Pleading to Keep Your Promise: Litigation Tactics Concerning Insurance Coverage for Breaches of Contract

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I. EXECUTIVE SUMMARY

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Contractual Liability Exclusions

What are Contractual Liability Exclusions?

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CGL

D&O

E&O

Common Problems with Contractual Liability Exclusions

Different Wording, Different Scope

Aetna

XL Specialty Insurance Co.

Pennsylvania Pulp & Paper Co., Inc.

Chapman

Breach of Contract or Tort? The Con-Tort Problem

Roots in Legal Theory

Application Under Texas Law

Overlap

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I. <u>EXECUTIVE SUMMARY</u> *(continued)*

Strategic Considerations Regarding Contractual Liability Exclusions

<u>Artful Pleading</u>

Importance

Four Characteristics of Artful Pleading

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Unique Situation

Five Important Considerations

<u>Settlement & Trial: The Allocation Problem</u>

II. INTRODUCTION

Shortly after an insured tenders a lawsuit to its insurance company for its defense, insurance counsel must closely scrutinize the petition or complaint to determine whether, because one or more of the claims asserted conceivably falls within the scope of the policy's coverage, the insurer has a duty to defend. Yet, to a certain extent, insurance counsel are making these decisions in the dark, without knowledge of two critical facts: first, whether the plaintiff's lawyer is aware of the insurance policy and is familiar both with the scope of its coverage as well as its exclusions, and; second, whether the plaintiff's lawyer has taken the exclusion into account when drafting the complaint—*i.e.*, whether the complaint has been "artfully pled."

Further, if the insurer rejects the insured's tender and is sued, a judge will determine whether the insured had a duty to defend, with potentially disastrous consequences. If the judge rules against the insurer, the insurer will not only have liability from the underlying policy, but may also face exorbitant damages under the Insurance Code or DTPA that greatly exceed the amount of coverage under the policy. Each and every lawsuit that may potentially trigger a duty to defend places insurance counsel in this precarious position.

Ideally, the courts would eliminate this uncertainty by establishing clear guidelines for which claims fall outside of standard exclusions. Settled, black letter law regarding standard exclusions would allow the marketplace to distribute risk efficiently, which would, in turn, reinforce the stability of the law. But because of the diversity of insurance policies, the varied wording of their respective exclusions, and the sheer

multiplicity of unique lawsuits, this judicially-created market efficiency remains pie in the sky.

And the law concerning contractual liability exclusions is one of the many areas where chaos rules over certainty. Therefore, this presentation discusses both the source of the uncertainty in current law and how this instability affects both sides' litigation tactics from pleading through appeal.

III. CONTRACTUAL LIABILITY EXCLUSIONS

What are Contractual Liability Exclusions?

Broadly defined, a contractual liability exclusion is an exclusion in (or endorsement to) an insurance policy whereby the insurer bars coverage for any damages resulting from some or all contracts entered into by the insured. Insurance policies generally describe contractual liability as "[l]iability ***assumed***...under any contract or agreement."[1] The purpose of a contractual liability exclusion is to protect the insurer from having to defend or indemnify the insured against breach of contract claims made by third parties. Without this exclusion, the risk to the insurer is enormous: because each insured could enter into hundreds or thousands of contracts, insurers risk being called on for defense costs and damages related to any contract that the insured allegedly breaches.

For purposes of this discussion, contractual liability exclusions have the most significant impact on litigation concerning comprehensive general liability, directors and officers, and errors and omissions insurance policies.[2] Thus, this paper provides a brief

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[1] *See Ranger Ins. Co. v. Mustang Aviation, Inc.*, 641 S.W.2d 587, 589 (Tex. App.—Dallas 1982, writ refused n.r.e.) (emphasis added).

[2] Of course, contractual liability provisions are present in other types of policies. *See, e.g.*, *Olympic, Inc. v. Providence Wash. Ins. Co.*, 648 P.2d 1008 (Alaska 1982) (landlord tenant policy); *Transport Indemn. Co. v. Paxton Nat'l Ins. Co.*, 657 F.2d 657 (5th Cir. 1981) (tractor trailer liability policy). But,

overview of each of these types of policies and their use of contractual liability exclusions.

