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Insurance Insights

Pursuing personal advantage: an age old story

Hakea Holdings Pty Ltd v McGrath (No 2) [2022] FCA 995

This case considers the liability of directors who pursue their own personal interest at the expense of the company and the impact of such conduct on coverage under D&O insurance policies. It also considers what constitutes a 'Claim' and a 'circumstance' under a common form of policy wording.

Proceedings

The plaintiff, Hakea Holdings Pty Ltd (**Hakea**), alleged, among other things, that the first defendant, Steven James McGrath (**McGrath**), who was one of its directors, breached his duties to it.

McGrath was also the sole director, shareholder, secretary, and general manager of Denham Constructions Pty Ltd (**Denham**).

In late 2012, Denham entered into a contract with Hakea to design and construct an aged care facility in Hamlyn Terrace, New South Wales (**project**). However, by late May 2015, Denham was either insolvent or in severe financial distress, such that it was not able to complete the project. Following Denham's subsequent failure to complete the project, Hakea suffered loss due to delay and additional costs resulting from its appointment of another builder to complete the project.

In April 2017, Hakea commenced these proceedings against McGrath. Hakea's case against McGrath was that a reasonable director in his position would or should have known by May 2015 that Denham's financial difficulties prevented it from completing the project and disclosed that fact to Hakea and ought to have disclosed that matter to Hakea.

In April 2017, McGrath filed for Bankruptcy.

For the period 23 January 2016 to 23 January 2017 (**period of insurance**), Hakea held a Directors' and Officers' liability insurance policy (**Policy**) issued by Neon Underwriting Ltd on behalf of Lloyd's Syndicate 2468 (**Neon**). Neon denied that the Policy provided cover for Hakea's claim.

In January 2019, Hakea joined Neon to the proceedings seeking a declaration that the Policy responded to the claim against McGrath.

The Declinature

Neon argued that the Policy did not cover McGrath in Hakea's claim because:

1. No 'Claim' was made by Hakea against McGrath during the Policy Period.

(**No Claim Issue**).

2. The claim was excluded by exclusion 5(a)(ii) of the policy which relevantly stated:

'The Underwriters shall not be liable for Loss in connection with any Claim … based upon, consequent upon, by reason of, arising out of, arising from, directly or indirectly resulting from, attributable to, in any way involving, or in connection with any …

(ii) … Director or Officer gaining any personal profit or advantage or receiving any remuneration to which he or she was not or is not legally entitled … provided that this exclusion shall only apply if such profit or advantage or remuneration … is established … by a final and non-appealable adjudication in any proceedings or court or a tribunal;…'

(**Personal Profit or Advantage Exclusion Issue**)

3. The claim was excluded by exclusion 5(a)(ii) of the policy which relevantly stated:

'The Underwriters shall not be liable for Loss in connection with any Claim … based upon, consequent upon, by reason of, arising out of, arising from, directly or indirectly resulting from, attributable to, in any way involving, or in connection with any …

(iii) circumstance notified or Claim made under any insurance which was in force prior to the Period of Insurance or circumstance or Claim which was known about by any of the Directors or Officers or the Company prior to the Period of Insurance.'

(**Notified or Known Circumstance or Claim Exclusion Issue**)

Decision

McGrath's Liability

Yates J found in favour of Hakea in its case against McGrath on the basis that McGrath breached his duty under s 180(1) of the *Corporations Act 2001* (Cth) by failing to inform Hakea that Denham was in severe financial distress and unable to complete the building work in a timely fashion.

His Honour noted that McGrath's obligations to discharge his duties as a director of Hakea with the degree of care and diligence that a reasonable director in his position, was not lessened simply because Mr McGrath was also a director of Denham.

Yates J also accepted Hakea's evidence that, had Mr McGrath disclosed Denham's severe financial distress as at 21 May 2015 and its inability to complete the project in a timely fashion, Hakea's directors would have proceeded to take out of Denham's hands the remaining work to be performed. His Honour held that, as a result of not taking such steps at that time, Hakea suffered loss or damage. The quantum of such loss remained part heard and did not form part of the decision.

No Claim Issue

The Court held that on the proper construction of the Policy's insuring clause and definition of 'Claim', the insuring clause would respond where:

- a written notice
- containing a demand for compensation or other relief
- was received by the insured (relevantly, McGrath)
- during the period of insurance.

The evidence established that on 20 January 2017 (three days prior to the end of the Policy Period) it sent a letter of demand (which contained a demand for compensation) to an email address operated by McGrath. Hakea relied upon the statutory presumption[1] that, where a document records the sending of an email to a particular destination at a particular time, the email was received at the destination at that time.

Firstly, Neon argued that the email address to which the letter of demand had been sent was not used by McGrath at the time. It relied on an email at about the relevant time which McGrath sent from the account to the liquidator of Denham in which he professed to not monitoring the email account frequently. The Court held that it was sufficient that the evidence established that the email address was relevantly 'operative' as at 20 January 2017, in the sense that it remained a mailbox for email communications to McGrath which had not been shut down and to which it could be inferred (in the absence of contrary evidence) he had access.

Secondly, Neon argued that, in order for Hakea to establish that a Claim was 'first made' it was necessary for it to prove that McGrath possessed actual knowledge during the Policy Period that a claim was being made against him. The Court rejected that argument, holding that the Policy definition of 'Claim' contained no such requirement. It was sufficient that Hakea had established that the email was received into McGrath's email account.

