of the risk could not, in practice, do that in relation to individual insurance.

[90] At the time the National Companies Bill was drafted there was some precedent in the Ontario Business Corporations Act 1970 (as it then stood) for adding to the legislation recommended by the Greene Committee a provision about insurance. The provisions of the Ontario Business Corporations Act on indemnification have been changed. The 1970 provisions are reproduced here because they were available when the National Companies Bill was drafted.

'Sec. 147. Indemnification of directors -

(1) Subject to sub-section 2, the by-laws of a corporation may provide that every director and officer of the corporation and his heirs, executors, administrators and other legal personal representatives may from time to time be indemnified and saved harmless by the corporation from and against,

(a) any liability and all costs, charges and expenses that he sustains or incurs in respect of any action, suit or proceeding that is proposed or commenced against him for or in respect of anything done or permitted by him in respect of the execution of the duties of his office; and

(b) all other costs, charges and expenses that he sustains or incurs in respect of the affairs of the corporation.

(2) Idem - No director or officer of a corporation shall be indemnified by the corporation in respect of any liability, costs, charges or expenses that he sustains or incurs in or about any action, suit or other proceeding as a result of which he is adjudged to be in breach of any duty or responsibility imposed upon him under this Act or under any other statute

unless, in an action brought against him in his capacity as director or officer, he has achieved complete or substantial success as a defendant.

(3) Insurance - A corporation may purchase and maintain insurance for the benefit of a director or officer thereof, except insurance against a liability, cost, charge or expense of the director or officer incurred as a result of a contravention of section 144.'<sup>(27)</sup>

[91] If section 237 were to be retained, there may be some who would argue that it should be amended so as to make it clear that it does not invalidate a policy of insurance taken out by a company where the whole of the premium is paid by the company. It is currently possible for a company to increase the remuneration of its directors to enable them to pay the premium on a policy taken out by the directors. That seems to make it pointless for section 237 to prevent the company from taking out a policy and paying the premium itself. Some may argue that it may be more economic for the company to take out the insurance in the first place. For example, the company may be prepared to self-insure for the first part of the risk.

[92] As will be noted later (see para [157]), it is becoming difficult, if not impossible, for individual directors to obtain separate directors' and officers' insurance.

(27) '*Sec. 144. Standards of care, etc. of directors:*

*Every director and officer of a corporation shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the corporation, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.'*

**CHAPTER 3 RELIEF FOR HONEST DIRECTORS : ANALYSIS OF SECTION 535**

[93] Although a blanket exclusion of liability cannot be provided in the articles or a contract, there is provision in section 535 for the Court having a discretion to relieve a director or officer from liability. Section 535 provides:

'535(1) If, in any civil proceeding against a person to whom this section applies for negligence, default, breach of trust or breach of duty in a capacity by virtue of which he is such a person, it appears to the Court before which the proceedings are taken that the person is or may be liable in respect of the negligence, default, or breach but that he has acted honestly and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default or breach, the Court may relieve him either wholly or partly from his liability on such terms as the Court thinks fit.

(2) Where a person to whom this section applies has reason to apprehend that any claim will or might be made against him in respect of any negligence, default, breach of trust or breach of duty in a capacity by virtue of which he is such a person, he may apply to the Court for relief, and the Court has the same power to relieve him as it would have had under sub-section (1) if it had been a Court before which proceedings against the person for negligence, default, breach of trust or breach of duty had been brought.

(3) Where a case to which sub-section (1) applies is being tried by a judge with a jury, the judge after hearing the evidence may, if he is satisfied that the defendant ought pursuant to that sub-section to be relieved either wholly or partly from the liability sought to be enforced against him, withdraw the case in whole or in part from the jury and forthwith direct judgment to be entered for the defendant on such terms as to costs or otherwise as the judge thinks fit and proper.

(4) This section applies to a person who is:

(a) an officer of a corporation;

(b) an auditor of a corporation, whether or not he is an officer of the corporation;

(c) an expert in relation to a matter in relation to which the civil proceeding has been taken or the claim will or might arise; or

(d) a receiver, receiver and manager, liquidator or other person appointed or directed by the Court to carry out any duty under this Act in relation to a corporation.

(5) For the purposes of this section, "officer" in relation to a corporation, means:

(a) a director, secretary, executive officer or employee of the corporation;

(b) a receiver, or receiver and manager, of property of the corporation;

(c) an official manager or deputy official manager of the corporation;

(d) a liquidator of the corporation; and

(e) a trustee or other person administering a compromise or arrangement made between the corporation and another person or other persons.

### **The origin of section 535**

[94] The original United Kingdom legislation<sup>(28)</sup> on which section 535 is based is much older than the provisions from which section 237 is derived. The original provision resulted from a recommendation in 1906 of the Company Law Amendment Committee chaired by Sir Robert Reid (later Lord Loreburn).

[95] The measure was adopted in Australian and New Zealand companies legislation. It has been said of it that the 'width of this section ... undoubtedly presents difficulty in interpretation'<sup>(29)</sup>

Paragraph 24 of the Committee's report (Cmd 3052) was as follows:

'We have already expressed an opinion that the number of companies into the formation or management of which fraud enters is small in comparison with the number of sound undertakings registered and working, under the Acts, and this being so the dishonest director is the exception. We think that nothing could be more unfortunate than that provisions designed for checking or punishing dishonesty or gross negligence should be turned into an engine of oppression for honest and prudent men. Now there are a variety of sections in the Companies Acts which impose upon directors and other persons connected with a company the duty of doing certain acts, making certain disclosures and returns, and furnishing certain information at the risk of incurring a penalty or liability to damages. It would not in our opinion be either safe or wise to diminish these obligations otherwise than, as in this Report suggested, but we do think that it would be both safe and wise to make some amendment in the law which shall prevent such penal provisions from operating unfairly. We therefore recommend that the law be amended:

*(28) Companies Act 1907 (UK) section 32 consolidated in Companies Act 1908 (UK) section 279.*

*(29) Dimond Manufacturing Co Ltd v Hamilton [1969] NZLR 609 at 645 per North P.*

(1) By giving power to the Court to relieve any director or promoter from liability for breach of any duty imposed on him by the Companies Acts, 1862 to 1900, provided that the breach has been occasioned by honest oversight, inadvertence, or error of judgment on his part.

(2) By giving the Court power, in an action for negligence or breach of trust against a director, to relieve him from his liability on such terms as the Court may consider proper, where the Court is satisfied that he has acted honestly and reasonably.

An analogous power, we may point out, has been already given to the Court in the case of trustees by Section 3(1)(a), of the Judicial Trustees Act, 1896.'

[96] The measure enacted was section 32 of the Companies Act 1907:

'32. If in any proceedings against a director of a company for negligence or breach of trust it appears to a court that the director is or may be liable in respect of the negligence or breach of trust, but has acted honestly and reasonably, and ought fairly to be excused for the negligence or breach of trust, the court may relieve him, either wholly or partly, from his liability on such terms as the court may think proper.'

[97] Section 237 and section 535 are related provisions.

[98] The fact that the two sections are related was recognised by the Greene Committee when it recommended the addition to the provision for relief of words which require the Court to take into account the circumstances of the appointment of a director for a special purpose. That provided 'some amelioration'<sup>(30)</sup> for the loss of protection under articles

(30) *Lawson v Mitchell* [1975] VR 579 at 589.

of association or otherwise that the Greene Committee was recommending.<sup>(31)</sup>

[99] There could be merit in re-locating section 535 near section 237 so as to make their relationship more readily apparent.

