Part 1

Executive Summary

Civil Penalties are a hybrid between Criminal and Civil law and are aimed at punishing white collar offenders through a civil court process.

There have been a number of high profile cases in recent years such as those following Australia's biggest corporate collapse – HIH Insurance Limited.

Civil Penalty Proceedings have increased for a number of reasons – most notably that they are cheaper and more efficient than criminal proceedings and make it more likely authorities such as ASIC can obtain a conviction.

Some Recent Cases

2001 HIH Insurance Limited (HIH)
ASIC successfully brought civil penalty proceedings against three former directors of HIH for breaches of their duties as directors. Their collective penalties totalled $1,155,000.

2003 The Water Wheel case
High profile businessman John Elliott and two of his fellow directors were found liable for breaching the insolvent trading provisions of the Corporations Act. Elliott and the then managing director, Plymin, were ordered to pay, jointly, compensation of over $1.4 million to the company. They were also ordered to pay pecuniary penalties of $15,000 and $25,000 respectively.

2004 Clifford Corporation Limited
Civil penalties were ordered against former directors for their contraventions of the Corporations Act, 2001 (Cth). They were ordered by the court to pay pecuniary penalties which, between them, totaled over $800,000.

2007 Steve Vizard
High profile media businessman, Steve Vizard was ordered to pay a civil penalty of $390,000 for improper use of confidential information gained whilst he was a director at Telstra.

What are Civil Penalties?

A civil penalty is imposed by courts when they apply civil, as opposed to criminal, procedures in determining liability and assessing the penalty for a wrongful act. It does not relate to the nature of the wrongful conduct itself.

Civil penalty provisions can be regarded as a **hybrid between criminal and civil law.** The purpose of imposing the penalty may be to punish the offender (the criminal component) but the sanction is based on civil court processes. Some regulatory schemes allow the prosecuting authority (for instance, ASIC) the choice of pursuing either, or both, criminal or civil processes.

Insolvent Trading

Section 588G of the Corporations Act, 2001 (Cth) states that where a director fails to prevent a company from incurring a debt when the company is insolvent, that director will be guilty of an offence known as insolvent trading. A breach of this provision can attract both criminal and civil penalties.

A monetary penalty is a common civil sanction. Other civil penalties include:

- injunctions
- banning orders
- licence revocations
- orders for reparation, and
- compensation

Why has there been a Recent Increase in Civil Penalty Proceedings?

An initial reluctance to utilise civil penalty sanctions – civil penalty provisions under the Corporations Law came into operation in 1993. Yet, a study by the Centre for Corporate Law and Securities Regulation carried out in 1999 showed that only 14 civil penalty applications to the court had been made by ASIC since 1993.

Gilligan, Bird and Ramsay in their paper titled: "The Efficacy of Civil Penalty Sanctions Under the Australian Corporations Law", cited four reasons for the initial reluctance:

1. Resource constraints – ASIC had limited financial and personnel resources.
2. Relations with other regulatory agencies and the judiciary - ASIC was uncertain as to how the judiciary would deal with civil penalty actions.
3. Availability of alternative sanctions – ASIC had other civil remedies such as injunctions and management banning orders.
4. Concerns about the utility of civil penalties – for instance, a monetary civil penalty action offered little to ASIC if an offender was bankrupt or the corporation was insolvent.

The recent increase
Within a short period (between September 1998 and December 2001), ASIC prosecuted 30 civil penalty applications.

This has occurred partly due to the difficulty of proving a criminal offence – that is "beyond reasonable doubt".

In the recent Steve Vizard case, ASIC chose not to proceed in criminal prosecution and opted for civil penalty proceedings instead. ASIC successfully brought proceedings against Vizard for civil penalties and a disqualification order.

ASIC showed that Vizard had breached his duty as a director of Telstra by improperly using information given to him as a director to gain an advantage for himself and others. ASIC chose not to issue criminal proceedings against Vizard for insider trading because a key witness was not prepared to give evidence against him. In the absence of the key witness, it would not have been easy for ASIC to satisfy the onerous burden of proof which is required in bringing a successful criminal proceeding.

