ENTREPRENEUR’S GUIDE
STARTUP
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Directors and officers have a wide range of statutory and common law duties and obligations. They include the following:

• an obligation to exercise care and diligence
• a duty to exercise their powers and discharge their duties in good faith in the best interests of the company and for a proper purpose
• a duty to avoid conflicts of interest between themselves and the company
• a duty to disclose personal interests and not to improperly use their position or information
• an obligation not to trade while insolvent.

Directors and officers also face potential personal liability under a range of State and Federal statutes, including Work Health and Safety laws, employment laws and environmental protection laws. In addition, a director may have disclosure obligations, which vary depending on whether the company is private or publicly listed on the Australian Securities Exchange. The disclosure obligations on publicly listed companies and their directors are onerous. They include the continuous disclosure regime, duties of disclosure with respect to the issue of prospectuses and Product Disclosure Statements for financial services, as well as liability for misleading information and documents.

It is in this context that difficult decisions and judgment calls will need to be made by a company’s directors and officers. Sometimes, decisions are made under pressure, often involving large sums of money. Even when directors make carefully considered decisions, errors can still be made. It is not always possible to please every stakeholder, and some interests may be adversely affected by a decision. A claim may be brought against a director or an officer by:

• the company itself
• shareholders
• regulators, such as the Australian Securities & Investments Commission, the Australian Prudential Regulation Authority and the Work Health and Safety authorities
• employees
• creditors
• customers
• competitors
• administrators or liquidators of the company (on behalf of unsecured creditors) or receivers (on behalf of secured creditors), if the company is insolvent.

If a director or officer is found to have breached a duty or obligation, he or she may have a liability to pay compensation (damages), a fine or a penalty. This amount is in addition to bearing their own legal defence costs and the legal costs of the regulator or the aggrieved party that brought the claim.

DIRECTORS AND OFFICERS INSURANCE

Directors and officers (D&O) insurance protects individuals who manage a company from claims made against them, which arise from decisions they make when running the company. D&O insurance only covers directors and officers against liability that they incur in their capacity as directors or officers. D&O insurance can provide corporate decision makers with protection and peace of mind. The existence of adequate D&O insurance will have the additional benefit of attracting and retaining high-quality candidates for board positions, particularly when the company may be seeking non-executive directors.

HOW A D&O INSURANCE POLICY WORKS

Although D&O insurance is, as the name suggests, primarily intended to protect the directors and officers of the company, the insurance policy is usually obtained and paid for by the company itself. For this reason, the company is usually described as the Policyholder.

WHO IS COVERED?

D&O insurance policies will usually identify the individuals it covers as ‘Insured Persons’ by listing their job title or role. A D&O insurance policy will invariably cover all past and present directors of the company and its executive officers (the chief executive officer, chief financial officer, chief operations officer and company secretary). A D&O insurance policy will also frequently cover those who are involved in the management of the company, and sometimes the definition of Insured Person may extend to employees. Every insurance policy wording is different, and a review of available policies will show that there is a sliding scale between individuals who are covered and those who are not. The definition of Insured Person should therefore be checked carefully, because it is a means by which the scope of coverage can be limited by the insurer.

INSURING CLAUSES

D&O insurance policies usually include three insuring clauses:

• Side A Cover: This clause provides cover for directors or officers when the company has not indemnified the director (e.g., if the company is insolvent) or is not permitted by law to do so (e.g., the Corporations Act prohibits a company from indemnifying its directors for liabilities to the company itself). Under this clause, the D&O policy provides direct cover to the individual directors and officers for liabilities and legal costs that they have incurred.
• Side B Cover: This clause reimburses the company when it has indemnified the director or officer, most usually under the director’s deed of indemnity. The D&O policy covers the company for its liability to indemnify its directors and officers when they have incurred liabilities and legal costs in relation to a claim. This clause is often referred to as ‘the company reimbursement clause’.
• Side C Cover: This clause is the only insuring clause that provides cover for the company for any liability that it has in its own right, as distinct from the liability of its directors and officers. The cover it provides is limited to claims made against a company as a result of the offer, sale or purchase of its
shares listed on the stock market. It is usually purchased by a publicly listed company to insure against shareholder class actions and securities market conduct breaches. Not every company requires such cover, and for this reason it is usually an optional component of a D&O insurance policy. If a company requires additional protection, many insurers offer a management liability policy that provides cover for the company in its own right in addition to cover for its directors and executives. This product is intended for smaller, unlisted businesses and is not discussed in this chapter.

**LIMIT OF INDEMNITY AND EXCESS**

The limit of indemnity will vary in each D&O insurance policy. Deciding on an appropriate level of cover will depend on several factors, but the type of business and the associated risks to which the directors may be exposed will be key factors. Insurance brokers will provide guidance, including on limits of indemnity purchased by comparable companies.

Sometimes a D&O policy will have *sub-limits*, which are capped limits within the limit of indemnity for some components of the cover, such as Work Health and Safety claims or defence costs in relation to specific types of claims.