[100] The fact that they are related assists interpretation of each of them. Thus, it has been held that provisions in the United Kingdom like section 535 apply only to proceedings against a director, officer or employee by, or on behalf of, or for the benefit of his company for breach of his duty as a director, officer or employee.<sup>(32)</sup> The relationship between section 535 with section 237 suggests that section 237 should be limited in the same way.<sup>(33)</sup>

**Has the Court's power extended to authorise relief in criminal proceedings as well as civil proceedings?**

[101] It will be noted that the first recommendation of the Reid Committee extended to giving relief against penalties while the second was about relief in civil proceedings. A bill implementing both recommendations was prepared but the first recommendation was negated by the House of Commons.<sup>(34)</sup>

*(31) The words added by the draftsman were rather cryptic. Curiously, the added words appear to have prevented relief being given to the directors in Re J Franklin & Son Ltd [1937] 4 All ER 43. Crossman J appears (at 47) to have thought that without them relief could more readily have been given.*

*(32) Customs and Excise Commissioners v Hedon Alpha Ltd [1981] 2 All ER 697.*

*(33) See above, para [ 60 ].*

*(34) H.C. Debates 21 August 1907.*

[102] With the introduction into the United Kingdom companies legislation of new penalties for 'defaults' of company officers in 1929 the word 'default' was introduced into the section empowering the Court to give relief. That led Stephenson LJ in *Customs and Excise Commissioners v Hedon Alpha Ltd* [1981] 2 All ER 697 to the view that section 448 of the Companies Act 1948 (UK) authorised relief not only in civil cases but also where a director was in 'default' in the sense of 'a failure to conduct himself properly as a director of the company in discharge of his obligations pursuant to the provisions of the 1948 Act'. Thus in effect the first recommendation of the Reid Committee was ultimately implemented.

[103] Although the interpretation in the United Kingdom led to some criminal proceedings being held to be within the section, the Victorian Full Court in *Lawson v Mitchell* [1975] VR 579 held, after a detailed examination of the legislative history of section 365 of the Companies Act 1961 (Vic), that the section was confined to civil proceedings.

[104] The National Companies Bill that was prepared by the Labour Government in 1974-1975 and which was introduced into the House of Representatives as a private member's Bill in 1976, but not enacted, had in clause 561 a provision empowering the Court in its discretion to give relief. Apparently under the influence of the decision in *Lawson v Mitchell* the provision was limited to civil liability. When the 1981 Act was drafted the provision was limited to civil proceedings.

**The suitability of language applicable to trustees for adoption in a measure about directors**

[105] The legislation that was enacted adopted the language of the Judicial Trustees Act 1896 section 3(1)(a) to provide the criteria by which the Court should be guided. It had to appear to the Court that the director or officer had acted honestly and reasonably and that, having regard to all the circumstances of the case, he ought fairly to be excused for the negligence or breach of trust.

[106] It may be open to question whether it was really appropriate to use statutory language suitable to trustees for application to directors. Unless a trust instrument provides otherwise a trustee is expected to conserve trust property and to invest only in certain low-risk investments. A trustee is not at liberty to use trust property in the conduct of a business unless the trust instrument gives authority to do so. Although there may be companies whose activities require the directors to be no more venturesome than trustees with limited investment powers, such companies are not representative. The ordinary understanding of a commercial company is that of an organisation formed to undertake commercial activity with a view to making profits by activity involving commercial risks. Some undertakings involve a high risk of loss of capital but, provided there has been adequate disclosure, shareholders who subscribe capital to such ventures cannot complain if the directors make decisions within the risks contemplated but nevertheless capital is lost.

[107] However, the legislation on which section 535 is based had the capacity for providing relief for directors who made a bad business decision. There is an instance of this in *Re Claridge's Patent Asphalte Co Ltd* [1921] 1 Ch 543. The facts were that early in 1914 the directors of a company, a company formed for a very specific manufacturing project, caused the company to enter a joint venture outside its objects. The joint venture failed and C company itself went into insolvent liquidation. The liquidator sought recovery from A, a director of a company who, with other directors, had authorised the investment of amounts in the ill-fated joint venture. Astbury J held that, even assuming that the investment was ultra vires the company and a breach of trust by A, relief should be given under the legislative equivalent of what in Australia is section 535. The directors had acted in good faith and reasonably. They had taken the advice of a Chancery barrister that the scheme was not ultra vires and they derived no special personal benefit. It had been argued that because the director was a paid director he was not entitled to relief but that was rejected.

**Section 535 as a business judgement provision?**

[108] It is instructive to consider the Court's reasons in *Re Claridge's Patent Asphalte Co Ltd* in the light of the business judgment rule as seen by the American Law Institute<sup>(35)</sup>;

(i) the director had informed himself and made reasonable inquiry with respect to the business judgment by taking appropriate legal advice;

(2) there was no suggestion of absence of good faith or presence of a conflicting interest; <sup>(36)</sup> and

(3) the director had a rational basis for the business judgment.

It was a decision that could have been arrived at by a reasonable board.

[109] Section 535 is not entirely comparable with the American Law Institute draft of a business judgment rule. Section 535 applies to relieve someone who is first judged to be liable or to be prospectively liable. But both provisions rest on the same basic idea. The original rationale of section 535 as seen by its progenitor, the Reid Committee, was the need to avoid imposing liability on those who acted honestly and reasonably.

[110] There is a question, quite apart from what should happen to section 237, as to whether the Companies Act should state a business judgment rule, so recognising the rationale for limited liability companies as facilitating the taking of risks. At present the business community is not given any assurance in the legislation that such a rule exists even though it may be applied under section 535. The matter is part of the considerable

(35) See para [ 37 ].

(36) It has been consistently held that the discretion to relieve will not be exercised in favour of a director who has benefited from the breach of duty. *Re Lasscock's Nurseries Ltd* [1940] SASR 251; *Permakraft (NZ) Ltd v Nicholson* (1982) 1 ACLC 488 reversed on other grounds (1985) 3 ACLC 453.

uncertainty in the business community as to the scope of liability of directors and officers. That uncertainty translates into expenditure on insurance.

[111] If there should be express recognition in the Companies Act of a business judgment rule, there is an issue as to whether the statement of the business judgment rule should be located as a qualification to section 229(2), stating the duty of care and diligence, or be a supplement to section 535. If included as a qualification of section 229(2) the business judgment rule would prevent liability arising. If included in section 535 it would provide guidance for relieving in respect of a breach of duty that has occurred.

[112] Section 535 might be supplemented by a provision that without affecting the generality of the earlier provisions of section 535 the legislative intention is that a Court shall not hold an officer liable in respect of a matter of business judgment where he has in that matter:

- (1) acted in good faith and without being subject to a conflict of interest or duties;
- (2) exercised an active discretion in the matter;
- (3) taken reasonable steps to inform himself;
- (4) acted with a reasonable degree of care in the circumstances including:
  - (a) any special skill, knowledge or acumen he possesses; and
  - (b) the degree of risk involved.

[113] That possible supplement to section 535 is posed for the purposes of showing an example of what could be done rather than what the Committee firmly proposes.

**The abandonment in the Companies Act 1981 (Cth) of the condition of relief that the director appears to have acted 'reasonably'.**

[114] In a passing comment in *Dimond Manufacturing Co Ltd v Hamilton* [1969] NZLR 609 at 645 Sir Alfred North P of the New Zealand Court of Appeal said of section 468 of the Companies Act 1955 (N.Z), the provision empowering the Court to give relief:

"It is difficult to understand how a negligent officer or auditor could nevertheless be held to have acted 'reasonably' but there it is, for the section undoubtedly recognises in some circumstances an auditor or other officer of the company though guilty of negligence may be held nevertheless to have acted reasonably."

[115] Although the Macarthur Committee recommended<sup>(37)</sup> against amendment, the Australian 1981 legislation removed the difficulty by abandoning the need for it to appear that the director had acted reasonably. The resulting width of section 535 may be thought to provide another reason why the section should be supplemented by some guideline provisions about business judgments.

*(37) Final Report of the Special Committee to Review the Companies Act (1973) para 532-535.*

## **CHAPTER 4 INDEMNIFICATION AND LIMITATION OF LIABILITY IN OTHER JURISDICTIONS**

[116] In some other jurisdictions there are legislative provisions quite different from section 237. Some appear to adopt the idea of indemnification by the enterprise.

### **Indemnification by the enterprise**

[117] As noted earlier the original common law concept of an employee's liability to indemnify the employer against loss caused by the employee's negligent performance of his duties has been replaced in New South Wales by legislation which denies the employer a right of indemnity from the employee. The implicit theory is that the enterprise rather than the employee should bear the loss caused by negligence connected with the employment. That theory owes something to the existence of insurance and the belief that the company is in the best position to spread the loss by taking out appropriate insurance. The cost of the premiums is an expense of the enterprise ultimately passed on to the consumer.

[118] There is a question whether that theory of enterprise liability should be extended to all persons who serve the company as directors and officers. Directors are not employees but they are so far identified with it as to be part of the enterprise.