Other reasons for increased civil penalty sanctions in preference to criminal sanctions (as noted by Justice Finkelstein in Australian Securities and Investments Commission v Petsas [2005] FCA 88) include the fact that:

- civil proceedings are cheaper and more efficient than criminal proceedings;
- the rules of evidence in civil proceedings are less strict;
- the protections afforded to defendants are not as great;
- the standard of proof is lower; and
- if there is a greater likelihood of obtaining a conviction, enforcing authorities such as ASIC may be more inclined to take action in doubtful or potentially doubtful cases.

Treasury Plans to Toughen Things Up

In 2007, the former Treasurer planned to 'make it quicker to bring proceedings against corporate crooks'. If that eventuates, we may see an even greater use of civil penalties by ASIC.

In a Discussion Paper issued in March 2007, former Treasurer Costello proposes both a greater use of civil penalties and the extension of the "business judgment rule" defence to liability of directors including insolvent trading breaches.

Part 2

Executive Summary

In the area of Civil Penalties, an “appropriate penalty” is a function of a number of criteria including the seriousness of the offence, the size of the profit made and personal circumstances of the offender.

Civil Penalties have been available under the Trade Practices Act since its inception in 1974. A distinction is made between provisions dealing with restrictive trade practices and the prohibition on misleading and deceptive conduct.

Directors and Officers are at risk of a personal liability if they have, in any way, aided or abetted an offence or have been in any way “knowingly concerned” in a contravention of the Trade Practices Act.

The Penalty

The tendency of regulators to use civil penalty sanctions in preference to criminal sanctions can create problems for the courts.

In *Australian Securities and Investments Commission v Petsas* [2005] FCA 88, Justice Finkelstein highlighted the case as the first occasion on which a judge had been required to impose a civil penalty on a person who had contravened the insider trading provisions which was also a criminal offence under the Corporations Act (Cth), 2001.

- Justice Finkelstein's own research showed that, ever since 1992, even first-time offenders who pleaded guilty to criminal offences such as insider trading were likely to suffer a term of imprisonment.
- Recent well-publicised criminal prosecutions for such a corporate breach include the high profile convictions of the late stockbroker Rene Rivkin and former Macquarie Bank investment banker Simon Hannes.

How should the court calculate an appropriate amount of civil penalty bearing in mind the purposes of imposing such penalties are punishment and deterrence?

In the case above, Petsas had acquired, through his position with ANZ bank, confidential and price sensitive information regarding merger discussions between a publicly listed wine production company, BRL Hardy Ltd, and an American alcoholic beverage production company, Constellation Brands. ANZ Bank had been engaged to perform confidential work in connection with the merger discussions. Petsas communicated that information to Miot and, together, they bought call options over BRL shares (in Miot's name) and subsequently profited from their sale.

Petsas was ultimately ordered to pay a penalty of $75,000 for his breach of trust in obtaining and distributing the confidential information and Miot was fined $65,000 for his use of the same information. The court took into account the personal circumstances of each of the offenders - their education, working history and their prospects of future employment in their chosen field. The court also considered the fact that each offender had entered early guilty pleas and that each had shown genuine remorse and was unlikely to offend again.

Methods of Calculating the Appropriate Penalty

In assessing the proper amount of penalty to be imposed in a civil penalty proceeding, Justice Finkelstein considered the following:

- the monetary value of a term of imprisonment (by reference to earnings foregone due to imprisonment and the value placed on restriction of freedom)
- a fine that represents the total harm caused by the offence (taking into account the costs suffered by the victims and the costs of apprehending, convicting and detaining the offender)
- the use of formulae that have been adopted under section 4B of the Crimes Act, 1914 (Cth), by which the court may, for specified offences, convert a prison sentence into a monetary amount.

The court took into account the following factors in determining an appropriate civil penalty for a breach of a provision that also creates a criminal offence (such as insider trading) under the Corporations Act:

- the seriousness of the offence
- whether a jail sentence could be imposed in a criminal hearing
- the equivalent penalty, in penalty units, under section 4B of the Crimes Act
- the stigma associated with a criminal conviction and the effect it has on the offender's opportunities for employment and travel
- the purpose of imposing a civil penalty for a violation of the provision
- the size of the profit made, and
- the personal circumstances of the offender.

