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NEWSLETTER

Insurer Obligated to Advance Defense Costs Despite Contract Exclusion and Despite the Uninsured Capacity in Which a Director Was Sued

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Applying Texas law, a federal district court in New York has held that an insurer is obligated to advance all defense costs incurred by an insured restaurant management company and one of its directors despite the applicability of the policy's contract exclusion to all but one of the causes of action asserted in the underlying complaint and even though all of the allegations against the individual defendant involved conduct by him in an uninsured capacity. *Julio & Sons Co. v. Travelers Casualty & Surety Co. of Am.*, 2008 WL 5273986 (S.D.N.Y. Dec. 17, 2008).

The underlying complaint was brought by an investment firm that had made a $3 million loan to the restaurant management company pursuant to a note purchase agreement and that had received warrants to purchase stock of the company pursuant to an accompanying warrant agreement. The investment firm alleged that the individual defendant, who was not a director at the time but rather was the company's majority shareholder, caused the company to take certain actions, including purchasing another entity and guaranteeing that entity's leases. These actions allegedly were taken without the investment firm's knowledge and consent and were in violation of the parties' agreements, as well as the defendants' fiduciary duties. The investment firm further contended that this conduct constituted fraud and negligent misrepresentation because the defendants purportedly had a duty to disclose that they had or were planning to enter into the transaction to purchase the other entity but failed to do so. Accordingly, the underlying complaint asserted causes of action against the restaurant management company and the individual for (1) breach of contract; (2) breach of fiduciary duty; (3) fraud; and (4) negligent misrepresentation.

The insurer denied coverage on a number of grounds, including that the individual was not insured under the policy and that the policy's contract exclusion applied. In the coverage litigation that followed, the restaurant management company filed a motion for partial summary judgment seeking to compel the insurer to advance defense costs incurred on behalf of both itself and the individual defendant.

As an initial matter, while recognizing that the insurer did not have a duty to defend under the policy, the court determined that a Texas court likely would apply the same standard to evaluate the insurer's obligation to advance defense costs. Accordingly, the court held that it must determine whether any one of the claims asserted in the underlying complaint would give rise to coverage because, if so, then the insurer must advance defense costs for the entire suit. The court then looked to Texas's "eight corners rule" and held that in making this determination, it could consider only the allegations in the complaint, the language in the policy and extrinsic evidence that went solely to the issue of coverage.

Finding that the agreements between the investment firm and the restaurant management company were the primary focus of the firm's allegations and that any interpretation of the agreements would necessarily decide issues relevant to the claims asserted in the underlying lawsuit, the court ruled that it could not consider them. The court did, however, hold that it was appropriate to consider documents proving that the individual defendant was elected to the position of director on February 15, 2007. In this regard, the court pointed out that the underlying complaint was not filed until that date and, therefore, did not include any allegation that the individual was a director or any claim that relied on his status as a director.

Because the evidence before it established that the individual was a "past, present or future duly elected . . . director" of the insured company, the court concluded that he qualified as an "Insured Person" under the policy. The insurer, however, took the position that because none of the allegations against the individual in the underlying complaint involved conduct in his capacity as a director, coverage was not triggered. In this regard, the court recognized that the policy covered an Insured Person for a Claim for a Wrongful Act. The court further recognized that the policy included several definitions of Wrongful Act, two of which defined the term to mean any act, error or omission by an Insured Person in his capacity as a director of the company, or any matter asserted against an Insured Person solely by reason of his status as a director of the company. The court found that neither of these definitions applied here.

Turning to a third definition, the court found that an act, error or omission "by the Insured Organization" also qualified as a Wrongful Act under the policy. According to the court, combining this definition with the insuring clause applicable to Insured Persons allowed the policy to be reasonably construed to grant coverage "for defense costs incurred in lawsuits which may seek to hold an Insured Person personally liable for alleged Wrongful Acts by an Insured Organization." Although recognizing that there might be an equally reasonable alternative interpretation that would result in no coverage for the director, the court concluded that, at best, there was an ambiguity that the court was required to resolve in favor of coverage. Accordingly, the court held that coverage for the director was triggered because the underlying complaint included allegations of misconduct by the restaurant management company.

Next, the court considered the policy's contract exclusion, which provided that the coverage "shall not apply to, and the [insurer] shall have no duty to defend or to pay, advance or reimburse Defense Expenses for, any Claim . . . for or arising out of or in consequence of any actual or alleged liability of the Insured Organization under any express contract or agreement." According to the court, the breach of contract count clearly and

unambiguously fell within the exclusion. As to the remaining causes of action, the court noted that Texas courts construing exclusions with similar broad lead-in language have applied a "but-for" test subject to a "limiting principle" that requires the court to "focus on the underlying pleading's factual allegations that show the origin of the damages rather than on the legal theories alleged."

Applying this standard, the court determined that the exclusion applied to the causes of action for fraud and negligent misrepresentation but not for the breach of fiduciary duty claim. In this regard, the court pointed out that the firm's claims for fraud and negligent misrepresentation were based on an extant duty to disclose and a duty to exercise reasonable care in communicating information, and that those duties adhered only if a legally material relationship existed between the parties. According to the court, the only such relationship here was contractual, and, therefore, plaintiff's claims for fraud and negligent misrepresentation would not have existed absent the firm's agreements with the company.

In contrast, the court found that the breach of fiduciary duty claim did not depend on any contractual relationship between the parties but rather arose out of duties purportedly owed to the investment firm based on its status as a warrant holder. According to the court, that the firm acquired the warrants pursuant to its agreement with the restaurant management company was irrelevant to the claim asserted. On this basis, the court determined that the contract exclusion did not apply to this claim in the underlying complaint. As a result, the insurer was required to advance all defense costs on behalf of both the restaurant management company and its director.