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Case Alert

Shaping the future of insurance law

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When will an insolvency exclusion apply?

Kaboko Mining Limited v Van Heerden (No 3) [2018] FCA 2055

AT A GLANCE

- The Federal Court recently rejected the application of an insolvency exclusion in a claim brought against directors of a company in voluntary administration.
- The case is a reminder that an insolvency exclusion does not automatically apply when the insured entity is insolvent.
- Where the exclusion applies to a "loss", then the insolvency of the insured entity must have caused the loss that is the subject of the claim for the insolvency exclusion to apply.

The case background

Kaboko Mining Limited entered into a prepayment agreement with Noble Resources Limited, under which Noble advanced Kaboko approximately USD6 million as prepayment for manganese ore.

In July 2014, Noble issued a default notice to the directors of Kaboko alleging that Kaboko had breached several terms of the prepayment agreement. In August 2014, Noble's solicitors issued a statutory demand for the amount of the advances. The statutory demand was set aside by the Supreme Court of Western Australia.

In 2015, a monetary default occurred on the prepayment agreement and Kaboko's directors appointed Administrators to Kaboko. The Administrators' Report identified possible breaches of directors' duties based on allegations by Noble and the Noble default notice.

In 2016, Kaboko commenced the proceedings against four current and former directors. The proceedings alleged breaches of ss180 and 181 of the *Corporations Act 2001* (Cth) and a breach of the general law duty to act in good faith in the best interests of Kaboko and for a proper purpose.

On 19 December 2018, the Federal Court handed down an interlocutory decision on a preliminary question as to the interpretation of the insolvency exclusion in the directors and officers insurance policy.

The insolvency exclusion

The policy contained the following endorsement:

> "*The Insurer 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 the Company or any actual or alleged inability of the Company to pay any or all of its debts as and when they fall due.*"

Kaboko and its insurers raised a preliminary question for determination on whether this insolvency exclusion precluded cover for the directors regarding the claims made in the substantive proceedings.

The parties' positions

Insurer

The insurer relied on the judgment of the NSW Supreme Court in *Quintano v BW Rose Pty Ltd* [2008] NSWSC 793 to contend that the insolvency exclusion operates if:

- the actual or alleged insolvency of Kaboko, or any actual or alleged inability of Kaboko to pay any or all of its debts, is the springboard or foundation for the claim, or
- if the loss in connection with the claim is either based on, or attributable to, such insolvency or inability to pay any or all of Kaboko's debts.

The insurer asserted that if Kaboko had met the statutory demand there would have been no claim or proceedings.

Kaboko

Kaboko submitted that the claims under ss180 and 181 of the *Corporations Act 2001* (Cth) for breaches of duties are the exact class of risk the policy is intended to insure.

Kaboko stated that the statutory demand did not cause Kaboko any loss and the true measure of Kaboko's loss from the alleged breaches was the loss of a valuable commercial opportunity.

The decision

Justice McKerracher accepted that there was no doubt that the alleged breaches ultimately led to Kaboko's insolvency. However, he found that the relevant loss (being the loss of Kaboko's opportunity to exploit a valuable commercial opportunity) did not arise out of, originate in, spring from nor have its foundation in, Kaboko's insolvency.

His Honour rejected the insurer's submissions because accepting them would mean the insolvency exclusion would extend to broader claims against directors where the director's conduct causing the claim also played some part in the eventual or alleged insolvency of the company. His Honour considered that such an interpretation would substantially defeat the indemnity granted by the policy and make it "*practically illusory*".

What's of interest to insurers?

This judgment is a reminder that the insolvency exclusion does not automatically apply when the insured entity is insolvent. Where the exclusion applies to a "loss" arising from an actual or alleged insolvency, there needs to be a causal link, not merely a coincidence, between the insolvency and the loss that is the subject of the claim. In other words, the insolvency of the insured entity must cause the loss that is the subject of the claim.

Need to know more?

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