Interestingly, Justice Finkelstein was also the presiding judge in the Steve Vizard case and made the point that he would have ordered a higher monetary penalty against Vizard "if left uninstructed" by ASIC. Clearly, his Honour did not think that the penalty imposed was sufficient for the offence committed by Vizard.

Indeed, his Honour disregarded ASIC's submission for a 5 years disqualification order against Vizard and, instead, ordered a disqualification of 10 years. The court was keen to send a strong message to the business community about such "white collar crime". Justice Finkelstein said that, even though Mr Vizard had expressed contrition and there was evidence of his good character, it was the nature of the offence, rather than the character of the offender, that should be the primary consideration when considering the penalty.

Furthermore, his Honour also made the point that the current maximum of $200,000 for each contravention was put in place 13 years ago and that this limit might require review by Parliament.[1]

Footnotes

(1) Whether this maximum penalty should be increased is being reviewed by the Government and was the subject of a Discussion Paper issued by Commonwealth Treasury in March, 2007.

What Legislation Imposes Civil Penalties?

Civil penalties have been available under Australian legislation since the enactment of the Customs Act, 1901 (Cth), however, the civil penalty imposed under that Act is more appropriately characterised as a debt owed to the Crown rather than a monetary punishment or deterrent for a wrongful act.

Civil penalties, as the term is commonly understood today, however, have been available under the Trade Practices Act (Cth) since its inception in 1974. Since then, numerous pieces of legislation have been enacted which impose civil penalties as a sanction against breaches of the Act. The following are just a few examples:

- Superannuation Industry (Supervision) Act, 1993
- Telecommunications Act, 1997
- Environment Protection and Biodiversity Conservation Act, 1999
- Sydney Airport Demand Management Act, 1997
- Occupational Health and Safety Act 2000
- Corporations Act, 2001
- Financial Services Reform Act, 2001
- Tax Laws Amendment (2006 Measurements No. 1) Act, 2006, and most recently:
- Anti-Money Laundering and Counter-Terrorism Financing Act, 2006.

Trade Practices Act, 1974

When the Trade Practices Act, 1974 (Cth) was enacted, a distinction was made between the trade practices provisions and the consumer protection provisions. The explanation for this distinction was made by then Attorney General, Lionel Murphy:

- Consumer protection provisions generally deal with conduct which amounts to a criminal offence. For instance, cases where there are false representations or conduct which is obviously fraudulent and which is of a kind ordinarily covered by the criminal law.
- In the trade practices area, the offending conduct is generally more of a commercial conduct dealing with competitors – anti-competitive action that could, for instance, drive a competitor out of business.

Parliament was keen not to import the notion of criminality into the trade practices area. In contrast, breaches of consumer protection provisions such as section 52 of the Trade Practices Act (prohibition in respect of misleading and deceptive conduct) will only give rise to a criminal penalty.

The Australian Law Reform Commission questioned the necessity for this distinction in their Report on “Compliance with the Trade Practices Act 1974” in 1991. The Commission said that there was no rational basis for this distinction and recommended that the consumer protection provisions (Part V) of the Act allow for civil penalties as well as criminal penalties.

The Chairman of the Australian Competition & Consumer Commission (ACCC), Mr Graeme Samuel echoed this view in his 15 March, 2007 address to the National Consumer Congress entitled “The Foundations of Good Consumer Protection: Strong Law, Vigorous enforcement and The Educated Consumer”. He made the point that “competition regulation and consumer protection are inextricably mixed” and advocated civil penalties be available as sanctions against breaches of some consumer protection provisions. He also called for the introduction of a jail term for very serious cartel conduct. A number of petrol distributors and retailers have in recent years been penalised for price fixing arrangements under Part IV of the Act but the ACCC believes that criminal sanctions, in the form of a term of imprisonment, should be available for the executives of companies responsible for such price fixing. The federal government is looking into this issue at present.

Today, however, a distinction remains between competition regulation and consumer protection under the Trade Practices Act. Only breaches of the restrictive trade practices provisions will give rise to civil penalties under the Act. To emphasise the deterrent aspect, the penalties in Part IV were significantly increased in 1993 to $10,000,000 in respect of corporations and $500,000 in respect of individuals.