### **Canadian legislation**

[119] Canadian federal legislation about indemnification of directors and officers, in effect, adopted an enterprise theory.

[120] The Canada Business Corporations Act 1975 was enacted with the following provisions:

Section 119. Indemnification of directors

'119. Indemnification.

(1) Except in respect of an action by or on behalf of the corporation or body corporate to procure a judgement in its

favour, a corporation may indemnify a director or officer of the corporation, a former director or officer of the corporation or a person who acts or acted at the corporation's request as a director or officer of a body corporate of which the corporation is or was a shareholder or creditor, and his heirs and legal representatives, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgement, reasonably incurred by him in respect of any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of such corporation or body corporate, if

(a) he acted honestly and in good faith with a view to the best interests of the corporation; and

(b) in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, he had reasonable grounds for believing that his conduct was lawful.

(2) Indemnification in derivative actions. A corporation may with the approval of a court indemnify a person referred to in subsection (1) in respect of an action by or on behalf of the corporation or body corporate to procure a judgement in its favour, to which he is made a party by reason of being or having been a director or an officer of the corporation or body corporate, against all costs, charges and expenses reasonably incurred by him in connection with such action if he fulfills the conditions set out in paragraphs (1)(a) and (b).

(3) Right to indemnify. Notwithstanding anything in this section, a corporation shall indemnify any person referred to in subsection (1) who has been substantially successful in the defence of any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of the corporation or body corporate against all

costs, charges and expenses reasonably incurred by him in respect of such action or proceeding.

(4) Directors' and officers' insurance. A corporation may purchase and maintain insurance for the benefit of any person referred to in this section against any liability incurred by him under paragraph 117(1)(b) in his capacity as a director or officer of the corporation. <sup>(38)</sup>

(5) Application to court. A corporation or a person referred to in subsection (1) may apply to a court for an order approving an indemnity under this section and the court may so order and make any further order it thinks fit.

(6) Notice to Director. An applicant under subsection (5) shall give the Director notice of the application and the Director is entitled to appear and be heard in person or by counsel.

(7) Other notice. Upon an application under subsection (5), the court may order notice to be given to any interested person and such person is entitled to appear and be heard in person or by counsel.'

(38) '117. *Duty of care of directors and officers.*

(1) *Every director and officer of a corporation in exercising his powers and discharging his duties shall*

(a) *act honestly and in good faith with a view to the best interests of the corporation; and*

(b) *exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.*

(2) *Duty to comply. Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholders' agreement.'*

[121] The Canada Business Corporations Act was amended in 1978. New sections 119(3) and (4) were substituted and section 117(3) was added to section 117.

'119(3) Notwithstanding anything in this section, a person referred to in subsection (1) is entitled to indemnity from the corporation in respect of all costs, charges and expenses reasonably incurred by him in the defence of any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of the corporation or a body corporate, if the person seeking indemnity:

(a) was substantially successful on the merits in his defence of the action or proceeding, and

(b) fulfils the conditions set out in paragraphs (1)(a) and (b).

(4) A corporation may purchase and maintain insurance for the benefit of any person referred to in subsection (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.

117(3) Subject to section 140(4), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with the Act or the regulations or relieves him from liability for a breach thereof.'

Section 140(4) relieves directors of their duties while a shareholders' agreement is in operation.

[122] Amendments made in 1982 to Ontario's Business Corporations Act made the Ontario provisions on indemnification and insurance similar to those in the Canada Business Corporations Act. (39)

[123] It will be noted that section 119 of the Canada Business Corporations Act gives the corporation the option of indemnifying its directors and officers. It authorises a corporation to indemnify directors and officers only if they acted honestly. There is no absolute power to indemnify in respect of an action by or on behalf of the corporation. The provision as to approval by a court for indemnity in respect of a company's action prevents abuse in cases where indemnification would, in effect, negate the director's duties to the corporation. It can also fulfill much the same function as section 535 of the Australian legislation but without stating criteria for the court's action.

[124] Even if the corporation does not elect to indemnify its directors and officers as allowed by section 119(1), it is obliged by section 119(3) to indemnify them against the expense of defending proceedings where they are substantially successful on the merits and were honest. That may be contrasted with section 237(2) which gives a company an option to indemnify against costs of successfully defending proceedings.

[125] There can be cases where a company has a board of directors which is divided and a director who has successfully defended may not be able to obtain the approval of a majority of the other directors to authorise indemnity for the defence costs. There is an issue whether section 237(2) should be amended to impose an obligation.

[126] The corporation is authorised to purchase insurance to cover directors' and officers' liability with regard to care, diligence and skill,

*(39) The new provisions are in BCA 1982 (Ont) section 136 corresponding to Canada BCA section 119.*

whether or not the corporation could indemnify the director or officer against liability. This is in contrast to the earlier Ontario legislation noted above which prohibited the purchase of insurance by the company to protect directors and officers in respect of a breach of the duty of care, diligence and skill owed to the corporation. So far as liability to the corporation is concerned, it is only liability relating to failure of the director or officer to act honestly and in good faith with a view to the best interests of the corporation that is excluded from the liability in respect of which the corporation can insure the director.

### **Legislation in United States jurisdictions<sup>(40)</sup>**

#### **Indemnification statutes**

[127] In the United States there are various forms of State indemnification statutes; examples are the Delaware Corporation Act, the California Corporation Act, the New York Corporation Act and the Revised Model Business Corporation Act. Some statutes contain two parts, a mandatory part and a permissive part.

[128] The mandatory part creates an enforceable right; the corporation is obliged to indemnify its directors and officers upon satisfaction of certain statutory prerequisites. The permissive part gives the corporation an option to indemnify its directors and officers if an appropriate body within the corporation, determines that the required statutory standard of conduct has been met. There are some States that have statutes that are entirely permissive.

[129] Mandatory indemnification requires a corporation to indemnify its directors and officers for expenses incurred in successfully defending a lawsuit. The relevant statutes differ in their wording on the degree of success required and whether the success was on the merits or on a procedural matter.

(40) *McKinney, Indemnification (Special Project) (1987) 40 Vanderbilt Law Review 737ff.*

[130] Statutes usually provide for permissive indemnification if the statutorily required standard of conduct for directors and officers has been met. There is a distinction between third party actions and derivative actions. In Delaware, in third party actions, a corporation may indemnify directors and officers if they have acted:

(1) in good faith,

(2) in a manner they reasonably believed to be in or not opposed to the best interests of the corporation, and

(3) in the context of a criminal proceeding, with no reasonable cause to believe their conduct was unlawful.

[131] In respect of a derivative action the same conditions apply and the corporation may not indemnify a director or officer who has been held liable to the corporation, without court approval. A director or officer is eligible for indemnification provided he has not been held liable to the corporation for gross negligence under the duty of care or for breach of the duty of loyalty.

[132] None of the representative statutes authorizes a blanket indemnification in advance; they require case-by-case authorisation after determination that the director or officer has met the applicable standard of conduct. Many statutes require notice of the indemnification to be sent to shareholders. In Delaware and New York the determination of whether the statutorily required standard of conduct has been met must be made either:

(1) by the board of directors by a majority vote of a quorum of directors who were not parties to the proceeding,

(2) by independent counsel, or

(3) by the shareholders.

California authorizes permissive indemnification only with the approval of a quorum of disinterested directors or the shareholders, the shares owned by the particular director or officers not being voted.

#### **Limitation of liability legislation**

[133] A recent addition to the Delaware corporation statute, section 102(b)(7) permits a corporation to include in its charter a provision that would limit a director's monetary liability for breaches of the duty of care. The official commentary to the legislation stated that 'the unavailability of traditional policies ... [has] threatened the quality and stability of governance of Delaware corporations because directors have become unwilling, in many instances, to serve without the protection which such insurance provides and, in other instances, may be deterred by the unavailability of insurance from making entrepreneurial decisions.' Section 102(b)(7) provides:

'(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any of the following matters:

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director:

(i) [f]or any breach of the director's duty of loyalty to the corporation or its stockholders,

(ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law,

(iii) under [section] 174 of this title, or

(iv) for any transaction from which the director derived an improper personal benefit.

No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.'

[134] That provision leaves the director liable to remedies of injunction and rescission. It limits monetary liability of directors only for their actions as directors and not their actions as officers.