Inclusion in Comprehensive General Liability Policies

Comprehensive general liability ("CGL") insurance policies protect the insured from claims for occurrences that result in bodily injury or property damage. An occurrence is defined as: "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."[3] Because an occurrence is equivalent to an accident[4], and an insured's breach of contract is usually an intentional or willful act, a breach of contract is not typically an "occurrence" within the meaning of CGL policies.[5]

Even though breaches of contract are not typically covered by CGL policies, insurers frequently take a belt and suspenders approach and include the contractual liability exclusion as extra protection. For example, many CGL policies include the following language:

> This insurance does not apply to claims for breach of contract, whether express or oral, nor claims for breach of an implied in law or implied in fact contract, whether "bodily injury," "property damage," "advertising injury,"

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because this presentation focuses on the applicability of contractual liability exclusions in the context of complex commercial litigation, these types of policies are not discussed.

3 *See* D. MALECK, ET AL., COMMERCIAL GEN. LIABL. (6th ed. 1997).

4 Texas courts define an accident, as it relates to a CGL policy, as follows: "[A]n injury is accidental if from the viewpoint of the insured, it is not the natural and probable consequence of the action or occurrence which produced the injury; or in other words, if the injury could not reasonably be anticipated by the insured, or would not ordinarily follow from the action or occurrence which caused the injury...both the actor's intent and the reasonably foreseeable effect of his conduct bear on the determination of whether an occurrence is accidental." *See Mid-Century Ins. Co v. Lindsey*, 997 S.W.2d 153, 155 (Tex. 1999).

5 *See Gibson & Assocs., Inc. v. Home Ins. Co.*, 966 F. Supp. 468, 474 (N.D. Tex. 1997) (collecting cases from jurisdictions throughout the United States).

"personal injury" or an "occurrence" or damages of any type is alleged; this exclusion also applies to any additional insureds under this policy.[6]

Because of most courts' reluctance to include a breach of contract as an occurrence under a CGL policy, and because insurers nonetheless include contractual liability exclusions, it stands to reason that courts should rarely (if ever) require an insurer to defend or indemnify a third party's claim against an insured for breach of contract. However, when the contractual liability endorsement only excludes "liability assumed under...any contract or agreement,"[7] federal courts in Texas have held that the provision only protects the insurer from ***third party claims*** asserted against the insured "as a contractual indemnitor of a third party's conduct."[8] If the third-party claim is a direct claim—*i.e.*, the insured is being sued for its own breach of contract—the insurer may have a duty to defend.[9]

Thus, despite the insurer's overly cautious approach, insurance counsel may be forced to choose between defending an uncovered lawsuit now or risking substantial liability later.

Inclusion in Directors & Officers Policies

Directors and Officers ("D&O") insurance policies protect companies against losses that result from wrongful acts committed by directors, officers, or employees in their official capacities. Contractual liability exclusions are absolutely necessary in D&O policies for two reasons. First, directors and officers enter into numerous contracts as

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6 *See B. Hall Contracting, Inc. v. Evanston Ins. Co.*, 447 F. Supp. 2d 634, 639 (N.D. Tex. 2006).

7 *See supra* at n. 1.

8 *See Federated Mut. Insc. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 726 (5th Cir. 1999).

9 *Id.*

part of their duties. Each of these contracts creates a unique risk to the insurer for defense and indemnity costs because, without the contractual liability exclusion, an insured can tender the defense of each and every breach of contract action. Second, D&O policies are broadly worded for "any losses" that result from "wrongful acts"; only by including the proper exclusions (including the contractual liability exclusion) can the insurer manage its risk under these policies.

Thus, most D&O policies include broad contractual liability exclusions, which are usually phrased to exclude coverage for any claim "alleging, arising out of, based upon, or attributable to any actual or alleged contractual liability of the Company or any other Insured under any express contract or agreement."[10] However, even under this broadly worded exclusion, courts are divided on whether an insurer has a duty to defend or indemnify an insured under a D&O policy for breach of contract.

For example, because of what is described below as the con-tort problem,[11] some courts have narrowed the scope of contractual liability exclusions in D&O policies. Courts here have two primary concerns. First, when the nature of the insured's business is to enter into contracts—*i.e.*, a company of stock brokers who enters into numerous stock purchase agreements on a daily basis—the court narrows the exclusion to prevent it from swallowing the entire policy.[12]

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10 *See Chapman v. Nat'l Union Fire Ins. Co.*, 171 S.W.3d 222, 225 (Tex. App.—Houston [1st Dist.] 2005, pet. denied).

11 *See infra* at IV.

12 *See Adm. Ins. Co. v. Briggs*, 264 F. Supp. 2d 460, 462 (N.D. Tex. 2003) ("Admiral's interpretation of this contract exclusion provision is overly broad. Its interpretation would exclude coverage under the Policy for all stock fraud claims because they all involve a contract for the sale of stock").

