The D&O Diary

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

# Contractual Liability Exclusion Precludes Coverage for Declaratory Judgment Claim

By Kevin LaCroix on June 24, 2024

Regular readers know that a recurring topic on this site is the question of the proper scope of the contractual liability exclusion found in many professional liability and management liability insurance policies. In **prior posts** I have argued that insurers sometimes apply the exclusion over-broadly so as to exclude matters I believe should otherwise be covered under the policy.

A recent Second Circuit, applying New York law, again examined the scope of the contractual liability exclusion's preclusive effect, rejecting a policyholder's claim that the exclusion did not apply to an underlying declaratory judgment claim,  one of several claims asserted against the company in the underlying action. Although I often disagree with courts' conclusions about the reach of the contractual liability exclusion, in this case the appellate court appears to have gotten it right, given the policy language at issue, in affirming the district court's exclusion precludes coverage for the declaratory judgment claim. A copy of the Second Circuit's June 17, 2024, opinion

*Background*

Paraco Gas Corporation is a closely held family corporation that distributes propane fuel and equipment. The company and certain of its officers were sued in an action (the "underlying action") alleging that officers of the company had transferred shares in violation of the terms of two Paraco shareholder agreements.

Paraco submitted the underlying action to its D&O insurer as a claim under its policy. The company denied coverage for the underlying action in reliance on the policy's contractual liability exclusion. The company and the officer defendants filed an insurance coverage lawsuit against the D&O insurer, seeking a declaratory judgment that the insurer was obligated to provide the company and the officers with a defense and indemnification for the underlying lawsuit, as well as damages for breach of contract. The district court granted the insurer's motion dismissing the coverage action, holding that the contractual liability provision unambiguously exclude coverage for the underlying action.

The company and the officers appealed the district court's ruling, arguing that the contractual liability exclusion did not preclude coverage for *all* of the claims in the underlying action. Paraco conceded that nine of the ten claims asserted in the underlying action arose out of alleged breaches of the two Paraco shareholder agreements. However, the company and individuals argued that coverage for Count IV of the underlying complaint, in which the claimant in the underlying action sought a judicial declaration that the separate agreement signed by one of the company's officers terminating one of the Paraco shareholder agreements was invalid, was not excluded from coverage. Paraco argued that this claim was based not on "contractual liability or obligation" but on the Board's abdication of its corporate and fiduciary duties to shareholders. These claims, Paraco argued, would exist regardless of the company's and individuals' obligations under the shareholder agreements.

*Relevant Policy Language*

The policy's contractual liability exclusion provides that:

> The Insurer shall not be liable to make any payment for Loss in connection with any Claim made against any Insured: … N. alleging, arising out of, based up on attributable to any actual or alleged contractual liability or obligation of the Company or an Insured Person

*The June 17, 2024, Opinion*

In a June 17, 2024, *per curiam* summary order, a three-judge panel of the Second Circuit affirmed the district court's holding that coverage for the underlying claims was precluded, holding specifically that all of the claims in the underlying action arose out of obligations under the shareholder agreements, and thus fell within the D&O insurance policy's contractual liability exclusion.

In interpreting the question of the applicability of the contractual liability exclusion to the declaratory judgment claim for which Paraco asserted that coverage was not precluded, the Court applied a "but for" test. The insurer had argued that the declaratory judgment claim could not exist *but for* the contractual obligations created by the shareholder agreement. The appellate court agreed.

The court said that Count IV, the declaratory judgment claim, "not only alleges the existence of facts showing that Appellants violated the terms of the Class A Shareholder Agreement, but the claim relies on that agreement for its theory of harm – demonstrating that the claim could not exist but for Joseph's alleged violation of the agreement's right of first refusal and stock transfer provisions."

Count IV's allegations, the appellate court said, "are replete with references to Joseph's breach of his obligations under the Class A Shareholder Agreement." So, the court said, "while Count IV is not a breach of contract claim per se, it certainly has a causal relationship to Appellants' contractual obligations." This, the court said, "places Count IV squarely within the orbit of the D&O Policy's exclusion from coverage."

The appellate court went on to say that Paraco's characterization of Count IV as arising out of the Board's obligations under its general corporate duties is "flawed for another distinct reason" – that is, that the allegations on which Paraco sought to rely "related to the Board functions to satisfy the pleading requirements for derivative actions." That is, the allegations on which Paraco sought to rely were made with respect to demand futility for the derivative claims, in order to explain why requesting the Board to sue the defendant officers would have been pointless. The Count IV allegations on which Paraco sought to rely were "clearly designed" to meet this pleading requirement.

the claim itself, and therefore does not impact our consideration."

*Discussion*

Although I frequently take exception to the breadth of the scope insurers seek to apply to the contractual liability exclusion, in this case, and based on the specific policy wording at issue, the insurer and the appellate court did not stretch the exclusion beyond its appropriate limits.

The key here is the "arising out of" language in the exclusion's preamble. As the appellate court noted, the declaratory judgment claim that Paraco had tried to argue was not precluded from coverage under the contractual liability exculsion clearly did "arise out of" the contractual breach allegations. The appellate court's further observation that the underlying claimant's demand futility allegations did not change the nature of the underlying claim is also sound.

Regular readers know that I have long argued that the contractual liability exclusion properly should be framed with a "for" wording rather than on a "based upon, arising out of" wording of the type found in the exclusion at issue here. It is interesting to contemplate how coverage for the underlying claims here might have been interpreted if the exclusion at issue had the "for" wording rather than the "based upon, arising out of" wording.

The appellate court had no problem concluding that all of the claims in the underlying complaint here "arose out of" a contractual liability or obligation. The outcome of the appellate court's analysis, at least with respect to Count IV,  might well have been different if the contractual liability exclusion had the "for" wording. In that regard, it is worth noting that the appellate court specifically said that Count IV "is not a breach of contract claim per se."

Reasonable minds could well disagree on the abstract question of whether a D&O insurance policy *should* cover the kind of declaratory judgment claim alleged in Count IV of the underlying action. The one thing I will say is that thinking through how the coverage analysis might have differed if the exclusion at issue here had the "for" wording rather than the "based upon, arising out of" wording reinforces my view that the policyholders and their advocates should prefer the "for" wording rather than the "based upon, arising out of" wording.

The further issue of whether or not a D&O insurance policy *should* provide coverage for the kind of claim the claimant asserted in Count IV is a closer question. I will say this: there is no possibility of a damages award for a declaratory judgment claim, since all the court will do is declare the parties' respective rights. So even if the exclusion had not applied to preclude coverage, the practical effect

action, as insurers must cover all claims if any claim is covered)

Looked at as a defense cost issue, the question of whether or not the policy *should* provide coverage for claims like this comes into focus. Given that we are just talking about defense costs, I think it could be argued that the policy, properly constructed, *should* provide coverage for the claims of the type for which Paraco sought coverage here.

I know that many readers on the insurer side of the aisle might disagree with this analysis. I encourage those who disagree to state the position using the blog's comment feature.

---