



Contract exclusions are common fixtures in directors and officers liability policies; however, they can be broadly interpreted to eliminate valuable coverage. The purpose of this Practice Note is to assist policyholders in identifying whether their policies contain a contract exclusion and providing them practical recommendations to assist in negotiating more favorable language in their policies.

What is a Contract Exclusion and How is it Applied?

Contract exclusions typically exclude coverage “alleging, arising out of or resulting, directly or indirectly, from any liability or obligation under any contract or agreement or out of any breach of contract.” The exclusion will often include an *exception* for any liability that an insured would have “in absence of such contract or agreement.” A typical example of liability “in absence of” a contract is tort liability.

The Ninth Circuit Court of Appeals recently interpreted a standard contract exclusion to completely eliminate coverage for policyholder Office Depot, Inc. (“Office Depot”) in Office Depot, Inc. v. AIG Specialty Ins. Co., 829 F. Appx. 263 (9th Cir. 2020). Office Depot sought defense and indemnity in connection with a former employee’s whistleblower lawsuit, which alleged that Office Depot overcharged numerous clients, including government entities. The lawsuit alleged violations of California’s False Claims Act. Office Depot had the same contract exclusion as excerpted in the paragraph above, and the Ninth Circuit held that, under California law, the exclusion’s triggering language (“arising out of”) only required a “minimal causal connection or incidental relationship” to a contract. The Court concluded that the claims against Office Depot arose “directly and indirectly” from Office Depot’s contracts with the City of Los Angeles.

The Court went on to state that contract exclusions, such as the one in Office Depot’s policy, also “exclude coverage of tort claims which could not exist without the relevant underlying contracts.” This language is particularly troubling to policyholders and their counsel, as the contract exclusion’s exception language should apply to tort claims regardless of whether the tortious behavior has some attenuated relationship to a contract (because tort liability is liability the policyholder has in absence of the contract). Also, how often does a business dispute *not* have some direct or indirect relationship to a contract? The Ninth Circuit’s decision in Office Depot underscores the importance of trying to negotiate and narrow the application of a contract exclusion.

¹SDV’s D&O Practice Notes series is designed to offer policyholders practical advice and to help educate them on important D&O issues.

How Can I Negotiate More Favorable Language in my Policy?

First and foremost, we recommend that a policyholder ask its insurer to remove the exclusion in its entirety. As you can imagine, many insurers will not agree to do this. In the event your insurer does not agree, here are a few recommendations to narrow the application of the exclusion:

- Request that the exclusion's "triggering"² language be changed from the broad "arising out of, directly or indirectly..." to "for breach of contract..." By narrowing the triggering language, the exclusion *should* only be triggered where a lawsuit includes a cause of action for breach of contract. This narrower exclusion should not apply to tort claims that have an attenuated relationship to a contract because the cause of action would be for tortious conduct, not for breach of contract.
- Request that the contract exclusion only apply to claims against the insured company and not to claims against individual insured directors and officers.
- Request that the contract exclusion not apply to defense costs. Thus, while there may not be indemnity coverage for the claim, the policyholder would at least be entitled to a defense funded by its insurer

Do you have a question concerning your D&O policy or a D&O claim? We encourage you to reach out to SDV's D&O Practice Group: Theresa Guertin at TGuertin@sdvlaw.com, Grace Hebbel at GHebbel@sdvlaw.com, Alexandra O'Neill at AOneill@sdvlaw.com, and Jesse Hidell-Carrijo at JHidell-Carrijo@sdvlaw.com.



²"Triggering" language is the prefatory language in the exclusion that must be satisfied in order to "trigger" the application of the exclusion.