[135] In jurisdictions which have derived their company law from the United Kingdom the Delaware measure looks very like a restoration of the situation before the Greene Committee recommended the ancestor of section 237. Even if there is reluctance to jettison section 237 altogether, there is a question whether shareholders might be prepared to limit the liability of directors to the company in terms of a multiple of the director's remuneration (including the bona fide market value of all non-cash items), the legislation stating a minimum multiple. It would be questionable whether on any vote to adopt such a limitation shares controlled by directors or their associates should be eligible to be voted. A further question is whether if any such limitation were favoured, it should be effective only for a limited period, say, three years, being capable of being renewed in the same form or in a varied form.

[136] The main arguments for allowing a limitation of liability would be as follows:

1. The current difficulty in obtaining adequate cover by way of insurance for individual directors and officers (see para [157]).
2. The need to discourage directors from being so averse to risk as to refrain from innovative business activity.
3. Removing barriers to recruitment of directors who may be competent but unwilling to assume unlimited liability.

[137] If there is merit in allowing articles to specify a limitation of liability, there is a question whether it should be over and above the sum for which a director or officer is insured against liability by the company, assuming it became lawful for the company to take out that insurance (see para [175]).

[138] The idea would be to provide 'effective deterrence against mismanagement but [to ensure also that] the consequences of liability would not be so significant as to deter capable people from serving as directors or increase the incentive to be risk-averse in the business decisions of those people when they do serve as directors.'<sup>(41)</sup>

*(41) I M Ramsay "Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance (1987) 5 Company and Securities Law Journal 129.*

## CHAPTER 5 DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

[139] Directors' and officers' liability insurance has existed overseas for over 40 years.

### **Directors' and officers' liability insurance in North America**

[140] In the North American setting the typical directors' and officers' ("D&O") policy provides two related types of cover;

- (1) corporate reimbursement cover, and
- (2) directors' and officers' individual liability cover.

[141] The first, 'corporate reimbursement cover', covers those indemnification payments to directors and officers that the corporation has to make under legislation, common law or the corporation's constituent documents. Thus, it will cover the mandatory indemnification payments of expenses where the director or officer has incurred costs, charges and expenses in successfully withstanding proceedings. It will also cover the permissive indemnification which the corporation may provide. In many American jurisdictions, in contrast to Australian jurisdictions, that can extend to the amount of judgements obtained by third parties against the director or officer.

[142] The second, 'directors' and officers' individual liability cover, covers the individual directors and officers for the situations where the corporation will not or cannot indemnify them.

[143] In the United States most indemnification statutes expressly authorise corporations to purchase and maintain liability insurance for directors and officers. The corporation can do that in respect of their liability whether it is indemnifiable or not. There would be limits in public policy to indemnify against the consequences of fraudulent or other intentional activity.

[144] In Canada the Canada Business Corporations Act 1975 section 119(4) authorises a corporation to purchase and maintain insurance for the benefit of its directors and officers against any liability incurred whilst acting in the capacity as a director or officer, except where the liability relates to a failure to act honestly and in good faith with a view to the best interests of the corporation.

[145] Since 1982 Ontario legislation in section 136(4) of the Business Corporations Act has been to the same effect.

### **Trends in Director's and Officers' Liability Insurance in North America**

[146] Until relatively recently, the provision of the cover afforded by D&O insurance relating to both the potential reimbursement liability of corporations and the individual liability of directors and officers, the premiums for which would be met by the relevant corporations (pursuant to express provisions of which section 145(g) of the Delaware General Corporation Law is an example), would appear to have been a standard expectation on the part of those involved in corporate governance in the United States.

[147] There appears little question that in the last few years there has been a serious "contraction" in the United States D&O market. Corporations renewing their cover have had to pay markedly higher premiums. Korn/Ferry International is reported to have made a 1985 study of 592 corporate boards and found that of those companies whose insurance policies were up for renewal, 68 per cent encountered an increase in premiums with an average increase of 362 per cent.<sup>(42)</sup> Many insurers reduced the limits of liability cover they were willing to underwrite. New exclusions were written into policies. An example is the exclusion of coverage for lawsuits arising from action taken in supporting or defending a take-over. Some insurers ceased writing policies in respect of corporations in particular industries. It has been reported that most insurers have stopped writing new policies for banks. The significance of that has to be seen in the light of the different structure of the banking industry in Australia. The Federal

(42) *Noted in 40 Vanderbilt Law Review 776 n12.*

Deposit Insurance Corporation reported that the number of commercial bank failures in 1986 in the United States had reached 86 and that the failures had prompted many claims against the former directors and officers of the failed banks.

[148] There have even been cases where a corporation has sued its directors and officers with a view to recouping on the D&O policy. That has led to further exclusions.

[149] The contraction of insurance protection is said to create difficulty for corporations in filling vacancies on their boards of directors. A Korn/Ferry International survey is said to have shown that one-fifth of the corporations surveyed indicated that a qualified candidate had rejected an invitation to join the board.

#### **Directors' and Officers' Liability Insurance in Australia**

[150] It appears that the writing of D&O policies in Australia commenced in the early 1980's, possibly prompted by the enactment of section 237(3), and has only become widespread in the latter half of this decade. Only a small number of companies presently write this class of cover.

[151] The Australian experience has not been as thoroughly documented as that of the United States. The available material indicates that the Australian liability insurance market has recently suffered a contraction; whether this has been to the extent of that experienced in the United States is not readily apparent. It may be that the availability in Australia has been affected by developments in the United States.

[152] A paper prepared in early 1987 by Alexander Stenhouse Ltd for the Institute of Directors in Australia notes that "... the market, such as it is :

- \* ceased in 1986 to write coverage for individuals;

- \* ceased, in many instances, to write cover relating to companies in a loss making situation;

\* will not generally write business relating to companies in a takeover or threatened takeover situation;

\* are reluctant to accept cover relating to 'entrepreneurial' style companies".

[153] That paper also identified a number of problems in relation to insurance that is eventually written, principally the level of cover (said to be a maximum of approximately \$20 million) and the insistence of underwriters on policies containing exclusionary and restrictive conditions to avoid cover where claims by company employees against directors are involved or where the company has failed to otherwise adequately insure assets and liabilities, to exclude liability arising from any commercial activities in North America and conditions which demonstrate an "unwillingness" to cover liability arising from decisions of another board on which the original (insured) company may have a significant minority shareholding.

[154] The paper by Alexander Stenhouse Ltd indicated that a number of conclusions were based on perceptions within the market rather than statistical evidence. In view of this and the relative lack of material concerning the Australian experience generally, the Committee in November 1988 forwarded a questionnaire (a copy of which is included as Appendix B) to the Chairmen of a number of Australian public companies. The companies are of varied size and turnover and representative of a range of operations. Thirty-nine (approximately 50%) of the selected companies replied. The Committee expresses its appreciation to those who were able to provide assistance in this way.

[155] The questionnaire sought information about trends in the local market over the period 1984 to 1988.

[156] The replies, which showed an average board size of nine members through the relevant period, indicate that there has not been the same reluctance to accept board or management positions due to difficulties with obtaining adequate D&O cover as appears to have been experienced in the United States. Only one person had refused an offer of a directorship of a

respondent company. Two persons had resigned from senior management positions in one company, apparently not as a result of any actual D&O claim against those officers. Two respondents reported a reluctance on the part of directors of a group parent company to accept subsidiary board appointments. This may in part result from restrictions in policies on group activities mentioned below.

[157] Structure of Insurance Cover: The Australian market would appear to have ceased to provide coverage for individual directors and officers alone. The norm is a "corporate insurance policy" composed of:

- \* a directors' and officers' liability policy component, covering acts or omissions for which the company cannot provide indemnity, the premium for which is at least notionally payable by the directors etc personally; and

- \* a company reimbursement policy component, covering reimbursement for indemnity that the company can provide for its directors and officers, the premium in respect of which is payable by the company.

The terms of the two component policies will be examined shortly.

[158] It is common for a much greater proportion of the total premium payable for the corporate insurance policy to be attributed to the company reimbursement component. Only one respondent indicated a 50%/50% split. Another recorded a 75% company reimbursement proportion. Most common (c 67%) was a 90%/10% split, with 95%/5% being the second most common breakdown (24%). One respondent recorded 97.5% of the premium as being attributable to the company reimbursement element.

