By: Kevin M. LaCroix

The D&O Diary

A Periodic Journal Containing Items of Interest From the World of Directors & Officers Liability, With Occasional Commentary

Contractual Liability Exclusion Does Not Bar Coverage for Fiduciary Duty Claim

By Kevin LaCroix on June 27, 2023

Many management liability exclusions contain contractual liability exclusions to clarify that the policy doesn't provide coverage for contractual breach claims. However, as I have pointed out in **prior posts**, insurers, in reliance on the exclusion's broad wording, often seek to apply these exclusions broadly, to apply to a wide variety of kinds of claims beyond contractual liability disputes. In a recent Fifth Circuit decision, the appellate court rejected an insurer's attempt to apply a contractual liability exclusion to preclude coverage for an underlying breach of fiduciary duty claim. The reasoning of the Fifth Circuit in rejecting the insurer's arguments provide policyholders with common sense reasoning on which to rely in seeking to avoid the application of the exclusion to noncontractual claims.

A copy of the Fifth Circuit's May 9, 2023, opinion can be found **here**. A June 23, 2023, *Law360* article written about the decision by attorneys from the Reed Smith law firm can be found **here**.

Background

Three members and partial owners of the Windmere Oaks Water Supply Corporation brought a lawsuit against Windmere, various Windmere officials, and others, alleging that Windmere had sold a valuable piece of land to a commercial entity owned by a Windmere board member "for pennies on the dollar." The claimants asserted that sale caused losses to Windmere. The claimants alleged that Windmere had "exceeded its powers" and that the board of directors had "exceeded their authority and breached their duties." The claimants alleged the unauthorized conveyance of property; improper use of the cooperative's assets; improper disbursement of the cooperative's assets to benefit the directors; and failure to recover loss, as well as for breach of fiduciary duty.

Windmere was insured under a Public Officials and Management Liability Insurance policy. Windermere sought to have the insurer defend the underlying claim. When the insurer denied its obligation to defend the lawsuit in reliance on the insurance policy's contractual liability exclusion, Windmere filed a lawsuit to enforce the contract. The parties filed cross-motions for summary judgment; the district court granted Windmere's motion and denied the insurer's motion. The insurer appealed.

The policy's contractual liability exclusion precludes coverage for loss "based upon, attributed to, arising out of, in consequence of, or in any way related to any contract or agreement to which the insured is a third party or a third-party beneficiary, including, but not limited to, any representations made in anticipation of a contract or any interference with the performance of a contract."

The May 9, 2023, Decision

In a brief, five-page May 9, 2023, opinion written by Judge James C. Ho for a unanimous three-judge panel, the Fifth Circuit, applying Texas law, affirmed the district court's grant of summary judgment for Windmere, in reliance on " a simple principle of law": that is, that "a claim for breach of fiduciary duty is not a claim for breach of contract, and is therefore not subject to exclusion from coverage under a contractual liability exclusion."

The underlying lawsuit, the appellate court said, "is not a suit for breach of contract." The court quoted with approval Windmere's argument that "the focus of the Underlying Lawsuit is, in fact, on the purported breach by … [the Windmere officials] of [their] fiduciary duties, by way of ultra vires acts and other misdeeds that gave rise to harm without regard to the ultimate contract." These claims, the appellate court said are "established by law – not by contract" and the claims "could stand alone even if no contract ever existed." The district court, the appellate court said, "did not err in declining to apply the contractual exclusion."

Discussion

For me the starting point for thinking of the issues involved here is not the contractual liability exclusion. It is instead the very purpose of the policy at issue. The purpose of a management liability policy like the one involved here is to provide protection against the very type of claim involved here. The kinds of claims asserted against the Windmere officials represent the very embodiment of the reason why executives at entities spend the entities' money to buy insurance – because in the course of the execution of their duties as executives at the entities, claims may arise in which it is alleged that the executives' committed wrongful acts.

It is appropriate that a liability policy like the one involved here should not provide coverage for allegations for an alleged breach of contract. Contractual liability arises from a voluntarily undertaken obligation; it is not imposed by a law, it arises from the contract itself. For that reason, it is perfectly appropriate that management liability policies should preclude coverage "for" a breach of contract claim.

However, in the current marketplace, most contractual liability exclusions are not written with this precise "for" preamble; rather, the exclusions often written with a broad preamble, extending the exclusion's preclusive effect not just to claims "for" a breach of contract but also to claims "based upon, arising out of, in any way relating to," etc.

The problem with this exclusionary language is that extends the preclusive effect far beyond the intended application to claims of breach of contract, to claims that have nothing to do with the contract. Even worse, it extends the preclusive effect to the very kinds of claims for which the policyholder bought the insurance in the first place, as for example in the very case we are now considering. The exclusion becomes the exception that entirely swallows up the policy's coverage. It renders the policy's coverage illusory and makes the entire underlying insurance transaction pointless.

The Fifth Circuit was having none of this. The appellate court in effect said that just because a lawsuit merely alleges the existence of a contract is not sufficient to preclude coverage, even given the broad preamble of the contractual liability exclusion. The Fifth Circuit, rightly in my view, instead took the commonsense approach of asking what the underlying lawsuit was about.

The underlying suit is not, the appellate court said, a claim for a breach of contract; rather, the focus in the allegations is that the officials breached their duties. The claims, the court said, are "established at law," not by contract. More to the point, and most helpfully, in rejecting the insurer's attempt to rely on the contractual liability exclusion, the appellate court said that the claims "could stand alone even if no contract ever existed."

While I think the Fifth Circuit got it just right, I am compelled to note a couple of things about the appellate court's decision. First, the court relied on a significant principle of insurance contract interpretation under Texas law, which is that "in case of doubt as to whether or not the allegations of a complaint against the insured state a cause of action within the coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt will be resolved in the insurer's favor." The law in many jurisdictions similarly provides that exclusions should be construed narrowly. The application of these principles in this case clearly influenced the court's reasoning here.

A second and subtler point about the appellate court's decision is the possibility that the court read the exclusion with the broad "based upon, etc" preamble as if it had the narrower "for" wording. The court opened its decision by stating a "simple principle of law" which is that "a claim for breach of fiduciary duty is not a claim *for* a breach of contract." The court later repeated that the underlying lawsuit "is not a suit *for* a breach of contract." I can imagine the insurer trying to argue with the appellate court that even if a claim is not a claim *for* a breach of contract, it can still be "based upon, attributable to, arising out of, in consequence of, or in any way related to" a contract or agreement. In effect, the appellate court chose to apply the exclusion as if it had been written the way that I believe it rightly should have been worded in the first place, that is, with the "for" wording, rather than the overly broad expansive preamble.

All of that said, the one thing the appellate court unquestionably got right is when it said that the exclusion should not be used to preclude coverage for claims that "could stand alone even if no contract existed." That principle alone would have and arguably should have been enough to prevent the insurer from seeking to have coverage precluded for a claim that represents the very type of dispute for which the policyholder bought the coverage in the first place.

Copyright ©2023, Kevin M. LaCroix. All Rights Reserved.