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Buying D&O Insurance? Exclude the Contractual Exclusion (Or at Least Limit It)

By Darin J. McMullen

Although a 2014 Florida federal court decision may have elevated policyholder concerns regarding the breadth of contractual liability exclusions in directors and officers insurance policies, prudent policyholders can minimize, if not altogether avoid, any such apprehensions. Moreover, the opinion giving rise to these recent apprehensions stands alone in its broad application of a contractual liability exclusion to tort claim and has not yet been adopted in other jurisdictions.

In an October 20, 2014, opinion in *Bond Safeguard Insurance Company et al. v. National Union Fire Insurance Company of Pittsburgh, PA,* the United States District Court for the Middle District of Florida granted summary judgment in favor of the D&O insurance company, National Union, holding that National Union was not liable to pay for a stipulated judgment entered into by its policyholder, Land Resource LCC. Land Resource had defaulted on bonds issued in conjunction with land development projects. As part of the issuance of the bonds, Land Resource and a Land Resource executive entered into an indemnification agreement with the bond companies whereby the indemnitors would indemnify for costs incurred by the bond insurers in connection with the bonds.

Following Land Resource's default, the bond issuers sued the Land Resource executive alleging that he had caused the default through negligent acts and omissions, as well as through misrepresentations of the company's financial condition to the bond issuing entities. Ultimately, the Land Resource executive entered into a stipulated judgment of $40 million with the bond insurers while assigning the bond insurers his rights under the D&O policy.

National Union denied coverage, asserting that the policy's contractual liability exclusion precluded coverage. That exclusion provided that National Union "shall not be liable" for claims "alleging, arising out of, based upon, or attributable to any actual or alleged contractual liability of the Company or any other insured." In seeking summary judgment, National Union

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argued that despite allegations of negligence and misrepresentation in the underlying complaint, the losses at issue arose out of Land Resource and its executive's breach of the indemnification agreement and the bonds themselves, and therefore were claims "arising out of" contractual liability.

The bond issuing companies argued that negligence and misrepresentation alleged were in fact torts and the fact that a contract or bond was part of the relevant fact pattern giving rise to such torts did not turn those claims into claims for contractual liability. The court, however, ignored the fact that potential liability arose in tort. Instead, the court held that the exclusion's "arising out of" language was broad enough to exclude coverage for tort claims sounding in negligence and misrepresentation because those torts arose out of defaults on the bonds and the failure of the Land Resource executive to perform a contractual obligation to honestly represent financials.

Although the *Bond Safeguard* decision gives policyholders reason to wonder whether contractual liability clauses in D&O policies will be broadly interpreted to exclude coverage wherever a contract is remotely in play, there are several factors which should minimize such concerns.

First, contractual liability exclusions are not standard in most D&O polices. The easiest way to avoid any concerns over the overbroad application of a contractual liability exclusion is to purchase a D&O policy that does not contain one and is not sold with an endorsement including one. Policyholders should consult with their brokers before purchase or renewal in order to assess which policies are available in the market that do not contain a contractual liability exclusion or endorsement.

Second, not all contractual liability exclusions are drafted and defined identically. The exclusion at issue in the *Bond Safeguard* matter highlights the potential problems with broadly worded exclusions. This particular provision contained broad language excluding claims "arising out of" contractual liability. The court ultimately determined that the "arising out of" language was "unambiguously broad" and therefore excluded coverage for the underlying tort claims because the court found that contractual breach was at the core of the tort claims.

Many exclusions use more narrow language, for example excluding coverage "for" instead of "arising out of" contractual liability. An exclusion tailored only to exclude claims "for contractual liability" should not be interpreted broadly to include claims that in any way touch or "arise out of" contractual liability, as was the case in *Bond Safeguard*. If a claim is "for" tort liability," it is not "for" contractual liability. Consequently, policyholders who cannot altogether avoid purchasing a D&O policy containing a contractual liability exclusion should purchase as narrowly tailored an exclusion as possible.

Finally, the scope and application of the *Bond Safeguard* decision may be limited both jurisdictionally and factually. In its opinion, the court emphasized that the Land Resource executive did not seek to minimize the amount of the judgment to which he stipulated. Indeed the court found it "compelling" that the stipulated judgment appeared to be "reached by collusion or an absence of effort to minimize liability." The suspicion of collusion and "additional benefits" to the executive and his family that flowed from the stipulated judgment colored the court's opinion and certainly will not be present in many claims.

Additionally, the *Bond Safeguard* court represents one federal court's prediction of how the Florida Supreme Court would interpret one contractual liability exclusion. It does not

represent the law of Florida, nor does it have precedential value in other jurisdictions. Thus its impact to policyholders facing similar exclusions in other jurisdictions is limited.

Consequently, while the decision and exceedingly broad application of the contractual liability exclusion in *Bond Safeguard* may both perplex and cause initial discomfort to D&O policyholders, such discomfort should be fleeting. Through careful analysis and planning during the purchase or renewal of a D&O policy, policyholders can either avoid inclusion of contractual liability exclusions altogether or purchase policies with more narrowly tailored exclusions. ▲

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