At-a-Glance

Issue 75 February 2019

In this Issue

Directors denied coverage in U.S. conflict of interest lawsuit due to capacity exclusion

In a recently released U.S. case from the Delaware Superior Court, coverage for individual directors subject to a conflict of interest lawsuit was denied under their company's directors' and officers' (D&O) liability insurance policy due to the 'capacity exclusion'. In *Goggin v. National Union Fire Ins. Co.*, two directors of the insured corporation, U.S. Coal, also invested in the company through investment vehicles of their own creation. These investment vehicles provided debt purchase and other capital restructuring to the company. A lawsuit was filed against the directors claiming that they breached their fiduciary duties to the company by providing unfair investment terms to the investment vehicles, stemming from their conflict of interest being both directors of, and investors in, U.S. Coal.

The directors claimed defence cost reimbursement under the D&O policy. The insurer denied coverage, pointing to the 'capacity exclusion' on the policy, which precluded coverage for loss "alleging, arising out of, based upon or attributable to" wrongful conduct of an individual insured while acting in any capacity outside their insured capacity (i.e. as an executive or employee of U.S. Coal). The insurer argued that the directors were not acting solely in their insured capacity when the wrongdoing occurred, but that they were also acting in their uninsured capacity as investors. The court ultimately sided with the insurer, applying the "but-for" test in its analysis – the directors would not have faced the conflict of interest allegations in the lawsuit "but-for" their positions as investors in the investment vehicles. As such, the lawsuit was excluded from coverage by the capacity exclusion – the allegations against the directors arose out of their uninsured investor positions with the investment vehicles. The court also found that the wording of the exclusion was unambiguous, and furthermore that "arising out of" is a far-reaching term in Delaware law.

A D&O liability insurance policy can provide financial protection for board members and executives when faced with breach of fiduciary duty claims. However, as demonstrated by this U.S. case, the capacity in which the insured individual is acting at the time the wrongful conduct occurs can complicate coverage in some cases, depending on the wording and exclusions contained in the insurance policy at issue. While 'capacity exclusions' aren't present on all D&O policies, they do exist and can, as demonstrated, cause unexpected coverage denials for insureds. An experienced insurance broker can review your company's D&O insurance policy and advise on the potential implications of any relevant exclusionary language.

AON
Empower Results®

D&O lawsuit results from social engineering losses

In 2016, the CEO of FACC, a Chinese owned, Austrian-based aerospace manufacturer, was duped in a social engineering scheme that ultimately cost the company approximately €52.8M. The chief executive officer, Waltar Stephan, received an email purporting to be from another senior employee at FACC. Stephan believed that the email was legitimate, and then acted on its instruction – ultimately leading FACC financial controllers to wire approximately €52.8M to fraudsters over numerous transfers. Upon realizing the fraud, the company was able to block €10.9M of the transfers at various financial institutions, ultimately leaving the company with a €41.9M loss from the deception. Furthermore, FACC was also left with an operating loss of €23.4M in its 2015/16 financial year, which contrasts sharply with the forecasted €18.6M operating profit in the absence of the fraud. Shortly thereafter, the company fired both Stephan and its CFO. At the time of the dismissal, the company stated that "The supervisory board came to the conclusion that Mr. Walter Stephan has severely violated his duties, in particular in relation to the 'fake president incident'."

Most recently, in December 2018, FACC filed a lawsuit against Stephan and its ex-CFO, seeking damages of €10M. The company is alleging that the defendants failed to set up adequate internal controls and to meet their obligations of collegial cooperation and supervision. A directors' and officers' (D&O) liability insurance policy can provide financial protection for board members and executives when faced with a supervisory lawsuit. The policy will also respond should a public company be named in a securities lawsuit. Indemnification for settlement and judgment amounts, as well as legal defence costs, can be provided by D&O liability insurance in the event of a covered claim.

Uber arbitration clause declared invalid by Ontario Court of Appeal

In a recently released decision from the Ontario Court of Appeal, the court declared the arbitration clause in Uber's driver services agreement invalid. While this ruling has direct, immediate implications for the Uber drivers' proposed class action lawsuit, it may also serve as a broader precedent for commercial agreements containing an arbitration clause.

In the initial action, an Uber Eats driver alleged that all Uber drivers in Ontario are employees and thus entitled to the benefits set out in Ontario's *Employment Standards Act* (ESA). However, the plaintiff driver had entered into a services agreement at the commencement of his relationship with Uber, which contained an arbitration clause that required all disputes arising from the agreement to be resolved by arbitration. While Uber favoured arbitration, the plaintiff argued that the arbitration clause didn't apply to his employment dispute, and, furthermore, was illegal and should not be enforced as the provision was unconscionable.

In reversing the lower court's decision, the Court of Appeal found that the arbitration provision was invalid. The court held that the "competence-competence" principle, which bestows the arbitral tribunal with jurisdiction to decide its own jurisdiction, had no application. The court reasoned that issues of arbitral jurisdiction relate to the scope of the arbitration provision itself, rather than the validity of the clause as a whole. As such, should a party wish to contest the validity of an arbitration provision, pursuant to this ruling the dispute would now need to be brought before the courts. The court also determined that the provision was unconscionable based on the facts of the case, and that it amounted to an illegal contracting out of the ESA when an employee-presumption stance was adopted.

Historically a jurisdiction friendly upholding arbitration provisions, this decision could change the tide of how these clauses are enforced in Ontario. Arbitration, which has traditionally been thought of as a lower cost alternative to the court process, could now become more expensive than anticipated should a party choose to contest the validity of an arbitration provision – and be forced to go to court to do so. Not only does this have the potential to undermine the purpose of an arbitration clause, but, as noted, it may have the effect of increasing the defendant's legal fees substantially. Many liability insurance policies, such as a directors' and officers' and an employment practices liability (EPL) insurance policy, can respond to provide defence cost coverage in the event an insured is faced with a claim. This could provide defendant insureds with valuable financial protection in the event they are forced to litigate the validity of an arbitration clause in court.

Key Contacts

Alexis Rivait
Vice President and Regional Manager
Financial Services Group
t +1.416.868.5597
alexis.rivait@aon.ca

David Quail, M.Sc., CRM
Vice President and Regional Manager
Financial Services Group
t +1.403.267.7066
david.quail@aon.ca

Denise Hall
Senior Vice President and National Broking Leader
Financial Services Group
t +1.416.868.5815
m +1.416.953.3280
denise.hall@aon.ca

Catherine Richmond, LL.B., CRM
Senior Vice President and Regional Manager
Financial Services Group
t +1.604.443.2429
m +1.604.318.5470
catherine.richmond@aon.ca

Catherine Lanctôt B.A.
Vice President and Manager
Financial Services Group
t +1.514.840.7008
catherine.lanctot@aon.ca

Brian Rosenbaum LL.B
Senior Vice President and National Director
Legal and Research Practice
Financial Services Group
t +1.416.868.2411
brian.rosenbaum@aon.ca