

CAN YOUR INSURER RELY ON AN INSOLVENCY EXCLUSION?

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Legal Briefings - By **Mark Darwin and Brendan Donohue**

Insolvency exclusion in D&O policy did not apply to claim by DOCA Administrators for breach of directors' general duties.

KEY TAKEAWAYS

1. In a recent Australian Federal Court decision indemnity for directors in respect of a claim by the company's administrators was not excluded by an insolvency exclusion in a Directors and Officers liability (**D&O liability**) policy, on the basis that the claim was not based on allegations of insolvent trading and the claim for breach of duties could have been made even if the company was not insolvent.
2. This decision has proved an important reminder for policyholders that it is not enough for your insurer to invoke an insolvency exclusion where the insolvency merely motivated, or was the occasion for, a claim being brought.
3. This is yet another case in which, at first glance, cover may be thought to be excluded, but detailed consideration revealed that the insurer's reliance on an exclusion was misplaced.

FACTS

In a recent Full Federal Court decision, administrators of Kaboko Mining Limited (**Kaboko**) acting under a Deed of Company Arrangement (**DOCA**) (clearly after the company had been declared insolvent) had commenced proceedings against the company's former directors. Damages were sought for alleged breaches of the Corporations Act and of the general law duty to act in good faith in the best interests of the company for a proper purpose.

The former directors sought indemnity for the claims under their D&O liability policy with AIG, but AIG denied indemnity, arguing that it was not liable to indemnify the former directors because of the insolvency exclusion which stated:

[AIG] shall not be liable under any Cover or Extension for any Loss in connection with any Claim arising out of, based upon or attributable to the actual or alleged insolvency of [Kaboko] or any actual or alleged liability of [Kaboko] to pay any or all of its debts as and when they fall due.

The primary judge found that the insolvency exclusion did not preclude cover under the policy for the claims made by Kaboko. AIG appealed the issue of the proper construction of the insolvency exclusion.

The relevant background was that Kaboko had agreed to sell manganese ore taken from certain mines in Zambia to a company called Noble Resources. Noble was required to advance to Kaboko US\$10m in two tranches to be used only for specified purposes.

Two years later Noble alleged that the advance had not been used for the specified purposes, that Kaboko did not keep proper financial records and that Kaboko was wrongly selling ore from the mines to third parties without its consent. Noble issued a demand for repayment of the advance and, when Kaboko failed to pay, Noble appointed receivers to Kaboko. Shortly thereafter Kaboko appointed administrators. A Deed of Company Arrangement was subsequently entered, following which the administrators brought the proceedings against the former directors (funded by Noble), seeking recovery of the advances on the basis of the alleged breaches of duty by the directors. Importantly, the proceedings did not allege that the directors were guilty of insolvent trading.

The key question was whether, in order to rely on an insolvency exclusion, insolvency had to be the subject matter of the claim against the directors, or whether it was enough that, by reason of the circumstances that led to the bringing of the claim, it could be said that the claim 'arose out of, was based upon or was attributable to' the actual or alleged insolvency of Kaboko (as here, since the claim was being made by the administrators after the company's insolvency).

THE INSURER'S ARGUMENT

In relation to the key question, AIG submitted that the exclusion applied where there was any loss in connection with any claim arising out of, based upon or attributable to an insolvency event. AIG therefore argued it could rely on the insolvency exclusion where there was a link between either the bringing of the claim or the nature of the loss for which indemnity was sought. AIG argued that there would have been no proceedings had Kaboko repaid Noble the advance when it was due, so that it followed that the proceedings were brought because Kaboko was insolvent.

DECISION

The Full Court of the Federal Court dismissed AIG's appeal, and construed the insolvency exclusion so that the former Directors were not deprived of cover.

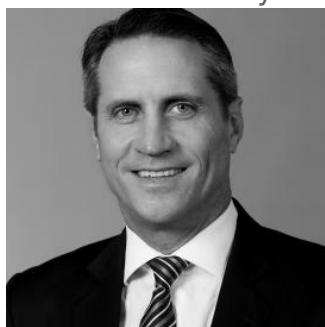
The court disagreed with AIG's submission and held that the insolvency exclusion must be linked to the subject matter of the claim against the former directors. Given the basis of Noble's claims against Kaboko was an alleged breach of the agreements and alleged breaches of various duties, Kaboko's claims against its former directors were therefore not properly characterised as claims based on an insolvency and could in fact have been made against the directors even if Kaboko was solvent.

REMINDER FOR POLICYHOLDERS

This decision is yet another reminder that an insurer's position that an exclusion must apply should not always be taken as determinative. Careful consideration should be given to coverage debates before policyholders walk away from or settle disputed insurance claims.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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