A D&O policy that provides cover under Sides A, B or C will usually have one overall, or aggregate, limit of indemnity for all claims, regardless of which insuring clause is triggered. Because there is, in effect, one pool of insurance money, a D&O policy that includes Side C cover can put at risk the cover available for directors. For example, significant defence costs incurred by the company in defending a class action paid under Side C will erode and potentially exhaust the limit available to the directors under Side A. For this reason, a company will often purchase one D&O policy providing Side A and Side B cover for the directors and officers and obtain a separate policy providing Side C cover. In this way, the limit of indemnity available for the benefit of the directors is preserved.

An excess, also referred to as the *deductible or retention*, is an amount an insured individual must contribute towards a claim. In most cases, no excess applies to the Side A insuring clause that covers directors and officers. An excess is usually applicable to Sides B and C, which provide cover to the company.

**PERIOD OF COVER**

D&O insurance usually runs for 12 months and can commence on any date, but for convenience, many companies align their insurance with the financial year. Most D&O insurance cover is provided on what is technically termed a ‘claims made and notified’ basis, which means that (1) the claim against the director has to be made, and (2) the insurer has to be notified of the claim, during the policy period. With some exceptions, D&O policies will not cover a director or officer for claims arising from factual circumstances that were likely to give rise to a claim, and that they knew about or ought reasonably to have known about, prior to the commencement of the policy.

Many D&O policies refer to a retroactive date, which is usually the date on which the insurer first issued a policy to the company. As a general rule, the insurer will not cover liability arising from any acts, errors or omissions that took place prior to that date.

**CLAIM**

The definition of ‘Claim’ is important in defining the scope of cover offered under the D&O policy. It is in the definition of Claim that the requirement of capacity, discussed earlier, becomes relevant. A D&O policy almost invariably defines a Claim by reference to a wrongful act committed by an Insured Person in his or her insured capacity.

The definition of Claim will include demands for compensation and non-pecuniary relief and the commencement of legal proceedings, including civil actions and criminal prosecutions. Most D&O policies include cover for formal investigations, but this is an area where insurers can limit or broaden the available cover through...
the definition of ‘Investigation’. A wide range of investigations and enquiries can be brought against directors and officers by regulators, liquidators and other officials. This issue should be given close consideration.

LOSS

The definition of ‘Loss’ in a D&O policy is very important. It will describe the financial loss that will be paid by the insurer. The definition will conventionally cover awards of damages, compensation, judgments, settlements and defence costs as well as the legal costs of the claimant. Many D&O policies provide cover for civil pecuniary penalties and fines payable by a director. The definition of Claim will usually exclude liability to pay taxes and punitive, exemplary and aggravated damages. The definition can vary between policies issued by different insurers and, as with the definition of Insured Person, can be a means by which the scope of coverage can be narrowed or widened.

WHAT IS USUALLY EXCLUDED FROM COVER?

A D&O insurance policy will contain exclusions that restrict coverage. Some must be included by law. Others are included because the risk is typically covered by another type of insurance policy. Additional exclusions may be added to the policy by endorsement, which is an amendment or addition to the policy that changes its standard policy terms. Some of the most commonly encountered exclusions are as follows.

PRIOR CIRCUMSTANCES

Commonly found in all liability insurance policies, this exclusion will exclude cover for claims arising from an act or omission that took place prior to the commencement of the policy, which the director or officer knew or ought reasonably to have known was likely to give rise to a claim.

FRAUD OR DISHONESTY EXCLUSION

All D&O insurance policies will exclude cover for loss resulting from deliberately fraudulent or dishonest acts, improper use of information and improper use of position. This exclusion will usually extend to exclude loss caused by any wilful breach of duty or statute, or conduct carried out with a reckless disregard for the consequences. This exclusion is often referred to as the ‘conduct’ exclusion.

The exclusion will usually state that it only operates once there has been a final adjudication by a Court or tribunal or written admission by the director or officer concerning the fraudulent or dishonest conduct. In this way, the insurer is still permitted to advance defence costs (see the section on Extensions) so that directors or officers can pay for lawyers to defend themselves against the allegations.

PROFESSIONAL SERVICES EXCLUSION

A professional services exclusion will exclude cover for acts and omissions committed by directors in the performance of professional services. The precise wording will vary in each policy, and there is often a fine line between acts carried out in the capacity of director and those carried out in a professional capacity. If the company is carrying out professional services, advice should be sought about potential gaps in cover between the D&O policy and the professional indemnity policy.

PROSPECTUS EXCLUSION

A prospectus exclusion excludes cover for claims arising from allegations of misstatement or misrepresentation in a prospectus or similar public disclosure document.

MAJOR SHAREHOLDER EXCLUSION

A major shareholder exclusion excludes cover for claims brought by parties holding a specified level of equity (usually 15 percent or more) in the company.

INSOLVENCY EXCLUSION

An insolvency exclusion excludes claims arising from the company’s insolvency or inability to pay its debts as and when they fall due. This exclusion is often added by endorsement if the
insurer has concerns about the ongoing financial position of the company.

