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TRIO OF RECENT CASES AFFIRMS BROAD SCOPE OF CONTRACT EXCLUSIONS

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For many companies, the subprime crisis will come and go, but the risk that contractual relationships can turn sour and lead to litigation remains a constant. A growing line of precedents holds that when policyholders purchase D&O or E&O coverage that includes an exclusion for claims "arising from" or "arising out of" liability under contract or breach of contract, they cannot look to their carriers to pick up the tab for lawsuits alleging that the policyholders failed to meet their contractual obligations, even if those suits also allege non-contractual causes of action based on the same alleged misconduct.[1] Recent decisions issued by the Eighth Circuit Court of Appeals and two federal district courts are the latest to affirm the broad scope of such exclusions.

SPIRTAS

In *Spirtas Co. v. Federal Insurance Co.*, 521 F.3d 833 (8th Cir. 2008), the insured organization subcontracted to perform demolition work on a construction project. A dispute later arose, and the project manager filed suit against the insured organization, alleging counts for breach of contract, breach of express or implied trust, conversion, unjust enrichment, and declaratory relief. The project manager alleged that the insured organization, in violation of its obligations under the subcontract, had not performed its work properly and had failed to use money it had received from the project manager to pay certain subcontractors and suppliers.

The insured organization sought defense and indemnity coverage under a D&O policy that provided broad entity coverage and placed the duty to defend on the insurer. The policy, however, excluded coverage for claims "based upon, arising from, or in consequence of any actual or alleged liability of an Insured Organization under any written or oral contract or agreement, provided that this Exclusion [] shall not apply to the extent that an Insured Organization would have been liable in the absence of the contract or agreement." The insurer denied coverage under that exclusion, and coverage litigation ensued.

The district court granted summary judgment in the insurer's favor, concluding that the contract exclusion barred defense and indemnity coverage because the underlying causes of action—including the tort counts—"ar[ose] from" contract because they involved alleged breaches of the policyholder's obligations under the subcontract. The court reasoned that even though conversion or unjust enrichment can be alleged in the absence of a contract, the conversion and unjust enrichment counts at issue had not been so alleged and instead flowed from the policyholder's alleged breaches of the subcontract.[2]

The Eighth Circuit affirmed. The court rejected the policyholder's argument that the district court's interpretation of "arising from" was overly broad, reasoning that "an exclusion precluding insurance coverage for claims arising from a contract not only applies to claims sounding directly in contract but also to claims sounding in tort as long as they flowed from or had their origins in the breach of the contract." The court further rejected the policyholder's assertion that contract exclusion precedents reaching the same conclusion were distinguishable because they involved the phrase "arising out of," instead of "arising from."[3]

Spirtas is an important precedent adding to the expanding list of decisions affirming the broad scope of contract exclusions that include "arising from" or "arising out of" language. This list also includes recent decisions by federal district courts in New Jersey and Massachusetts.

NORTH PLAINFIELD

In *North Plainfield Board of Education v. Zurich American Insurance Co.*, No. 05-4398, 2008 WL 2074013 (D.N.J. May 15, 2008), the policyholder board of education entered into a series of contracts for the renovation and expansion of five schools. Contractual relations eventually deteriorated, and the construction contractor, the

successor thereto, and the electrical contractor filed separate suits against the policyholder. The complaints alleged counts including breach of contract, quantum meruit, breach of the implied duty of good faith and fair dealing, civil rights violations, retaliatory termination, conversion, fraudulent inducement, and rescission.

The policyholder sought defense and indemnity coverage under E&O policies that barred coverage for claims "arising out of breach of contract," except to the extent of a $100,000 aggregate limit of liability for the defense of such claims. The insurer asserted that the contract exclusion applied, and coverage litigation ensued.

The court denied the policyholder's motion for summary judgment, holding that the contract exclusion unambiguously applied to claims that "originated from, grew out of, or had a substantial nexus with breach of contract" or that alleged injuries that would not have occurred but for alleged contractual breaches. The court concluded that each suit against the policyholder was a "Claim" that fell in both of these categories, and that the contract exclusion accordingly applied. In so ruling, the court reasoned that the "contractual relationship between the parties was 'endemic' to all causes of action asserted," and that the non-contractual counts arose from the same facts and circumstances as the contractual counts.[4]

GE HFS HOLDINGS

In *GE HFS Holdings, Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pa.*, 520 F. Supp. 2d 213 (D. Mass. 2007), the policyholder home health care agency entered into a revolving credit loan agreement pursuant to which it was obligated to provide reports to the lender, upon which the lender could rely in advancing amounts to the policyholder. After receiving these reports and advancing various amounts, the lender allegedly discovered that certain of the reports overstated the policyholder's assets. The lender eventually sued certain of the policyholder's directors and officers, alleging in part that they had negligently supervised the preparation of the misstated reports. Coverage litigation eventually ensued, and the policyholder's D&O insurer and one of the policyholder's directors filed cross motions for summary judgment.

Adopting a magistrate judge's opinion, the court ruled in favor of the insurer, holding that an exclusion for claims "alleging, arising out of, based upon or attributable to any actual or alleged contractual liability of the Company or an Insured" barred defense and indemnity coverage for the negligence claim. The court reasoned that the phrase "arising out of" must be interpreted "expansively," and captured the negligence claim because it involved alleged failures to perform contractual obligations.

The *GE HFS* court also rejected the policyholder's argument that applying the exclusion to bar coverage for non-contractual claims that in some way involve contracts would render coverage illusory. The court reasoned that although the exclusion limited the private company policyholder's scope of coverage, numerous activities of its directors and officers remained potentially covered.

CONCLUSION

Spirtas and the growing line of precedents interpreting contract exclusions that include "arising from" language demonstrate that such exclusions bar coverage for claims alleging that policyholders failed to perform their contractual obligations, irrespective of whether such claims are alleged in contract. This line of precedents is likely to continue to grow.

The views expressed herein are solely those of the author and should not be attributed to the author's firm or its clients.

FOOTNOTES

1 At least some courts applying contract exclusions lacking such broad "arising from" qualifiers have reached the same conclusion. *See, e.g., CIM Ins. Corp. v. Midpac Auto Ctr., Inc.,* 108 F. Supp. 2d 1092, 1100-02 (D. Haw. 2000) (exclusion barred coverage for counts including fraud, breach of fiduciary duty, unjust enrichment and constructive trust). And even absent a contract exclusion, a policyholder is not entitled to indemnity coverage for amounts owed under contract, even if sued in tort. *See, e.g., August Entm't, Inc. v. Philadelphia Indem. Ins. Co.,* 52 Cal. Rptr. 3d 908 (App. 2d Dist. 2007).

2 *Spirtas Co. v. Fed. Ins. Co.*, 481 F. Supp. 2d 993 (E.D. Mo. 2007).

3 521 F.3d at 835-37.

4 The court also granted summary judgment in favor of the policyholder's general liability insurer, relying on similar reasoning in holding that a contract exclusion barred defense or indemnity coverage under an advertising injury coverage provision.

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