[159] Terms of Cover: One corporate insurance policy examined by the Committee would appear to be representative of the general range of matters addressed by this type of insurance.

[160] Both policies comprising the corporate insurance policy cover liability for any "Wrongful Act" of any director or officer (defined to include any past present or future director, secretary, executive officer or employee) committed in their capacity as directors or officers of the company.

[161] Both policies include liability arising from the activities of subsidiaries of the insured company. However, both components exclude liability for actions taken "in conflict or in preferment of the interests of the Company over those of a Subsidiary company or vice versa". That exception is contained in the definition of "Wrongful Acts" (those matters which found the relevant liability). "Wrongful Acts" includes "... breach of duty breach of trust neglect error misstatement misleading statement omission breach of warranty of authority ..." etc.

[162] Both component policies exclude liability arising from certain situations, the most significant being claims;

\* Based upon or attributable to the gaining by any director or officer of any personal profit or advantage or receipt of remuneration to which there is no legal entitlement, a narrower test than that applied to determine whether, strictly, a breach of duty to the company has occurred, namely whether an observer could reasonably conclude that the director had placed himself in a situation where his duty to the company and his personal interest might conflict, actual receipt of improper profits etc. being unnecessary

\* Brought about or contributed to by any "dishonest, fraudulent, criminal or malicious ..... wilful or reckless" act or omission by any director or officer, wilfulness being made out where there is "full knowledge and expectation of those consequences" which lead to the claim, recklessness being constituted by acting in the face of "awareness of and disregard for those consequences". The first category of actions would appear to be aimed at actual, rather than constructive, dishonesty. The definitions of both "wilful" and

"reckless" would not seem to impose an onerous standard, although the required degree of perceived probability of the adverse consequences of the relevant actions is not immediately apparent

\* Arising from or attributable to or involving any attempt by any person to acquire shares in the company against the opposition of the board or involving any action by the board to resist such attempts

\* Brought by or on behalf of the Company or any director or officer against any other director or officer ("insured versus insured" claims) except any claim "brought by a shareholder of the Company in the name of the Company" provided that the shareholder is not a director or officer nor has been assisted in any way in taking action by any director or officer, the insurers liability in such a case being limited to the actual loss suffered by the shareholder as a direct result of any Wrongful Act.

[163] The directors' and officers' liability policy also excludes claims in respect of any loss for which a director or officer would be lawfully entitled to be indemnified by the company. Both policies also exclude claims which are properly the subject of other classes of insurance (bodily injury to third parties, loss or damage to tangible property etc) or for breach of certain statutory obligations, for example, environment protection legislation.

#### **Trends in D&O Insurance in Australia**

[164] Incidence of Cover: Responses to the Committee's questionnaire reveal a constant increase in the proportion of companies taking out a corporate insurance policy - 60% in 1984, 63% in 1985, 77% in 1986, 91% in 1987 and 94% during 1988. It should be borne in mind that the respondents are all public companies; possible difficulties in relation to proprietary companies are mentioned below.

[165] Quantum of Cover: The Alexander Stenhouse Ltd paper mentioned earlier referred to an available limit of \$20 million. The cover provided by D&O policies is not a limit on a "per claim" basis. Ordinarily the amount is

the aggregate which may be recovered under both company reimbursement and directors' and officers' liability policies in any period (usually a year) of insurance. There is apparently no "reinstatement" applicable to D&O policies.

There has been a steady increase in the amount of cover provided in the past few years. In 1988 the average aggregate amount was \$15.83 million, with \$10.00 million being the median.

[166] Exclusionary Terms: The Committee has been advised that at least one D&O insurer "tailors" policy terms, having regard to the history and qualifications of the directors of the company involved and ordinarily declines to cover acts or omissions arising out of operations in which a company claims some particular expertise. It is apparent from questionnaire responses that some "specialist" companies have policies written on this basis.

[167] Although there would appear to be a perception that corporate operations outside Australia and New Zealand are commonly excluded, 81% of questionnaire respondents reported no such geographical limitation. The balance noted exclusion of US and Canadian operations or an excess payable/ lower indemnity limit for such operations. Other exclusions related to claims against directors of subsidiary companies by the holding company, actions arising from dealing in the shares of a target company and other hostile takeover situations, breach of internal regulations and policies, actions for foreign currency exchange losses and claims by substantial shareholders (defined in the one relevant case to mean any person holding 15% or more of issued capital). Such exclusions, which from the responses would not appear to have been imposed due to any history of claims, did not apply to a significant proportion of respondent companies. It is not clear whether respondents may have considered any standard policy exclusions to be not relevant for the purposes of the questionnaire.

[168] Premium Movements: The paper by Alexander Stenhouse Ltd was printed in February 1987 and refers (on page 2) to an "astonishing" rise in premiums within the preceding 2 years. The Committee's questionnaire responses tend to support that view, at least for 1986.

For 1984, only 14% of respondents recorded a premium increase averaging 24%, the range being 2% to 100% with a median of 3%.

In 1985, 42% paid higher premiums; the average was 32% with a range of 5% to 147% and a median of 17%. Only one respondent reported a decrease (of 4%).

In 1986, 44% of respondents reported an increase, the average being 66% with a range of 8% to 240% and a median of 36%. No premium falls were reported.

For 1987, increases averaging 35% were noted by 58% of respondents with a range of 5% to 193% and median of 25%. Only one company recorded a decrease (of 12%).

In 1988, 50% of respondents paid more, on average 25%; the range of increases was 3% to 85% with a median of 24%. Decreases were noted by 14% of companies, the average fall being 20% with a range of 10% to 50% and a median of 10%.

For the period 1984 to 1988, increases averaged 36% and decreases 7%.

The most commonly expressed reasons for premium increases were, in order of frequency, "general market conditions", payouts and premium levels in the United States, increased turnover and acquisitions by the insured company, claims experience of underwriters, general problems in obtaining cover within the industry, "overseas experience" (not clear whether in jurisdictions other than those of North America) and an expectation that directors and officers will in the future become more vulnerable to actions, particularly those initiated by "disaffected" minority shareholders.

The reasons given for decreases are related more to the performance of individual companies (lack of claims, greater overall strength of commercial operations) and greater competition amongst insurers; one respondent referred to a recent "softening" of the market.

[169] Claims Experience: No claims were reported by questionnaire respondents.

[170] Alternatives to present D&O market: The questionnaire asked whether the introduction of a compulsory liability fund for all companies, a possibility raised in the Alexander Stenhouse Ltd. paper, would be a preferable alternative to the current D&O private market.

[171] The majority of respondents opposed the introduction of such a fund, some simply on the basis of disagreement with any form of compulsory insurance, many for more detailed and various reasons, including;

- \* Flexibility of the existing market, particularly in regard to negotiation of acceptable premiums and variety of terms and conditions on the basis of the efficiency and claims history of individual companies and differing risk "profiles" of various types of companies

- \* Such a fund would penalise companies with a good claims history - the premiums payable to a fund by such companies would in effect subsidise inefficient companies

- \* The existence of a fund would encourage shareholders etc to become unnecessarily litigious

- \* There would be an insufficient premium "pool" at the outset of such a fund - even a small number of D&O claims (which are usually for substantial monetary amounts) could exhaust the fund before it became truly viable.

[172] Some respondents, while opposed to the introduction of a compulsory fund (whether administered by government or private sector organisations) thought the present system could be improved by the provision of a limit on the liability of directors for acts or omissions not involving actual dishonesty and by allowing companies to directly make premium payments.

[173] Those in favour of a compulsory fund mentioned the need for the terms of insurance cover to be determined by Australian experience (not North American market forces) and the difficulty that companies that have only recently commenced operation or those engaged in more "speculative" undertakings have in obtaining adequate cover within the existing market. A

number of respondents considered that the level of contributions payable should be determined by the incidence of claims by companies against a fund.