Second, insurers often overestimate the number (and type) of claims that the contractual liability exclusion allows them to escape. More simply stated, "the fact that [the lawsuit] had its origins in a contract does not mechanically turn the claim into one for breach of contract."[13] Thus, in many cases, although the third-party has asserted a claim for breach of contract, if the third-party claim also asserts causes of action for torts such as fraud[14], fraudulent misrepresentations[15], negligence[16], and gross negligence[17], the insurer may still have a duty to defend and/or indemnify, irrespective of the contractual liability exclusion.

Inclusion in Errors & Omissions Policies

Errors and Omissions ("E&O") insurance policies protect companies from negligent acts, errors, and omissions committed either by the insured or by any person for whom the insured is legally liable. E&O policies that contain contractual liability exclusions face the same con-tort problem as D&O policies. Because E&O policies cover negligent acts and omissions, courts are left to determine whether the liability exists solely because of an express contract (which, if true, results in the claim being barred by the exclusion) or whether the claim is a result of negligence regarding a duty

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13 *See Waste Corp. of Am., Inc. v. Genesis Ins. Co.*, 382 F. Supp. 2d 1349, 1359 (S.D. Fla. 2005).

14 *See supra* at n. 12.

15 *Id.*

16 *See supra* at n. 13.

17 *Id.*

imposed by contract (which, if true, results in the insurer having a duty to defend and/or indemnify).[18]

IV. COMMON PROBLEMS WITH CONTRACTUAL LIABILITY EXCLUSIONS

Different Wording, Different Scope

As noted above, the traditional contractual liability exclusion is phrased to exclude "liability ***assumed*** under…any contract or agreement."[19] This language, while clear and inclusive, has allowed courts to find exceptions to the contractual liability exclusion. A survey of case law regarding contractual liability exclusions reveals that a less than precise or underinclusive wording of the exclusion can result in significant liability for an insurer.

For example, "liability assumed under any contract is the most weakly phrased exclusion and, appropriately, courts find many cases that fall outside of its purview. In *Aetna Casualty & Surety Company v. Lumbermens Mutual Casualty Company*, a New York Court found that the traditional liability exclusion did not protect an insurer against a contribution lawsuit by a co-insurer. Because the exclusion was worded so narrowly, the court did not analyze whether all of the plaintiff's claims arose out of contract, but instead summarily held that: "[W]here, as here, the insured [] is liable to the owner under either the indemnity provision of its contract or in tort independent of the contract, the exclusion for liability assumed under the contract will not apply."[20] The court, therefore,

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18 *See Cagle v. Comm. Standard Ins. Co.*, 427 S.W.2d 939, 943-44 (Tex. Civ. App. 1968) (quoting 63 A.L.R. 2d 1122).

19 *See supra* at n. 1.

20 *See Aetna Cas. & Surety Co. v. Lumbermens Mut. Cas. Co.*, 136 A.D.2d 246, 248 (N.Y. Sup. Ct. 1988).

essentially ruled that, so long as the insured had tort liability, the contractual liability exclusion would not preclude a co-insurer from recovering contribution damages against the insurer. This ruling eviscerates the exclusion because, as discussed below, it is not difficult for the plaintiff to find tort theories upon which to base his claim.

Similarly, in a recent Texas opinion, a court once again found that the contractual liability exclusion was too weakly worded to preclude liability. In *XL Specialty Insurance Company v. Kiewit Offshore Services, Limited*, the insurer issued a marine CGL policy that contained "an exclusion for liability assumed under any contract or agreement, but [] also has an exception to that exclusion if coverage for such liability is afforded under the underlying general liability exclusion."[21] In this particular case, the insurer included an exception that swallowed the exclusion in its policy.

The insured here, RBT Welders, Inc. ("RBT"), supplied workers to Kiewit Offshore Services ("Kiewit") through a subcontract that required RBT to indemnify Kiewit for any loss arising from the actions of RBT's employees.[22] As a result of the negligence of one of RBT's employees, there was an explosion at Kiewit's plant that killed a Kiewit worker and resulted in a wrongful death lawsuit.[23] When Kiewit requested that RBT, pursuant to the terms of the subcontract, indemnify Kiewit in the wrongful death action, RBT's insurer refused on the basis of the contractual liability exclusion.[24] But, because the insurer included an exception that allowed policy coverage

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21 *See XL Specialty Ins. Co. v. Kiewit Offshore Servs., Ltd.*, 336 F. Supp. 2d 673, 675-676 (S.D. Tex. 2004).

