

Texas Appellate Court, Applying "Eight Corners Rule," Determines that D&O Policy's Contractual Liability and Prior Litigation Exclusions Bar Coverage

January 2005

A Texas state appellate court has upheld summary judgment in favor of an insurer, holding that, under Texas's "eight corners rule," coverage was precluded for a suit against a director and his firm arising out of the alleged breach of a divorce agreement based on a D&O policy's contractual liability and prior litigation exclusions. *King Chapman & Broussard Consulting Group, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 2005 WL 20541 (Tex. Ct. App. Jan. 6, 2005).

The underlying claim arose from a suit against two insureds, a director of a consulting firm and the consulting firm itself, by the former spouse of the director. The suit alleged, *inter alia*, that the director had breached his fiduciary obligations under the divorce agreement that he and his former spouse entered into in 1996. The director and the firm settled the suit and demanded payment of defense and indemnity costs from the insurer. The insurer denied liability, asserting that the allegations did not fall within the scope of coverage since the director was not sued in his capacity as a director, and, alternatively, that even if these allegations were within the scope of the insuring agreement, coverage was precluded under both the contractual liability exclusion and the prior litigation exclusion.

Without reaching the issue of whether the director was being sued in his capacity as such, the court held that coverage was precluded under both exclusions. According to the court, under Texas's "eight corners rule," the determination of a duty to defend is made by examining the allegations in the pleadings in conjunction with the language contained in the insurance policy. Under this approach, the court indicated that an insurer owes no duty to defend if the pleadings allege facts excluded under the policy, citing *Fidelity & Guaranty Insurance Underwriters, Inc. v. McManus*, 633 S.W.2d 787 (Tex. 1982). Applying this standard, the court determined that, based on the allegations in the underlying complaint, the two policy exclusions unambiguously barred coverage.

With respect to the contractual liability exclusion, the court noted that the exclusion barred coverage for claims "alleging, arising out of, based upon or attributable to any actual or alleged contractual liability . . . under any express contract or agreement." The underlying suit alleged that the director breached his obligations under a divorce agreement and that the director breached his "fiduciary obligations" established under that agreement. The court determined that, although a breach of fiduciary duty claim ordinarily sounds in tort, the underlying claim "'[arose] out of' and [was] 'attributable to' the alleged breach" of the agreement, as the fiduciary relationship was created by the divorce agreement. Thus, the court held that coverage was precluded as a matter of law under this exclusion.

The court also held that the prior litigation exclusion, precluding coverage for claims "alleging, arising out of, based upon or attributable to as of the Continuity Date [September 9, 1999], any pending or prior litigation" also applied because the divorce proceedings occurred in 1996. The court determined that each of the allegations in the current suit "[arose] out of specific sections of the 1996 divorce decree" and that the divorce proceedings constituted "prior litigation" triggering the exclusion. In reaching this conclusion, the court rejected the argument that the prior litigation exclusion was ambiguous, noting that there could be no "interpretive issue as to whether the divorce litigation was 'prior' to the [policy's] inception date."

The court then addressed the insureds' request that it consider extrinsic evidence in determining the insurer's obligation under the policy based on *State Farm Fire & Casualty Co. v. Wade*, 827 S.W.2d 448, 453 (Tex. Ct. App. 1992), a case in which the policyholder contended a Texas appellate court had considered extrinsic evidence in connection with a coverage determination. The court rejected this request as contrary to existing precedent. In that regard, the court also observed that the United States Court of Appeals for the Fifth Circuit, in the recent case of *Northfield Insurance Co. v. Loving Home Care, Inc.*, 363 F.3d 523 (5th Cir. 2004), had rejected a request to consider extrinsic evidence in similar circumstances, and, in doing so, had predicted that the Texas Supreme Court would likewise "not recognize any exception to the strict eight corners rule."

For more information, please contact us at 202.719.7130.