Personal Profit or Advantage Exclusion Issue

Neon argued that the Personal Profit or Advantage Exclusion operated to exclude cover for Hakea's claim on the basis that:

- by not disclosing Denham's liquidity issues to Hakea, McGrath facilitated the continuation of the construction contract and consequential payments to Denham and
- those payments to Denham contributed to funds used by McGrath to pay his personal expenses.

Yates J accepted Neon's submissions and further noted that Hakea's Amended Commercial List Statement pleaded that:

- as the sole director of and shareholder in Denham, Mr McGrath had a personal interest in Denham continuing with the project

[1] s161(1)(d) and (e) of the Evidence Act (as then applying)

- when Mr McGrath's personal interest in Denham came into conflict with his duty as a director of Hakea, Mr McGrath preferred his personal interest and sought to obtain an improper advantage for himself.

His Honour rejected Hakea's arguments that only Denham benefitted from the payments made to it by Hakea under the contract, and that any indirect benefit obtained by McGrath was, in any event, one to which he was legally entitled as a shareholder and director of Denham.

Notified or Known Circumstance or Claim Exclusion Issue

Neon submitted that it was entitled to decline cover based upon the Notified or Known Circumstance or Claim Exclusion which excluded claims in connection with any *'circumstance or Claim which was known about by any of the Directors or Officers or the Company prior to the Period of Insurance.'*

Neon argued that, prior to the inception of the Policy, McGrath was aware of the 'circumstance' that Denham was in severe financial distress, such that it could not complete the building contract in a timely fashion. Such knowledge was, itself, the result of McGrath's knowledge that:

- Denham's financial performance was poor
- Denham had a high level of debt (including a large tax debt)
- McGrath had been unsuccessful in his attempts to obtain finance to fund Denham's debts
- Denham was not meeting its payment obligations to sub-contractors.

Hakea submitted that, in order for the Prior Known Circumstances Exclusion to apply, Neon must prove that, before the inception of the policy, Mr McGrath knew - in the sense of being actually conscious - that there was a "definite risk" or a "real possibility" or that it was "on the cards" that a claim would be made against him[2]. It submitted that, in order to prove this, Neon needed to demonstrate that Mr McGrath knew that there had been a wrongful act, error or omission, by him and that Hakea had, or could have, suffered loss as a result.

Yates J considered that, on the proper interpretation of the exclusion, the word 'circumstances' (appearing as part of the expression 'circumstance or Claim which was known about') could not have been intended to be a reference to any facts known to the director, prior to the inception of the policy, that might subsequently provide the factual substratum for a Claim. Such an interpretation would drastically, and unrealistically, limit the availability of the indemnity that is to be provided under the policy, and thus fail to give the policy a commercial construction.

Rather, the term 'circumstance' in exclusion 5(a)(iii), must be read in the context of the whole of the exclusion which juxtaposes 'a circumstance notified or Claim made' under any insurance in force prior to the Policy Period and a "circumstance or Claim which was known about" prior to the Policy Period.

The juxtaposition of "circumstance" with "Claim" indicates that a "circumstance" is of the same general character as a "Claim"; it is just that the "circumstance" has not matured into a written notice received by the director or officer for a demand for compensation or other relief in a wrongful act.

[2] *DellaVedova and Ritchie v Woodward* [2016] NSWSC 1715

While McGrath was aware that Denham was in severe financial distress, such that it could not complete the building contract in a timely fashion, and that he deliberately did not disclose these facts to Hakea, Yates J was not persuaded that, before the inception of the policy, Mr McGrath was on notice, or otherwise knew, that his conduct, as summarised above, exposed him to any liability, or potential liability, to Hakea.

Conclusion

The Court's decision on liability provides a reminder of the well-established difficulties presented where a director of company (**first company**) also acts as a service provider to that company through a second company (**second company**) of which they are also a director and shareholder.

Such director will be under a duty to the first company to disclose matters known to them in their capacity as director of the second company, where such matters are relevant to protect the first company from potential loss. They will not be relieved from their usual obligations to act in the best interest of the first company merely by reason of the fact that they are a director of the second company.

Moreover, a director who prefers their own personal interests (including those of the second company in which they have a direct interest) over that of the first company, will likely not be able to claim on their directors' & officers' insurance policy due to the common exclusion of claims in connection with the director obtaining such personal profit, advantage or benefit to which they were not legally entitled.

The other insurance issues, though contested, provide a fairly uncontentious application of existing principles as to what constitutes a 'Claim' and a 'circumstance'.

Yates J's judgment in the No Claim Issue is of particular note because his Honour firmly rejected Neon's (somewhat novel) submission that, in order to establish that a '*Claim*' had been '*received*', an insured must show, not only that it physically received a '*notice*' containing a '*demand*' for compensation (or other relief) of the type covered by the policy, but also that the insured appreciated that the relevant notice constituted a demand for compensation (or other relief).

Similarly, Yates J's decision in the Notified or Known Circumstance or Claim Exclusion Issue is of interest because it firmly rejected Neon's submission that the reference to '*circumstance*' in that exclusion could be satisfied by showing that the insured director was aware, prior to the inception of the policy, of any fact or matter that might subsequently provide the factual substratum for a Claim. As his Honour rightly pointed out, such a broad interpretation of '*circumstance*' in this context would unduly circumscribe cover to an extent that undermines the policy's commercial efficacy.

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