Broadly speaking, Part IV of the Trade Practices Act prohibits the making of contracts or the engaging in any conduct by corporations which involves:

- the practices of monopolisation, exclusive dealings or resale price maintenance

- predatory price discrimination

- secondary boycott, and

- acquisitions that would result in a substantial lessening of competition.

Directors and officers are at risk of a personal liability if they have, in any way, aided or abetted the offence or have been in any way "knowingly concerned" in the contravention.

The following two cases serve as a reminder of the onerous costs of breaching competition laws, particularly when senior management implement or condone the conduct.

Jurlique

The action by the ACCC against Jurlique International Pty Ltd serves as a warning against potential breaches of the resale price maintenance provisions of the Trade Practices Act. Resale price maintenance involves conduct in which a supplier induces a retailer not to sell below a minimum price. Jurlique's contraventions included:

- attempting to induce retailers not to discount Jurlique products,
- entering into contracts with retailers so they would not sell below specified prices,
- withholding supply because retailers discounted prices, and
- using product statements likely to be understood as the minimum resale price.

On 8 February 2007, the Federal Court ordered four Jurlique International companies, as well as Jurlique's founder and former managing director, Dr Klein, to pay a record-breaking $3.4 million in penalties. Dr Klein was found personally liable for being knowingly concerned in the resale price maintenance breaches. He was ordered to pay a penalty of $200,000 and a further $20,000 in costs.

Qantas

Another case to note is the recent $200 million class action against Qantas and several other airlines for price fixing. The main plaintiff, Auskay International, alleges that the carriers made agreements seven years ago to fix fuel, security and war-risk charges.

If the action is successful, Qantas is expected to be the hardest hit as it has the biggest portion of the market. The Federal Court proceedings follow prosecutions and class actions that have been filed in the United States and Canada in relation to the same cartel. It will be interesting to see how the case will proceed in Australia. Strictly speaking, if the ACCC is not involved, it is more likely that the remedy would involve one of compensation rather than one of civil penalties.

A new section 77A of the Trade Practices Act came into effect on 1 January, 2007.

This section prohibits a body corporate from indemnifying a person against a civil liability. **A Civil Liability** is defined as a liability to pay a pecuniary penalty for a contravention of a provision of Part IV of the Act. Effectively, this means that a corporation is prohibited from indemnifying a person, such as a director or officer of the corporation, from a breach of a provision of Part IV of the Act.

Furthermore, the Act prohibits the corporation from indemnifying the person in respect of their legal costs incurred in defending the civil liability proceedings.

Section 77A clearly has implications for directors and officers. They can no longer look to the company to indemnify them in respect of their personal liability in cases of breach.

Directors and officers will need to re-examine their internal corporate indemnity agreements with their corporations if they have not already done so and also revisit their Directors and Officers Liability Policy to determine if there are any coverage issues. We shall be discussing insurance coverage issues in relation to Civil Penalties in Part 4 of this White Paper Series.

Part 3

Executive Summary

Changes to the Civil Penalty provisions of the Corporations Act present Directors and Officers with new risks.

They face the potential for significant fines and the concept of Double Jeopardy has been weakened so that errant directors may face both Civil and Criminal action.

With these penalties in mind, Directors and Officers need to clearly understand their responsibilities, especially in areas such as insolvent trading, continuous disclosure and insider trading.

Introduction

Until 1993, contraventions of directors' statutory duties were criminal offences under the then Corporations Law and punishable by criminal sanctions, including imprisonment. However as they were criminal offences, the regulator had to establish the offence "beyond reasonable doubt".

The civil penalties provisions under the Corporations Act were introduced to allow punishment of directors and officers for offences which fell short of a criminal offence. The rationale was that the lower standard of proof and the fewer procedural protections available to an offender in a civil action would make it easier to punish corporate offenders. The introduction of civil penalties was intended to balance the desire to protect the public against unscrupulous directors and the need to ensure there was no undue burden placed on honest directors.

These provisions came into operation in February 1993 and they are now found in Part 9.4B of the Corporations Act, 2001.

What Happens when you Breach the Corporations Act?