[174] An alternative which was mentioned by one respondent and which is supported by at least one insurance industry consultant contacted on behalf of the Committee is the introduction of a compulsory fund administered by a professional body. The features suggested by that consultant are:

- \* Membership could be a prerequisite to availability of cover and ability to act as a director. Membership and cover would be open to directors of both public and proprietary companies and be personal to the director (but related to membership of a nominated board); the continuance of both would depend on adherence by the director to the code of conduct specified by the professional body. If a director was expelled from the professional body for breach of that code, both insurance coverage and the ability to continue to act in the capacity of a director would automatically cease

- \* It would not be compulsory for officers other than directors to obtain any form of insurance, the availability and terms of cover for those officers being left for determination by the private market

- \* One common coverage amount (perhaps in the order of \$500,000) would be provided, although level of contribution would vary according to the category of company on the board of which the director is to serve

- \* The first category would be comprised of proprietary companies and family trusts, the second by public companies, while the third category would relate to multiple directorships. For the last category, each additional directorship would attract a further premium payment

- \* Directors would be at liberty to take out supplementary insurance, the other insurers presumably meeting the amount of any claim over and above the amount of the compulsory cover.

One perceived benefit of such a scheme would be the greater coverage for directors of proprietary companies. While there may be less likelihood of actions by shareholders against such directors while those companies are going concerns than is the case with the directors of public companies, the incorporation status of proprietary companies does not prevent actions arising from losses or ultimate corporate failure.

**Should the Companies Act 1981 (Cth) be amended to authorise a company to purchase and maintain insurance to cover its directors and officers?**

[175] The arguments for an amendment adopting something like the provision in the Canadian Business Corporations Act 1975 section 119(4) (see paras [120] and [121]) would include the following:

1. It is in the interests of the company, its shareholders and the community that directors and officers should be insured so far as that is possible for at least two reasons:

(a) there will be a fund to compensate, at least as to part, a plaintiff for loss caused by the director or officer;

(b) directors will be less likely to be discouraged from taking good faith business risks, though this may only be so where adequate insurance can be obtained. By allowing the company to obtain insurance virtually every director and officer would be routinely provided with indemnity insurance. At present directors and officers may elect not to have, or neglect to have, insurance. A director or officer may organise his or her assets so that the director or officer is judgement-proof.

2. It is impossible to achieve the aim of section 237(3) in seeking to prevent use of the company's resources to provide cover for directors and officers. Companies that are concerned that their directors and officers should be insured may secretly include in the amount of remuneration an unidentified sum of money that is intended to be used by the directors or officers for that purpose.

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

4. 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. The company may also be able to self-insure for part of the risk.

## CHAPTER 6 ISSUES FOR DISCUSSION

[176] The following appear to be the principal issues prompted by the foregoing material:

1. Does section 237 serve any useful purpose in relation to the honest actions of a director, officer or employee that is not served by the common law?
2. Should section 237 be replaced by legislation similar to that in section 119 of the Canada Business Corporations Act so that a company would have authority to indemnify, at its option, directors, officers and employees in respect of civil liability to third persons provided they acted honestly and in good faith with a view to the best interests of the company? See paras [121] and [175].
3. Could there ever be circumstances in which it would be justifiable for a company to indemnify in respect of liability of a director, officer or employee to pay a fine or other monetary penalty? See para [60].
4. Should there be legislation under which a director, officer or employee could be indemnified by the company, at its option, with the approval of a court in respect of actions by or on behalf of the company where he has acted honestly and in good faith with a view to the best interests of the company and, where his conduct was in breach of a penal provision, he had reasonable grounds for believing that his conduct was lawful? See Canada Business Corporations Act s119(2). See paras [121] and [175].
5. If legislation of the kind referred to in issue 2 is favoured, how should the company's option to provide indemnity be exercised? Should it be determined only by the fully informed consent of the company in general meeting? If legislation of the kind referred to in issue 4 is favoured, how should the company's option to indemnify with court approval be exercised?

6. Should a company be obliged to indemnify a director, officer or employee against expenses incurred in successfully defending proceedings? What should be the qualifications (if any) on that duty? See para [125].

7. Should section 535 be retained, even if legislation referred to in issues 2, 3, 4, 5 and 6 were enacted?

8. If section 535 is retained, should it be extended to criminal proceedings? To what kind of criminal proceedings should it be extended? See paras [102] to [104].

9. Should the Companies Act be amended to indicate that it embodies a business judgment rule? See paras [108] to [113]. Should it be a qualification in section 229(2) or should it appear in section 535?

10. Should section 535 be re-located in the Act so as to be near the provisions about indemnification whether in the form of section 237 or other provisions? See paras [97] to [99].

11. If section 237 is to be retained, should it be amended to make it clear that it is concerned with liability for breaches of duty owed to the company alone? See paras [55] to [61].

12. Should section 237 be amended to clarify what is meant by 'negligence, default, breach of duty or breach of trust'? If so, how might that be done? See paras [12] to [18].

13. Should section 237, if retained, contain wording to indicate more clearly the repositories of provisions which offend the section? See paras [66] to [71].

14. Should section 237 be amended to make it clear that provisions to which the company is not a party are not caught by section 237? See paras [66] to [71].

15. Should section 237 be amended to make it clear that it does not apply to a company's contract indemnifying directors, officers or employees of another company? See paras [72] to [74].

16. If section 237 is to be retained, how should it be amended to dispose of doubts relating to insurance in respect of directors' and officers' liability?

17. Should legislation authorise a company to purchase and maintain insurance for the benefit of a director or officer against liability incurred by him in his or her capacity as director or officer? Should the insurance extend to monetary penalties for breach of legislation? Should the only qualification be that the failure of the director or officer giving rise to liability should not relate to his or her failure to act honestly and in good faith with a view to the best interests of the company? See paras [120] to [123].

18. If the legislation is to permit companies to purchase and maintain directors and officers liability ("D&O") insurance, what disclosure in the company's accounts should be made? Alternatively, if there should be no requirement of disclosure in the accounts because of fear of attracting litigation, what provision should be made for satisfying the legitimate interest of members in the company's expenditure?

19. Does the information provided by the questionnaire responses discussed in Chapter 5 provide an accurate indication of the state of the D&O insurance market in Australia? Is there any significant aspect of that market that has not been addressed in the questionnaire?

20. Does the D&O insurance market provide adequate coverage for a sufficiently broad range of companies operating in Australia and their directors and officers? How many companies or their directors and officers have to rely on self-insurance? What are the reasons for this?

21. Does failure or inability of companies or their directors and officers to maintain adequate D&O insurance adversely affect the provision of capital or credit to companies because of concern on the part of investors or creditors that losses may not be recoverable?

22. Would the introduction of some kind of compulsory D&O liability fund ensure coverage for a broader range of companies (particularly those that have only recently commenced operation, proprietary companies and those engaged in more speculative ventures) and directors and officers than that applying under the existing insurance market? If so, what should be the terms and conditions under which such a fund should operate? Who should administer it? To which companies should it apply? See paras [170] to [174].

23. Should the Act contain provisions clarifying the power of the company in general meeting to ratify past action of a director, officer or employee? If so, under what conditions? Should the company in general meeting be stated to have power to authorise in advance conduct which would otherwise be a breach of duty? If so, under what conditions? See paras [79] to [83].

24. Should the Act contain provisions expressly empowering a company to formulate the duties of directors, officers and employees? What (if any) should be the limits on that power? See Paras [76] to [78].

25. Should the Act be amended to authorise a company to provide in its articles that the liability of a non-executive director who has acted honestly but in breach of the duty of care and diligence may be limited to a minimum multiple of his or her average annual remuneration as a director over a period? If so, what should the minimum multiple be? Should remuneration be calculated by reference to the value of all payments and benefits, whether direct or indirect, in favour of a director or immediate family to avoid the setting of artificially low remuneration amounts for liability limitation purposes? Should any such provision be of limited duration? If so, what should be the permitted maximum duration? What forms of

liability should be excepted from the limitation of liability? Should the provisions only be capable of being inserted in the articles after the company is formed? See paras [133] to [138]

26. Should similar amendments be made in respect of the liability of an executive director? If so, should the limitation apply only to acts in the capacity of a director?

27. Section 237 applies in respect of all employees of a company. Should the legislation on indemnification and insurance distinguish between:

(i) executive officers who are directors;

(ii) other executive officers; and

(iii) other employees?

28. Should provisions about indemnification and relief for persons other than directors, company executives and other employees be outside sections 237 and 535?

29. Section 237 applies to non-commercial companies as well as commercial companies. Should the legislation in this area distinguish between the two classes of company? If so, what should be the provisions applicable to a non-commercial company that is not engaged in trading for the acquisition of pecuniary gain by its members?