EXTENSIONS
Several extensions may be found in a D&O policy. They are called extensions because they extend cover beyond that provided in the Side A, B and C insuring clauses. They provide additional protection by catering for situations that do not trigger cover under those insuring clauses. Although some extensions are now found so frequently in D&O policies as to be considered standard, a range of optional extensions is usually available to be selected to suit the requirements of the company and its directors. The most commonly found extension is the provision for the advancement of defence costs. The vast majority of D&O policies contain a provision whereby the insurer can pay defence costs as they are incurred during the course of the defence of a claim or investigation. Should an exclusion operate to deny cover, for example, in the event of the criminal conviction of a director, the defence costs advanced by the insurer will become repayable by the director. Other common extensions include the following:

- **Cover for outside directorships:** This provides cover for directors sitting on the boards of external companies (which are not subsidiaries of the Policyholder) at the direction of the Policyholder.
- **Continuity cover:** This is, in effect, a waiver of any late notification of a claim provided that the Policyholder has held uninterrupted cover with the insurer since a specified date (known as a Continuity Date) and the claim could have been notified after that date. By forgiving the late notification, it creates an incentive for a company to remain loyal to its insurer.
- **Run-off cover for retired directors:** See the section called ‘What Happens if a Director Leaves the Company?’
- **Extended discovery period:** This is a further period after expiry of the policy during which the insurer agrees to accept notification of claims.

• **New subsidiaries:** This extends cover to subsidiaries acquired by the company during the period of the policy.
• **Extensions that meet the needs of specific industries:** These include situations such as a pollution extension for mining companies.

Cover under extensions may have sub-limits of indemnity.

WHAT HAPPENS IF A DIRECTOR LEAVES THE COMPANY?
A claim may be made against a director after he or she has left the company, sometimes many years later. The director may have moved to another company or retired. Alternatively, the company may have been taken over by, or merged with, another company. Such changes in control must be notified to the insurer and will affect the company’s D&O cover, typically bringing it to an end. Although the insurance policy may have expired, the director may still have liability for acts or omissions carried out in that capacity while he or she was employed with the company.

Because of the claims made and notified requirements of a D&O policy (as referred to earlier), the company must have a policy in force at the time the claim is made against the director or officer for cover to be available. For this reason, it is important for the director to check that the D&O insurance policy includes ‘run-off cover’, which provides cover for the director after he or she ceases to hold office. Some policies include this as a standard feature of the coverage offered; in others, it is an optional extension. Sometimes it can be added to the policy by way of endorsement before expiry. Run-off cover is also available to be purchased by the director in a separate stand-alone policy. The duration of the run-off cover should be at least seven years.

SEVERABILITY
D&O policies cover many individuals as Insured Persons, and in some cases the conduct of
one director will have an impact on other directors. For example, if a director is accused of misconduct or misrepresentations to the insurer, this may affect the ability of an ‘innocent’ director to obtain cover under the same policy.

Most D&O policies contain ‘severability and non-imputation’ clauses, which provide that the wrongful acts of one director are not imputed to another. In some cases, the proposal to the insurer and the insurance contract will be separate for each insured person, and there will be no imputation of acts or omissions from one insured person to another. Many policies limit those with knowledge of the company to a small number of executive directors and officers. Each insurance policy is different and should be checked carefully.

THE RESIDUAL RISK
A director should be aware that some risks cannot be transferred to the company or covered by D&O insurance. These risks include the following:

- damage to personal and business reputation
- personal financial losses resulting from a downturn in business or income
- liability for fraud, wilful misconduct and criminal conduct (and for defence costs incurred if the conduct is proved)
- liability for fines and penalties for criminal offences, and certain civil pecuniary penalties (cover may be available depending on the particular policy).

SOME PRACTICAL ASPECTS
It is important that directors obtain a copy of the complete D&O insurance policy, which will consist of the schedule, the wording and any endorsements. Directors should not rely on a summary provided by the company or the insurance broker.

The D&O insurance policy may prohibit disclosure of anything in the policy to third parties, including the limit of liability. Directors should carefully review the confidentiality provisions and be careful not to breach them.

Throughout the process of obtaining D&O cover, either for the first time or on renewal, advice should be obtained from a specialist insurance broker. Consideration should especially be given to whether there is continuity in cover, and whether there may be ‘gaps’ between policies.
Mr. Smith has over 20 years of experience as an insurance lawyer, principally in the areas of directors and officers insurance and professional indemnity insurance, acting both as coverage counsel and defence counsel. He advises on a wide range of insurance risks, acting for insurers based in Australia, the U.S. and London. Mr. Smith has acted in several large claims against directors and officers, many arising out of high-profile corporate collapses involving Australian Securities Exchange-listed public companies. He has extensive litigation experience in the Courts of New South Wales and Victoria as well as in the Federal Court of Australia. As an insurance lawyer, Mr. Smith for many years co-presented classes of the University of New South Wales postgraduate course in Insurance Law on policy conditions and exclusions.