The consequences following a breach of the provisions of the Corporations Act are complicated. Simply put, a contravention of the Corporations Act may now carry liability under three different provisions:

1. civil liability provisions
2. civil penalty provisions, and
3. criminal liability provisions.

As far as civil penalty provisions are concerned, the declaration provision (section 1317E) is the pivotal one. Once the court is satisfied that a person has contravened a penalty provision (as defined in the Act), it must make a declaration of contravention. The court may then order a pecuniary penalty, a compensation order and a banning order.

Note that a failure to comply with a provision of the Corporations Act could result in the offender having a civil liability (such as a director's liability for breach of continuous disclosure provisions in a shareholder class action), as well as being liable under both civil penalty and criminal provisions. Breaches of the following provisions could result in both civil and criminal liability:

- insolvent trading
- continuous disclosure
- insider trading.

Double Jeopardy

The general rule is that a person cannot be convicted of the same crime in respect of the same conduct on more than one occasion. In the HIH case, former directors Adler and Williams faced criminal charges brought by ASIC and the Director of Public Prosecutions after the civil penalty proceedings had ended. Adler immediately argued double jeopardy.

However, the court allowed the criminal prosecution to proceed based on similar events to the civil penalties on the basis that a distinction exists between the duty that a director owes to the company and criminal activities that undermine the confidence of the Australian financial markets. In any event, the Corporations Act specifically allows criminal proceedings to be brought after civil proceedings have been initiated.

Both Adler and William pleaded guilty to the criminal charges and both were sentenced to four and a half years imprisonment.

Continuous Disclosure Requirements

Since the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (CLERP 9) commenced on 1 July, 2004, civil penalties for corporations failing their continuous disclosure obligations have been increased from $200,000 to $1,000,000. Liability has also been extended to directors and officers if they are involved in the contravention.

A director would **not** be entitled to be indemnified by the corporation in respect of a penalty order made against him or her for failing their continuous disclosure obligations. There is, however, a due diligence defence available to directors or officers if they can show they:

- took all reasonable steps to ensure the entity complied with its continuous disclosure obligations, and

- after doing so, believed on reasonable grounds that the entity was complying with its continuous disclosure obligations.

Insolvent Trading and the Role of Non-Executive Directors

Reasonable directors and officers know whether all steps have been taken to ensure that the company has complied with continuous disclosure requirements. Most reasonable directors and officers would know not to breach insider trading provisions. But what about the possibility of breaching the insolvent trading provisions – particularly when you are a non-executive director of a company that has become insolvent?

In June 2003, John Elliott and two other directors of Water Wheel Mills Pty Ltd and Water Wheel Holdings Ltd, were found by the Victorian Supreme Court to have breached the insolvent trading provisions of the Corporations Law. They had failed to prevent the companies from incurring debts at a time when the companies were insolvent.

The court noted that the contraventions were serious and represented a sustained, continuous course of inexcusable and unjustifiable neglect of important duties. The directors were presented with unmistakable evidence and repeated warnings that the company was heading towards insolvency in the first half of 1999 and was indeed insolvent by September 1999.
Yet, it was only placed into voluntary administration in February 2000.

As a non-executive director, John Elliott was criticised by the court because he failed to make proper enquiries as to the company's financial position or address the company's solvency problems – even though he was found to have been on notice from March 1999.

All three directors were found unfit to manage a corporation and each received prohibition orders (banned from managing another corporation) varying in length. Elliot, for instance, was banned from managing a corporation for a period of 4 years. He and another director were ordered to pay, jointly, compensation of $1.428 million.

While the court found the contraventions to be of a serious nature, it took into account the length of the prohibition orders and the size of the compensation orders made against directors, and imposed a relatively small pecuniary penalty (Elliot was fined $15,000). Elliott's appeal against this decision was unsuccessful.

The Water Wheel case sounds a serious warning to non-executive directors. Apart from developing strategy and promoting company performance, one of the roles of non-executive directors is to ensure financial information is accurate and that financial controls and risk management systems are robust and defensible. The courts clearly indicated in the Water Wheel case that non-executive directors are not excused from insolvent trading claims simply because they are not themselves capable of preventing the company from incurring debts. Indeed they are expected to remain fully and appropriately informed of the company's financial position and to act accordingly.