30. Should section 237 distinguish between other types of companies (e.g. wholly-owned subsidiaries, exempt proprietary companies)?

31. Should there be a legal requirement that before being eligible for appointment as a director a person shall either:

(a) have participated to a significant level in a course of study designed to inform about basic responsibilities involved in directing a company; or

(b) be a member of a professional body which sets standards for the directing of companies?

What should be the length and elements of that course of study? Under whose auspices should the course of study be conducted? In respect of which directorships should any such requirement apply? To which companies should the requirement apply? See paras [38] to [48].

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**ERRATA**

In the following Appendices A and B pages (v) and (vi) of Appendix A should be transposed with pages (v) and (vi) of Appendix B

## APPENDIX A

### Civil Liabilities of Directors and Officers under Companies and Securities legislation

NOTE: This Appendix is not intended to be an exhaustive statement of the obligations and liabilities of company directors and other officers contained in the relevant legislation. Moreover, what appears below are merely summaries of the more important aspects of the provisions in question. Reference should be made to the full text of the relevant provisions in any situation where the actual terms of the legislation may be of significance.

#### (i) Companies Act

(a) S.107 : Liability to compensate those who have suffered loss/ damage where untrue statement/non-disclosure of material matter in a prospectus

\* deeming provisions of section 104 - Liability not dependent on registration of prospectus;

\* knowledge of untruthfulness/materiality of omitted matter necessary;

\* not a liability based merely on status as director - defences basically of withdrawal of consent to issue/ belief in accuracy (and basis therefor) contained in sub-section 107(5);

\* liability is that of directors etc., not the corporation, to those who have subscribed for/purchased shares etc. in reliance on terms of prospectus.

#### (b) S. 110: Liability in relation to allotment of shares

\* a company shall not allot shares resulting from acceptance of invitations to the public unless the minimum subscription (paragraph 98(1)(d)) has been subscribed and the amounts payable on application for those shares (by sub-section 110(4) at least 5% of the nominal value thereof, except in the case of a no liability company) have been received;

\* if both of these conditions have not been satisfied within 4 months from issue of the relevant prospectus, sub-section 110(5) provides for repayment of all amounts received;

\* if such repayment is not made within 7 days of that obligation arising, the directors of the company are jointly and severally liable to pay those

(ii)

amounts, together with interest, unless (pursuant to sub-section 110(7)) the directors can prove that default in payment by the company was not due to any "misconduct or negligence" on their part;

\* in addition, by sub-section 110(10), any director who "knowingly contravenes" any provision of section 110, or who permits or authorises such contravention, is not only guilty of an offence but is also liable to compensate the company and any person to whom shares have been allotted in contravention of the section for any loss, damages or costs sustained or incurred by reason of the contravention (the sub-section requires any proceedings for such proceedings to be commenced within 2 years from the date of the relevant allotment).

(c) S.144A(2): Joint and several liability of directors and company: Failure to maintain substantial shareholdings register

\* S.143 requires a company to maintain a register of all advices as to attainment, alteration and cessation of substantial shareholdings of shares in the company received pursuant to obligations under sections 137, 138 and 139 respectively;

\* S.144A(2) liability is to pay damages to any person who suffers loss/damage as a result of failure to maintain register;

\* again, not merely "status-based"-director/officer must have been by act or omission "knowingly concerned in or party to" such default.

(d) S.218(3): Liability in relation to company's negotiable instruments

\* any officer (which includes directors) who signs, issues, etc any negotiable instrument/letter of credit of the company on which the correct name of company (pursuant to section 35(4)) does not appear as required by s.218(1) is liable to the holder of the instrument/letter for amount due thereon unless amount paid by the company;

\* again, liability not based merely on status; positive act of signature, issue etc necessary;

(iii)

\* although payment of amount due relieves officer of liability, no obligation to pay nor "secondary" liability on part of company for issue, etc

\* liability not dependent on state of officer's belief as to correctness of name - implies an obligation to ascertain s.35 incorporation name/name on change (s.36).

(e) S.229: General standard of conduct provision

\* both specific (prohibition) and general (positive obligation) provisions;

\* general provisions relate to "officers" (including directors but excluding employees - definition in 229(5)) and are:

229(1) - at all times to act honestly in exercise of powers and discharge of the duties of the office; and

229(2) - at all times to exercise a reasonable degree of care and diligence in the exercise of powers and discharge of the duties of the office.

\* specific provisions relate to "officers and employees" and prohibit:

229(3) - improper use of information acquired by virtue of office/employment to gain advantage for self or other person or cause detriment to the corporation; and

229(4) - improper use of officer/employee position to gain such advantage or cause such detriment.

\* breach/non-observance of any of the provisions constitutes an offence - monetary penalties/imprisonment may be imposed;

\* S.229(6) - court before which officer/employee is convicted empowered to order compensation to the corporation for any loss/damage suffered;

(iv)

\* S.229(7) - corporation may bring action (whether or not officer/employee has been convicted of an offence against the section) to recover any profit resulting from contravention together with amount equal to any loss/damage suffered by the corporation;

(f) S.229A: Liability for discharge of a liability incurred while corporation acting as trustee

\* if a "relevant corporation" (defined in s.229A(3)) incurs a liability while acting/purporting to act in a trustee capacity and that corporation is not entitled to be fully indemnified out of trust assets, the corporation and those who were directors at the time the liability was incurred other than "innocent directors" (see below) are jointly and severally liable to discharge that liability;

\* s.229A(3) - "innocent directors" are those who would have been entitled to be fully indemnified by one or more of the other trustees.

(g) S.230: Liability in respect of loans to directors, relatives, etc.

(dealt with more fully in CSLRC Discussion Paper 8 of August 1988;)

\* sub-section 230(5) - joint and several liability of directors and officers ("general" sub-section 5(1) definition) to indemnify the company in respect of any loss arising from the making of a loan, giving of a guarantee or provision of security undertaken in contravention of the section;

\* sub-section 230(6) provides a defence to any such proceeding if the director etc. "had no knowledge" of the making of the loan etc.

(h) S.241: Liability in relation to failure to convene meetings

\* provided certain criteria are satisfied, sub-section 241(1) permits company members to requisition the holding of a general meeting of the company by written notice to the directors;

(v)

\* If the total premiums have been treated as a package, what proportion of the total has been set for;

\* the company reimbursement policy?

\* the individual directors and officers liability policy?

\* Since 1 January 1984, what percentage movements

the total premiums have been treated as a package, what (either increase or decrease) have there been in the amount of premiums generally?

in 1984

in 1985

in 1986

in 1987

in 1988

\* By what percentage have any increases in the premiums exceeded those other types of liability insurance maintained paid for by the company?

in 1984

in 1985

in 1986

in 1987

in 1988

\* Has there been any difference in any movement in premiums for either of the two parts of the Corporate Insurance policy? If so, please provide details.

(vi)

\* What have been the reasons given for any premium movements?

(d) \* How many claims were made against the insurer?

(i) \*\* in respect of Directors and Officers Liability Policy

in 1984

in 1985

in 1986

in 1987

in 1988

(ii) \*\* in respect of Company Reimbursement Policy

in 1984

in 1985

in 1986

in 1987

in 1988

(iii) \*\* please state, briefly what the alleged breaches were in terms of the types of action by the director or officer concerned;

(vii)

section 119), is liable to the creditors of the company to the extent by which the dividend payments exceed the profits of the company (s.565(2));

\* proceedings for recovery may be instituted by the creditors or liquidators of the company whether or not the person has been convicted of an offence under s.565(2);

\* where the whole amount involved has been recovered from one director/executive officer, contribution may be sought from any other person who directed, or consented to the relevant payment (S.565(3)).

(ii) Securities Industry Act ("SIA") and Futures Industry Act ("FIA")

\* Both the SIA (s.130) and FIA (s.137) provide for compensation to be paid by a director or other officer to another party to a transaction involving securities or futures contracts where the director etc is in possession of "inside information" or where the director etc has passed on such information to another who has then effected the transaction; the liability to pay compensation in both cases does not arise merely because of the status of the director or officer.

