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Victory for policyholders as Texas court interprets contract exclusion narrowly in favor of coverage

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Contractual liability exclusions in D&O policies frequently give rise to coverage disputes, and our prior posts have shown that those disputes do not always end well for policyholders faced with broad exclusionary language.

Allied argued that the contractual liability exclusion applied because that exclusion required only an "incidental relationship" to the conduct alleged in the underlying lawsuit.

Texas policyholders got better news in a recent win narrowly interpreting and refusing to apply a contract exclusion to a water company's D&O claim. In *Windermere Oaks Water Supply Corporation v. Allied World Specialty Insurance Company*, a federal judge in the U.S. District Court for the Western District of Texas found that a D&O insurer had a duty to defend the company's $1 million suit because the fiduciary duty that was allegedly breached in the underlying suit did not arise "directly" and "exclusively" from the terms of the contract.

Background

Windermere Oaks Water Supply, a non-profit Texas corporation, and its board members brought suit against the company's D&O insurer, Allied World, seeking defense and indemnity for claims asserted in an underlying action. The underlying lawsuit alleged that, between 2015 and 2016, the WSC board of directors exceeded their authority and breached their duties by transferring a tract of land within the Spicewood Airport community to another board member, resulting in losses of over $1 million.

The coverage dispute

The Water Plus Package policy issued by Allied to WSC included a contractual liability exclusion that barred coverage for claims "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 party."

Allied denied WSC claim, contending that coverage was barred by the policy's exclusions for contractual liability, criminal acts, and violation of law. Specifically, Allied argued that the contractual liability exclusion applied because that exclusion required only an "incidental relationship" to the conduct alleged in the underlying lawsuit, which the insurer asserted was established because the claims in the underlying suit arose out of WSC's agreement to sell the disputed tract of land. WSC disagreed, arguing that the claims did not arise from any breach of the contract for the sale of the Airport Tract, but from a breach of fiduciary duty because the directors failed to market, advertise, and sell the land for the best price available.

The decision

The court agreed with WSC and refused to apply the contract exclusion (or any of the other exclusions) to WSC's claim. It held that under Texas law, the contract exclusion did not apply because the board members' alleged breach of fiduciary duty did not arise "directly and exclusively" from the terms of the contract to sell the airport land.

Rather, the breach arose from "common law and statutory duties" that the WSC board of directors owed to the WSC and its member-owners to maximize the value of the sale. As such, the exclusion could not apply and Allied was required to provide WSC and the board members with a defense in the underlying lawsuit.

Discussion

In *Windermere*, the court interpreted the contract exclusion narrowly in light of the insurer's broad duty to defend, which requires resolving all doubts in favor of the insured and construing the underlying pleadings liberally. Other courts, however, have reached different results, including interpretation of similar exclusionary language that applied to any claim "arising out of" a contract.

For example, in *TriPacific Capital Advisors, LLC v. Federal Insurance Co.*, a California federal court recently interpreted "arising out of"

and "arising from" in a contract exclusion to require only a minimal causation or incidental relationship. There, the court held that the contract exclusion applied not only to breach of contract claims, but also to any claims "arising from" contractual liability owed by the company.

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Given the frequency of deal-related D&O claims that have at least a tangential relationship to a transaction, agreement, or alleged understanding between the parties, insurers will not hesitate to cite the contract exclusion as a basis to deny coverage, even for fiduciary or other tort claims that are independent from any breach of contract.

How then can policyholders ensure they are positioning themselves to avoid overbroad exclusionary language and maximize potential recovery? First, carefully review and, if necessary, modify any contract exclusions to narrow their scope and ensure they are not applied in the manner asserted by the insurers in *Windemere* and *TriPacific*.

Given the divergent views between courts on similar policy language, the answer may also come down to understanding governing law that would apply to a given claim, as well as any choice-of-law, choice-of-forum, or similar policy provisions that may impact the scope of available coverage. Retaining experienced brokers, coverage counsel, and other professionals to not only negotiate robust coverage at each placement and renewal but also pursue recovery in the event of a claim can help mitigate the risk of unexpected denials and maximize recoveries.

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