Navigating the "Tort Problem" in Contractual Liability Exclusions: A Matter of Timing?

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In today’s insurance market, a number of professional liability insurance policies contain so-called “broad form” contractual liability exclusions. A standard, broad form contractual liability exclusion will typically exclude coverage for Loss in connection with any Claim “based upon, arising from, or in consequence of any actual or alleged liability of any Insured under any express contract of agreement.” Given the various contractual relationships that inevitably arise in the professional liability context – think shareholder agreements, partnership agreements, employment agreements, and more – the issue of applying the contractual liability exclusion is one that comes up time and time again.

The issue is fairly straightforward when a lawsuit contains only a breach of contract cause of action – the contractual liability exclusion will operate to bar coverage. However, when a complaint contains both contract and tort-based causes of action, the applicability of the exclusion is not so clear-cut. The key issue in applying these exclusions is whether, in addition to the breach of contract cause of action, the contractual liability exclusion can be applied to exclude coverage for tort-based causes of action as well, to the extent they are “based upon” or “arise out of” contract. The answer to that question is yes - sometimes. Of course, courts reach different results depending on the language of the policy and the specific facts of the case. However, in searching for a common thread, it appears that courts also focus on more objective criteria in deciding these cases: the temporal relationship between the written agreement and the commission of the alleged tort. Two recent cases highlight the significance of this “timing” factor in driving the court’s ultimate decision on the issue.

In October 2014, the United States District Court for the Middle District of Florida applied a contractual liability exclusion to exclude coverage for a negligent misrepresentation cause of action – the contractual liability exclusion will operate to bar coverage. However, when a complaint contains both contract and tort-based causes of action, the applicability of the exclusion is not so clear-cut. The key issue in applying these exclusions is whether, in addition to the breach of contract cause of action, the contractual liability exclusion can be applied to exclude coverage for tort-based causes of action as well, to the extent they are “based upon” or “arise out of” contract. The answer to that question is yes - sometimes. Of course, courts reach different results depending on the language of the policy and the specific facts of the case. However, in searching for a common thread, it appears that courts also focus on more objective criteria in deciding these cases: the temporal relationship between the written agreement and the commission of the alleged tort. Two recent cases highlight the significance of this “timing” factor in driving the court’s ultimate decision on the issue.

In October 2014, the United States District Court for the Middle District of Florida applied a contractual liability exclusion to exclude coverage for a negligent misrepresentation cause of action. In Bond Safeguard Insurance Co., et al. v. National Union Fire Insurance Co. of Pittsburgh, P.A. [1], the court held that the contractual liability exclusion precluded coverage for the tort-based cause of action because it arose out of the defendants’ breaches of their contractual obligations. The contractual liability exclusion excluded coverage for:

Loss in connection with a Claim made against an Insured . . . 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.

The underlying action arose from the defaults of various bond principals on subdivision bonds that the plaintiffs began issuing on behalf of a land development company (LDC) in 2003 to guarantee completion of certain land development projects. As a prerequisite to the execution of the bonds, the plaintiffs required the defendants to execute a General Agreement of Indemnity (GAI). Pursuant to the GAI, the defendants were contractually obligated to indemnify the plaintiffs for any liability, cost, charge or expense they incurred in relation to the bonds. The plaintiffs suffered
approximately $40 million in losses as a result of settling obligations under the defaulted bonds. The plaintiffs alleged that the defendants were liable for the losses because the defendants: (1) caused the land development company to default on the development projects by negligent acts and omissions; and (2) induced plaintiffs to issue the bonds and forego certain suretyship remedies by negligently failing to fully disclose to the plaintiffs the financial condition of the land development company.

The court began with an observation that the phrase “arising out of” as used in the contractual liability exclusion is “unambiguously broad and precludes coverage for purported tort claims that depend on the existence of actual or alleged contractual liability of an insured.” The court held that the insurer met its burden to establish that plaintiffs’ negligent misrepresentation cause of action “depended on (and was not merely incidental to) the defendants’ contractual liability under the GAI...” The court noted that the plaintiffs themselves made concessions that their tort cause of action arose out of defaults on the bonds, and that they would have suffered no losses had the defendants performed their obligations under the GAI. Significantly, the court noted:

The evidence concerning Plaintiff’s business dealings with Ward and LRC are consistent with these concessions as is Plaintiffs’ Second Amended Complaint, which asserts that Ward’s negligence commenced after 2003 and further provides that the Underlying Action arose from “the defaults of various bond principals” on the Bonds [emphasis added].

Therefore, the court held that the contractual liability exclusion barred coverage for the negligent misrepresentation cause of action.

However, in December 2014 the United States District Court for the District of Rhode Island reached a different result. In Transched Systems Limited v. Federal Insurance Co.[2], the court held that because the alleged misrepresentations preceded the entering of the contract, the contractual liability exclusion did not apply to exclude coverage for a tort-based cause of action. The contractual liability exclusion in the policy excluded coverage for:

[any claim 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 agreement.]

In the underlying lawsuit, the plaintiff alleged that the defendants made material misrepresentations during the negotiation and execution of an Asset Purchase Agreement (APA). After a jury trial, the insured was found liable for three causes of action: (1) breach of contract regarding misrepresentations and warranties in the APA; (2) breach of the implied covenant of good faith and fair dealing; and (3) intentional misrepresentation. The insurer denied coverage for the judgment against the insured, citing both the Fraud Exclusion and the contractual liability exclusion. The insurer argued that the plaintiff’s intentional misrepresentation claim arose from the APA because the defendants made intentional misrepresentations that induced it to enter into the APA and that those misrepresentations were ultimately contained in the APA. The court disagreed, noting that many of the misrepresentations occurred before the APA was created, and that “at least a portion of [the defendants’] liability” for the intentional misrepresentations occurred before the APA existed.”
Both *Bond Safeguard* and *Transched Systems* are instructive in terms of how courts approach the “tort problem” in the context of contractual liability exclusions. At the outset, in determining whether a contractual liability exclusion can operate to exclude coverage for a tort-based cause of action, the key questions are: (1) is the tort-based cause of action based upon the contract? and (2) would the defendant be liable even in the absence of the agreement? Although the factors are easy enough to identify, applying the factors can be more difficult in practice. However, as a first step, and as the two cases above suggest, one place to start might be a fairly straightforward concept: timing. When was the contract entered into? And when were the alleged misrepresentations made? In *Bond Safeguard*, the court specifically noted that the defendants’ negligence commenced after 2003, at which point the plaintiffs had already begun issuing bonds on behalf of the land development company. By contrast, in *Transched Systems*, the court noted that many of the misrepresentations occurred before the APA was even created.

While timing, in and of itself, is not a full-proof method for evaluating coverage in these situations, it can provide a quick roadmap for an initial assessment of whether the contractual liability exclusion could apply to exclude coverage for a tort-based cause of action. Depending on the breadth of the preamble language and the relationship between the alleged tort and the written agreement, the contractual liability exclusion could apply to exclude the tort-based causes of action regardless of timing. Other times, however, something as simple as timing could aid in determining whether the alleged misrepresentations were in fact “based upon” contractual liability.

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