That means if it appears the company might become insolvent, they must take immediate steps to appoint an administrator. If they cannot persuade the majority of directors of this course the director should resign in order to protect his or her interest.

Maximum Penalties

The maximum pecuniary penalty that may be ordered under the Corporations Act is $200,000 against an individual or $1,000,000 against a corporation. As discussed in Part 2 of this White Paper Series, the government is now reviewing this amount to see if the monetary limit against an individual should be increased.

Penalty Privilege Defence

A discussion on civil penalties would be incomplete without discussing penalty privilege. This privilege entitles a defendant in civil penalty proceedings to resist orders to disclose information or produce documents which may help to establish the defendant's liability to the penalty (see Refrigerated Express Lines (A/asia) Pty Limited v Australian Meat and Livestock Corporation and Others (1979) 42 FLR 204 at 207-8).

This privilege applies only to individuals. They may claim this privilege in actions where, for instance, breaches of directors' duties, insolvent trading, market manipulation, insider trading and breaches of continuous disclosure requirements are alleged.

Recently, the High Court confirmed that this privilege is also available in civil proceedings where only banning orders and compensation orders (not pecuniary penalties) are sought (see Rich v ASIC (2004) 220 CLR 129). The court made the point that penalties which attract the privilege are not confined to monetary penalties. However, in a reaction to that decision, the Corporations Amendment (Insolvency) Act 2007, which commenced on 31 December 2007, has removed the penalty privilege in relation to proceedings brought by ASIC for disqualification, banning, suspension and cancellation orders.

Part 4

Executive Summary

The use of Civil Penalties as a sanction against White Collar Crime is growing.

While criminality cannot be insured against, insurance can protect Directors and Officers in respect of unintentional or accidental wrongful acts and for legal costs incurred in defending legal proceedings where criminal conduct is alleged but not proven.

Companies and their Corporate Officers need to understand what their D&O policies do and do not cover. They need to pay careful attention to wordings, consider extensions that might extend their cover and also look at other risk management strategies – such as a clear focus on quality Corporate Governance.

Civil Penalties – Can You Be Covered?

In the first 3 Parts of this Liberty White Paper Series on Civil Penalties, we discussed the significant rise in the use of civil penalties to impose sanctions for white collar crimes.

We have already discussed the way in which civil penalties may be imposed under the Trade Practices Act, 1974 (Cth) and the Corporations Act, 2001 (Cth). These two Acts are just examples of numerous pieces of legislation that provide for civil penalties. From a corporate governance point of view, corporations and their directors and officers are facing an increasing risk of having civil penalties imposed upon them for their corporate decisions.

Some would say that offending corporate officers deserve to suffer the consequences of their actions. But what if your breach was innocent? What if you had not realised, as a director, that the company was trading whilst insolvent? Should you be able to insure your liability for resultant civil penalties? Can you do so? These issues and more will be discussed in Part 4 of this Liberty White Paper Series.

Insurability of Civil Penalties

If an insurance contract seeks to cover an insured corporation or their director or officer for an intentional wrongdoing, then that contract would be clearly illegal. Such a contract would be against public policy and would have no effect. Why?

Intentional Wrongs

A fundamental principle of contract law is that a person is not allowed to benefit from their crime, especially when they intend the consequences, or are reckless as to what might happen. The consequences of a wilful or dishonest breach of the Corporations Act, for instance, should not and would not be insurable. This would be against public policy because it would remove the deterrent effect of court-ordered penalties.

Indeed, no insurer would provide cover for intentional wrongs. A contract of insurance must involve an element of uncertainty. In the case of Directors' & Officers' Liability (D&O) Insurance, the uncertainty is in whether or not the event which results in liability will happen.

Liability for intentional breaches of legislation which result in criminal penalties is typically excluded under D&O policies.

Unintentional Wrongs

What if the wrong was unintentional? What if you, as a director, had not realised or appreciated the true financial position of the company and had allowed the company to trade whilst it was insolvent? Or, in the case of managed investment schemes, what if a "responsible entity" unwittingly failed to comply with one of its duties under Part 5C of the Corporations Act? A breach of one or more of these duties could result in civil penalties.