(iii) Companies (Acquisition of Shares) Act

(a) Section 44 : Liability for mis-statements in take-over documentation

(1) - s.44(9) - Liability for false/misleading matter or omission of matter (materiality test for all) attaches to;

\* in the case of a Part A statement (or subsequent notices under s.42 or s.43) - directors of offeror corporations;

\* in the case of a Part B statement or Part D statement - directors of the target company;

\* in the case of a Part C statement (or subsequent notice under s.42 or s.43) - directors of on-market offeror corporations;

(viii)

\* in the case of report set out in, or accompanying, a Part B statement, a report set out in a Part D statement or reports pursuant to sections 37, 38 or sub-section 43(4) - directors of report provider corporations.

\* exempted are directors who were not present at the board meeting at which the resolution authorising the execution of the relevant statement was agreed to or who were present and voted against such resolution.

(2) - S.44(10) - Liability for matter that is false or misleading (materiality test for both) attaches to:

\* in the case of any statement (relating to prescribed matters) made by an intending offeror or on-market offeror corporation - directors of that corporation "in default" - defined in s.55;

\* in the case of any relevant statement made by a prospective target company - directors of that company in default;

\* in the case of any relevant statement made during the currency of a take-over offer or offers constituted by a take-over announcement - directors of the offeror, on-market offeror or target company (and directors of associated corporations in all those cases);

\* liability in all cases is to compensate any person for loss or damage sustained by that person by reason of reliance on the false or misleading matter or by reason of the omission of material matter, whether or not the person liable has been convicted of an offence under the various provisions;

\* defences to actions for compensation include belief on reasonable grounds that false matter was true, misleading matter was not misleading or that no material matter had been omitted/did not know omitted matter was material; as well, it is a defence that the person gave reasonable notice to recipients of the documentation as soon as became aware that matter false or misleading or of the omission;

\* actions brought under s.44 do not affect any other cause of action based on the same facts (s.44(21)).

## APPENDIX B

NOTE: If there is insufficient space for any comments etc., please attach a separate sheet containing reference to the number of the question involved.

(1) For some time concern has been expressed in relation to the width of directors' and officers' duties and liability for breach of those duties.

Since 1 January 1984 how many persons, as a result of expressed concern about directors' and officers' liability for breach of duty generally, have;

- \* resigned from a directorship of your company?
- \* refused an offer of a directorship of your company?
- \* resigned from a senior management position with your company?
- \* refused an offer of a senior management position with your company?

Any Comments you may wish to make

(2) What has been the size of the board of directors in your company?:

in 1984  
1985  
1986  
1987  
1988

(ii)

(3) Questions about company D & O insurance arrangements:

(a) Preface: The Committee understands that there are two types of policy:

(i) Corporate Insurance Policy; and

(ii) Individual D & O Liability Policy.

The first, the CORPORATE INSURANCE POLICY, is in turn two policies,

(a) Directors and Officers Liability Policy

\* to indemnify Directors and Officers against their present liability for wrongful but not dishonest acts;

\* where the company cannot lawfully indemnify them;

\* hence, premium is payable by directors and officers personally.

(b) Company Reimbursement Policy

\* to reimburse the company for indemnity that it can lawfully give to directors and officers (effectively, defence costs where the director or officer succeeds in legal proceedings).

The second, the INDIVIDUAL D & O LIABILITY POLICY, affords to a nominated director or officer cover in respect of all positions held and nominated by him. There is no cover for the company.

(b) Did your company have a CORPORATE INSURANCE POLICY?

YES

NO

in 1984

in 1985

in 1986

in 1987

in 1988

(iii)

(c) If your company had a CORPORATE INSURANCE POLICY, either single or as part of a master policy;

(i) \* for how much was each individual director or officer covered?

in 1984	\$
1985	\$
1986	\$
1987	\$
1988	\$

(ii) \* for how much was the company covered on its reimbursement policy?

in 1984	\$
1985	\$
1986	\$
1987	\$
1988	\$

(iii) \* have the terms of the cover been changed to reduce cover - \*\* in respect of geographical limitation?

YES

NO

in 1984

in 1985

in 1986

in 1987

in 1988

Comment: (details of reduction)

(iv)

(iv) \*\* in respect of actions of directors in particular situations (e.g. take-overs)?

YES

NO

in 1984

in 1985

in 1986

in 1987

in 1988

Comment: (details of reduction)

(v) \*\* In any other respect? (please specify)

YES

NO

(vi) \* Have the total premiums for the CORPORATE INSURANCE POLICY been treated as "package" amounts, broken down into proportions for each part of the policy, or treated as two separate premiums?;

(v)

\* if the directors fail to convene a meeting within 21 days after deposit of the requisition with the company, the requisitioning members may proceed themselves to convene the meeting;

\* by sub-section 241(4), the company is obliged to repay to requisitioning members any reasonable expenses incurred as a result of the failure of the directors to comply with the initial requisition; the company is then required to retain any sums by way of fees or other remuneration due or to become due to defaulting directors to meet the expenses paid to such members.

(i) S.542: General Provision - Orders against persons concerned with corporations

\* enables a "prescribed person" (official manager, liquidator, provisional liquidator or person authorised by NCSC) to apply to relevant Supreme Court;

\* if the Court is satisfied that any person is guilty of "fraud, negligence, default, breach of trust or breach of duty" in relation to a corporation and that the corporation has suffered, or is likely to suffer, loss or damage as a result, the Court may make orders, including directions to pay money or transfer property to the corporation and to pay to the corporation the amount of any loss or damage;

\* the provisions do not operate to prevent the institution of any other proceedings in relation to the matters covered by the application (s.542(5)).

(j) S.556 & S.557: Liability for debts

\* if a company incurs a debt and immediately prior thereto there are reasonable grounds for expecting that the company will not be able to pay all its debts as they fall due (whether "original" debts or in aggregate after the incurring of the relevant debt), any director or person who "took part" in the management of the company at the time the debt was incurred is, in addition to being guilty of an offence, liable jointly and severally with the company for the payment of the debt (s.556(1));

(vi)

\* under s.556(2), it is a defence to prove that the director/person concerned in management had not given express or implied authority or consent to the incurring of the debt or that there was no reasonable cause to expect that the company would not be able to meet its obligations as and when they became due;

\* s.556(3) provides that an action may be brought for recovery of a debt whether or not there has been any conviction for an offence under s.556(1);

\* the company is not liable to any party who has made payment of the whole or part of a debt liability for which arose by virtue of s.556(1) - s.556(4)i

\* sub-section 556(5) provides greater penalties for anyone knowingly concerned in any fraudulent conduct by the company involving the incurring of debts etc in the circumstances outlined in s.556(1);

\* s.557(1) provides that where a person has been convicted of an offence under s.556(1), the NCSC or the person to whom the relevant debt is payable may apply to the Court for a declaration that that person shall be personally liable without limitation of liability for payment of the whole or part of the debt, as the Court thinks proper;

\* s.557(2) applies to convictions under s.556(5) involving fraudulence and allows a similar declaration in respect of payment to the relevant company of an amount to satisfy so much of the debts of the company as the Court thinks proper in this case the application can be made by the Commission or other "prescribed persons" (s.557(3)).

(k) S.565: Liability for improper payment of dividends

\* any director or executive officer (which, by the definition contained in s.5(1), means any person who is concerned, or takes part, in the management of a corporation, whether or not that person holds the office of director) who "wilfully pays or permits to be paid" any dividend (which includes any bonus or payment by way of bonus) out of what to that person's knowledge is not profits (except out of the share premium account pursuant to

(viii)

(4) Would the introduction of a compulsory liability fund provide a preferable alternative to the existing D & O market? How should such a fund be built up? Who should administer it? Should contribution level be subject to "no claim bonuses" or loadings for repeated claims?

(5) If your company does not have a CORPORATE INSURANCE POLICY;

YES

NO

(a) \* does it encourage each director and officer to obtain an INDIVIDUAL DIRECTORS AND OFFICERS LIABILITY POLICY?

YES

NO

(b) \* have any of those directors and officers encountered difficulty in obtaining such a policy?

YES

NO

in 1984

in 1985

in 1986

in 1987

in 1988

(viii)

(c) \* if difficulties have been encountered, what have they been?

(d) \* if your company has elected to carry its own risks of indemnifying directors and officers for their defence costs in proceedings in which they succeed, what is the reason for doing so?

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