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The Broad Scope of Contractual Liability Exclusions in D&O Policies

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On August 17, 2012, the U.S. District Court for the Middle District of Pennsylvania, in *Federal Insurance Co. v. KDW Restructuring & Liquidation Services LLC et al.*, Case No. 3:07-cv-01357, held that Federal Insurance Company does not have a duty to defend or to indemnify its insured, Uni-Marts, LLC, under a D&O policy for claims arising out of Uni-Marts' alleged misrepresentations and omissions to gas station purchasers. Relying on the interpretation of a broad contractual liability exclusion under Pennsylvania law, Judge William Nealon of the Middle District found that contractual relationships were at the core of the misrepresentations and omissions and, thus, were excluded from coverage.

The Uni-Marts Class Action

Until 2008, Uni-Marts owned and operated gas stations and convenience stores. Between 2004 and 2005, Uni-Marts engaged in efforts to sell gas station/convenience store locations through a public bidding process. To encourage participants, Uni-Marts distributed written materials and hosted seminars for potential purchasers during which the company described – and certified – the historical costs, expenses and profits of each of its stores. Prior to the sales, Uni-Marts also provided potential purchasers a "Purchase and Sale Agreement," setting forth the terms of the sale, a "Fuel Supply Agreement" that would govern the store owners' purchase of fuel from Uni-Marts suppliers, and a "Right of First Refusal Agreement" that gave store owners a right of first refusal in connection with any sale of the real estate on which the store was located. Uni-Marts ultimately sold approximately 150 stores through the public bidding process.

On February 28, 2006, an attorney purporting to represent Uni-Marts store owners wrote to Uni-Marts alleging that Uni-Marts had made material misrepresentations in connection with the sale agreements. The letter alleged that the store owners "ha[d] suffered serious damages and consequences from these misrepresentations," and advised that absent an amicable resolution, the store owners were prepared to institute litigation.

Despite devoting several months to negotiations, the parties failed to resolve their differences. The gas station owners filed a class action suit in the Court of Common Pleas of Luzerne County in January of 2007. The class action complaint asserted five causes of action: (a) fraud in the inducement, (b) negligent misrepresentation, (c) breach of a fuel supply agreement, (d) breach of a purchase agreement, and (e) breach of a contractual right of first refusal. In November of 2007, the parties settled the class action and Uni-Marts agreed to pay the gas station operators $2 million.

The D&O Coverage Action

Uni-Marts was insured by Federal under D&O liability policies between June 20, 2005 and June 30, 2007. Federal's D&O policies contained a contractual liability exclusion providing that coverage is unavailable for claims "based upon, arising from, or in consequence of any actual or alleged liability […] under any written or oral contract or agreement, provided that this Exclusion […] shall not apply to the extent that an [insured] would have been liable in the absence of the contract or agreement."

In December of 2006, Uni-Marts gave notice to Federal of its dispute with the gas station operators. In July of 2007, Federal filed a declaratory judgment action against Uni-Marts contending that coverage was barred as a result of (a) late notice and (b) the contractual liability exclusion. Shortly thereafter, Uni-Marts answered the complaint and counterclaimed seeking a declaration that the D&O policy affords coverage for Uni-Marts' defense costs and potential liability.

In May of 2012, Federal filed a motion for summary judgment based on the contractual liability exclusion.[1] In response, Uni-Marts argued that Federal should be required to cover the fraudulent inducement and negligent misrepresentation counts because the claims arose from the company's pre-contractual behavior. On August 17, 2012, the court granted summary judgment in favor of Federal.

Recognizing that jurisdictions differ in their definition of the scope of the contractual liability exclusion, Judge Nealon nevertheless found that, in Pennsylvania, the phrase "arising from" or "arising out of," when used in a policy exclusion – even a broad exclusion, like the one at issue – is unambiguous. Following precedent, the court explained that the phrase means "causally connected with," and not "proximately caused by." Thus, under Pennsylvania law, "but for" causation – i.e., a cause and effect relationship – is enough to satisfy the terms of the of the policy and require application of the exclusion. In the words of the court, "the question [is] would the store owners' fraud in the inducement and negligent misrepresentation claims exist even in the absence of the contracts and the breach thereof." "The heart of the damages sought," explained the court, "ring of breach of contract damages and the injuries undoubtedly flow from the contractual relationship between the parties." Therefore, "[t]he injuries suffered by the class plaintiffs would not have occurred had there been no contracts and no breach thereof."

The court also found support in Pennsylvania's "gist of the action doctrine," which precludes recasting ordinary breach of contract claims into tort claims. Although Pennsylvania courts have, in the past, found that similar precontractual conduct falls outside the "gist of the action" doctrine, Judge Nealon explained that the record proved that the misrepresentations and omissions at issue were not only pre-contractual, but were actually part of the "Representations, Warranties and Covenants of the Seller" of the purchase agreements. Thus, the "gist of the action" doctrine also barred coverage. "Requiring Federal to cover this loss, which in essence is derived from a business agreement gone bad, would be greatly expanding the coverage of the D&O policy beyond that which is called for by its plain language," said the court.

Judge Nealon's detailed analysis makes clear that Pennsylvania will honor and enforce even very broad contractual liability exclusions, provided their terms are clear and unambiguous. The ruling, however, is not as far-reaching as may appear at first blush. The fact that Uni-Marts distributed the agreements prior to the bidding process, and that the misrepresentations were incorporated into the body of the final contracts was the tipping point. Otherwise, Judge Nealon suggested, precontractual fraudulent conduct may fall outside the "gist of the action" doctrine – and the contractual liability exclusion.

Conclusion

Parties may often be tempted to assume that claims alleging fraud or negligent misrepresentation, particularly those involving precontractual conduct, fall outside the scope of a contractual liability exclusion. As Judge Nealon's thorough analysis demonstrates, that assumption may not always be warranted. Broad language in the preamble of the exclusion as well as the factual connection between the alleged misrepresentations and the terms of the underlying contract and the type of damages sought may render the tort claims within the scope of the exclusion.

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1 Uni-Marts went into bankruptcy in 2008, and the action was stayed until January of 2012 when KDW Restructuring and Liquidation Services, LLC, the trustee in bankruptcy, was substituted for Uni-Marts by agreement of the parties.

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