Technically, to allow a person to insure against a civil penalty might seem to frustrate one of the purposes of the legal sanction. If directors can push their liability for these civil penalties onto insurers, they will have less incentive to avoid committing the wrongful act.

The flip side of this argument is that, if a director or officer is permitted to insure against the consequences of an act proscribed by the Corporations Act, the same director or officer should be able to insure against liability for civil penalties where the wrongful conduct was committed either innocently or through negligence, as opposed to a deliberate or reckless infringement. The focus is on the nature of the wrong rather than on the type of remedies - be it compensation or civil penalties - that may be imposed as a result.

To say that the availability of insurance coverage removes any deterrent effect is also not entirely correct. Assuming a D&O policy provides coverage for a civil penalty claim and a claim is made under the policy, the inevitable consequence would be that the insurer, having paid out the claim (assuming there are no applicable exclusions), would review that claim at renewal. An increase in premiums or a refusal to renew the policy may come into play. There **is** a commercial deterrent even if liability for civil penalties is covered under the policy.

Finally, from a pragmatic point of view, even if the insurability of civil penalties is questionable on the ground of public policy, this issue will probably only arise if the insurer were to take the point when a claim is made. There is nothing to prevent an insurer from paying out the claim, assuming it is a valid claim. From a commercial stand-point, an insurer who offers coverage in respect of liability for civil penalties, and who has received premiums for such coverage, is unlikely to deny a claim based simply on public policy grounds. Of course, the onus is on the insured to show that the claim is within the terms of the policy and that no exclusions apply.

To What Extent Are You Covered?

Assuming there is no illegality issue with insuring liability for civil penalties (and most insurance policies that offer coverage for civil penalties proceed on this basis), what coverage issues must a director or officer look out for in a D&O policy?

Some D&O policies specifically exclude cover for fines and penalties. Others exclude fines and penalties but then provide limited cover for civil penalties by way of an extension.

With managed investment schemes, a failure by a responsible entity or their directors or officers to perform their duties as set out in the Corporations Act may result in civil penalties. In that event, their liabilities to pay civil penalties may be covered by their D&O policies provided there are no other applicable exclusions.

Similarly, if civil penalties are ordered against a company or their directors or officers due to a breach of the continuous disclosure obligations, the liability to pay these penalties may be covered under a D&O policy (unless the breach was a wilful one in which case other exclusions may apply).

Directors and officers need to peruse their D&O policies to ensure that they have a good understanding of the precise scope of their coverage. For instance, if they do have cover for civil penalties, are they covered only for civil penalties under the Corporations Act, 2001 or are they covered for breaches of other legislation (such as the Trade Practices Act, 1974)? Are they covered for pecuniary penalties as well as compensation orders? Is the cover sub-limited?

Fraud & Dishonesty

Most D&O policies contain a Fraud & Dishonesty Exclusion and an Illegal Benefits/Improper Profits Exclusion. Sometimes these exclusions are combined into the one exclusion.

This means that, even if a D&O policy provides specific coverage for civil penalties, a claim may not be covered because certain exclusions may apply. For instance, liability for civil penalties arising from insider trading breaches is likely to be excluded because of the Illegal Benefits/Improper Profits Exclusion. So, too, would liabilities arising from fraudulent or dishonest conduct.

However, some D&O policies only exclude liability from conduct such as fraud and dishonesty where it has been established either by the insured's admission or by the judgment, award or finding of a court, tribunal, commission or arbitrator that such conduct occurred. Under these policies a mere allegation of fraud or dishonesty will not trigger the operation of the exclusion.

This means insurers agree to pay for the legal costs incurred in defending the director or officer until such time as the allegation is proved. In that event, the Fraud & Dishonesty Exclusion or any other applicable exclusion would apply and the insured director or officer would need to repay any defence costs paid up to that point in time. Of course, much depends on the precise terms and conditions of the insurance policy.

Coverage for Insolvent Trading Breaches

As outlined in Part 3 of this Liberty White Paper Series, a number of sanctions may be imposed on a director for insolvent trading pursuant to:

- civil penalty provisions
- criminal penalty provisions, and
- compensation provisions enabling recovery by a liquidator or a creditor.

