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Case Alert

Shaping the future of insurance law

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Appeal decision clarifies when insolvency exclusion applies

***AIG Australia Limited v Kaboko Mining Limited* [2019] FCAFC 96**

AT A GLANCE

- The Full Federal Court recently upheld a primary judgment rejecting the application of an insolvency exclusion in a claim brought against directors of a company in voluntary administration.
- The Full Court judgment primarily relied on the words used in the policy rather than subjective commercial considerations in arriving at its decision.
- This judgment provides certainty to insurers as it sets out an objective test - that insolvency exclusions apply where the claims could not be advanced but for the existence of the insolvency or inability to pay debts when due.

In early February 2019 we wrote an alert about the Kaboko Mining case, a complex matter that tested insolvency exclusions. In *AIG Australia Limited v Kaboko Mining Limited* [2019] FCAFC 96, the Full Federal Court upheld the primary judgment. We now look at the positive impact of this decision for the insurance industry as it identified the circumstances where an insolvency exclusion will apply.

The importance of the appeal decision for insurers

In the Kaboko Mining case, the primary judgment declined to apply the insolvency exclusion based on its reliance on what could be considered subjective commercial considerations in determining the extent of cover provided.

The Full Court judgment upheld the primary judgment declining to apply the insolvency exclusion. However, the Full Court's reasoning relied primarily on a close consideration of the policy wording rather than commercial considerations. As such, the decision provides some certainty for insurers by providing a test for the application of insolvency exclusions.

The Full Court judgment indicates that insolvency exclusions still have work to do where the claims could not be advanced but for the existence of the insolvency or inability to pay debts – such as insolvent trading claims and breaches of fiduciary duty that arise in a context where the company is insolvent or cannot pay debts. We consider that this reasoning also applies to the application of insolvency exclusion in the context of claims for investigation costs incurred in response to liquidators' notices for production and public examinations.

The case background

Kaboko Mining Limited entered into a prepayment agreement with Noble Resources Limited, under which Noble advanced Kaboko approximately USD$6 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 proceedings against four current and former directors. The proceedings alleged breaches of s180 and s181 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 by allowing Kaboko to breach the pre-payment agreement by failing to:

- maintain proper financial records
- use the advances as permitted
- ensure that Kaboko or its subsidiaries held all the relevant mining licences that it had warranted that it held, and
- allowing Kaboko to sell the manganese ore it mined to third parties without Noble's consent.

On 19 December 2018, the Federal Court handed down an interlocutory decision on a preliminary question about 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 primary judgment

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".

The appeal judgment

On 14 June 2019, the Full Court issued a unanimous judgment upholding the primary judgment. The Full Court noted that the use of the words "in connection with any Claim" meant that the key question to be answered is:

> "Whether it is the subject matter of the Claim that must have the specified insolvency link or whether the link is also established where, by reason of the circumstances that have led to the bringing of the claim, it can be said that the Claim arises out of, is based upon or it attributable to the actual or alleged insolvency of Kaboko or its inability to pay its debts when due."

The Full Court held that it is the subject matter of the claim that needs to be attributable to the insolvency for the exclusion to apply for the following reasons:

- neither the definition of claim nor the terms of the insolvency exclusion direct attention to why the claim was brought
- the definition of claim is by reference to proceedings "for a specified act, error, or omission" so the focus of the definition is on the character of the claim (i.e. its content, source and nature)
- the use of the words "arising out of, based upon or attributable to" Kaboko's insolvency rather than "because of" Kaboko's insolvency indicate a focus on the subject matter of the claim
- there is no evident commercial rationale for the extent of coverage for a particular claim to be dependent on the motivations behind the bringing of the claim rather than the nature of the claim and the loss it seeks to recover, and
- if the scope of the exclusion depended on an inquiry into the reason for bringing a claim, then there would need to be an objective or subjective inquiry into the state of mind of those bringing the claim. It can be seen that there would be complexity in such an inquiry.

On the basis that it is the subject matter of the claim that determines whether the insolvency exclusion applies, the Full Court held that the insolvency exclusion did not apply because the claims against the directors were not founded on any allegation of insolvency as:

> "Each of the claims made could be advanced irrespective of whether Kaboko was placed in administration. They are not claims that are based upon insolvent trading. They are not claims of breaches of fiduciary duty by directors that only arise in a context where the company is insolvent or cannot pay debts when they fall due."

The Full Court stated that a claim for the costs of the receivers and managers and the administrator would be excluded due to the application of the insolvency exclusion because "it is a loss which would not have occurred if Kaboko had not been insolvent".

The Full Court rejected the argument that the failure by Kaboko to pay its debts to Noble was part of the cause of the loss of opportunity on the basis that:

> "Rather than the claim to loss depending upon insolvency and inability to pay debts when due, it depends on the opposite claim, namely if the duties of the Former Officers had not been breached then the opportunity would have been able to be exploited."

Essentially, the Full Court found that where the exclusion applies to a "Loss" in connection with a "Claim", then the insolvency must have caused the loss that is the subject of the claim for the insolvency exclusion to apply. This provides clarity that the Court will look to the nature of the claim and the loss it seeks to recover rather than the motivations behind bringing the claim in determining the extent of cover provided.

With a possible economic downturn forecasted, the ambit of an insolvency exclusion will assume greater importance. If insurers do not wish to cover claims by insolvency practitioners (irrespective of the causal basis of such claims), insurers should consider a specific wording to that effect, which in addition expressly excludes claims brought by or on behalf of administrators, receivers and liquidators. We can assist in advising on such wording if required.

Need to know more?

For more information please contact us.

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