22 *Id.* at 675.

23 *Id.* at 674.

24 *Id.*

for a breach of contract if the breaching act was otherwise covered by the policy, the insurer had written themselves out of their own exclusion. Thus, the court held that RBT's insurer had to both defend and indemnify Kiewit in the wrongful death lawsuit.[25] Once again, the insurer had not carefully drafted a policy that forced the court to examine the full scope of the contractual liability exclusion.

More strongly worded policies, however, have been read expansively by courts and require courts to conduct a thorough analysis of whether all of the tort claims arise out of an underlying contract. For example, in *Pennsylvania Pulp & Paper Company, Inc. v. Nationwide Mutual Insurance Co.*, a Texas court analyzed a case where a third party sued an insured for breach of contract and violations of DTPA for failing to protect confidentiality technology licensed to the insured under a licensing agreement.[26] The insured tendered defense of this claim to their insurer, who refused to defend the lawsuit based on the contractual liability exclusion, which "exclude[d] from coverage ***any 'advertising injury' arising out of***...[b]reach of contract."[27]

Because the exclusion focused on the ***injury arising out of*** a breach of contract, the court took a harder view at the third party plaintiff's tort claims. After determining that the plaintiff's DTPA damages arose out of the insured's breach of the licensing agreement, the court held that, because of the contractual liability exclusion, the insurer did not have a duty to defend or indemnify the insured.[28]

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25 *Id.* at 675.

26 *Penn. Pulp & Paper Co. v. Nationwide Mut. Ins. Co.*, 100 S.W.3d 566, 568-569 (Tex. App.—Houston [14th Dist. 2003], pet. denied).

27 *Id.* at 573 (emphasis added).

28 *Id.* at 573.

Finally, in *Chapman v. National Union Fire Insurance Company*, the insurer drafted the broadest contractual liability exclusion yet, which excludes liability for any claim "alleging, arising out of, based upon, or attributable to any actual or alleged contractual liability of the Company or any other Insured under any express contract or agreement."[29] Although the plaintiff's complaint in *Chapman* was very poorly pled, the broad wording of this exclusion forces any court to examine whether the tort claims arise out of an underlying contract.

Through our survey of the law, we have determined that the *Chapman* exclusion is the broadest and any insurer who wishes to escape liability absolutely must emulate its broad wording, as plaintiff's lawyers have little or no difficulty convincing judges around the nation that their tort claims survive more weakly worded contractual liability exclusions.

Breach of Contract or Tort? The Con-Tort Problem

For over half a century, scholars have debated whether there is a concrete distinction between liability based on contract and liability based on tort. All sides can agree, however, that "the borderland of tort and contract, and the nature and limitations of the tort action arising out of a breach of contract are poorly defined."[30] These poorly defined borders create massive uncertainty both for insurers and corporate defendants alike, and plaintiff's lawyers have capitalized on this uncertainty.

For example, a corporate defendant who is sued for breach of contract may face significant financial exposure, but is protected from punitive damages, whereas a tort

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29 *See supra* at n. 10.

30 *See* WILLIAM L. PROSSER, SELECTED TOPICS ON THE LAW OF TORTS, 380 (1953).

claim arising out of contract creates the real risk of ruinous liability. Similarly, the borderland between contract and tort is vitally important to any insurer whose policies have contractual liability exclusions, as the plaintiff's tort claims convert a standard breach of contract claim from an uncovered claim to a covered claim, which demands defense costs and possibly indemnification.

Unfortunately, Texas courts have not clearly defined the boundary between contract and tort. The Texas Supreme Court has stated that "where there is a general duty, even though it arises from the relation created by, or from the terms of a contract, and that duty is violated, either by negligent performance or negligent nonperformance, the breach of the duty may constitute actionable negligence."[31] This case, which gave rise to a tort for negligent performance of a contract, was later reaffirmed by the Supreme Court, who again stated that "[t]he acts of a party may breach duties in tort or contract alone or ***simultaneously in both***,"[32] thus creating the modern con-tort problem.

What is the test, then, for determining whether an action sounds in contract or in tort? According to the Texas Supreme Court, the standard is that "[w]hen the injury is only the economic loss to the subject of a contract itself, the action sounds in contract alone."[33] This definition, while reasonably clear, has unfortunately resulted in a significant split of authority in the Texas appellate courts.

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31 *See Montgomery Ward v. Scharrenbeck*, 204 S.W.2d 508, 510 (Tex. 1947).

32 *See Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617, 618 (Tex. 1986) (emphasis added).

33 *Id.*