As D&O policies do not cover a director or officer for liability incurred as a result of a wilful breach of duty, it follows that they will not cover a director or officer for liability incurred for insolvent trading where such a contravention is a criminal offence. This is because a criminal offence is committed as a result of a wilful breach of duty which in turn requires proof of intentional deceit or dishonesty. As discussed above, most D&O policies would typically exclude such conduct from its coverage.

As far as liability for a pecuniary penalty or a compensation order is concerned, companies are not allowed to indemnify a director or officer against their liability owed to the company or a liability for a pecuniary penalty order or a compensation order (see section 199A of the Corporations Act). This means that, if directors and officers are covered under their D&O policy for pecuniary penalties or compensation orders, they would be covered under the Directors & Officers Liability Section ("Side A") as opposed to the Company Reimbursement Section ("Side B") of their policy.

Coverage for Civil Penalties under the Trade Practices Act

In respect of civil penalties ordered under the Trade Practices Act, 1974 (Cth), the new section 77A of the Act prohibits a corporation from indemnifying a person from penalties imposed following breaches of Part IVA of the Act (competition regulation provisions). This was discussed in Part 2 of this Liberty White Paper Series.

Again, assuming there is coverage for liability for such civil penalties, directors and officers would need to seek indemnity under Side A of their D&O policy. Indemnity is, of course, subject to the terms, conditions and exclusions of the policy. For instance, if the cover for civil penalties is limited to those penalties ordered under the provisions of the Corporations Act, then any liability for civil penalties ordered under the Trade Practices Act would not be covered.

Conclusion

Much can be written on the topic of civil penalties and many arguments for and against their insurability can be advanced. The aim of this Liberty White Paper Series is simply to raise an awareness of the increased risks that corporations and their directors and officers face in terms of civil penalties.

Directors and officers – and potentially those in middle management (see Part 1 of this Series) need to appreciate their increased risks of personal financial liability when performing day-to-day management duties. They also need to review the relevant legislation, their corporate indemnity and their D&O policy to understand the extent of their protection against such liability.

Knowledge is the best form of insurance. Good corporate governance practices coupled with a sound appreciation and management of risks helps protect corporations and their directors and officers from liabilities for civil penalties – whether they are insured for them or not.

D&O Insurance Premium Splitting

Section 199B of the Corporations Act is well known to those in the D&O insurance market. It does not allow a company to pay, or even agree to pay, the insurance premium for a contract that seeks to insure a director or officer against liability (other than for legal costs) which arises out of:

1. conduct involving a wilful breach of duty in relation to the company, or
2. a breach of section 182 or section 183 of the Corporations Act.

Section 182 deals with the improper use of position, whilst section 183 deals with the improper use of information, by a director or officer to gain an advantage.

If a company does pay a premium for directors and officers to insure them against the liability mentioned above, not only is the company (and its directors and officers) likely to have committed a strict liability offence, the insurance policy will also be void or unenforceable to the extent of the cover provided for that liability.

As mentioned above, many D&O policies contain Fraud & Dishonesty Exclusions or Illegal Benefits/Improper Profits Exclusions. Does that mean that the company is able to pay 100% of the D&O Insurance premium given the presence of these exclusions?

There are differing views on the issue of splitting D&O premiums between a company and its directors and officers. Some say that, given the prohibition stipulated in section 199B, it is advisable for directors and officers to pay a portion of the D&O premium on the basis that, even if the policy does provide some cover in relation to the liability mentioned in section 199B (most D&O policies typically do not provide coverage for such conduct), the policy would remain valid since that part of the coverage would have been paid for by the directors and officers themselves (and not the company). Others say this logic is flawed because there is only one contract of insurance and the company is still paying for a contract (albeit not 100% payment) that provides the prohibited cover.

Liberty's view is that premium splitting is unnecessary. A company is able to pay 100% of the premiums for the D&O cover for its directors and officers provided that the exclusions in the policy reflect precisely the prohibition specified in section 199B of the Corporations Act. We therefore suggest that directors and officers review their D&O policies to ensure that the wording of their relevant exclusions strictly reflect the language used in section 199B.

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