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Publication

09/30/2019

Seventh Circuit Holds Overbroad Breach of Contract Exclusion Renders E&O Coverage Illusory

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On September 23, 2019, the Seventh Circuit acknowledged a common problem with Errors & Omissions ("E&O") insurance for professional services by finding that an overbroad breach of contract exclusion rendered coverage illusory. *Crum & Forster Specialty Ins. Co. v. DVO, Inc.*, Case No. 18-2571. The court ordered that the insurance policy had to be reformed to meet the insured's reasonable expectations of coverage.

The insured, DVO, Inc., entered into a contract to design and build anaerobic digesters for WTE-S&S AG Enterprise, LLC. Slip op. at 2. Anaerobic digesters use microorganisms to breakdown biodegradable materials to create biogas, and WTE wanted to use them to generate electricity from cow manure. *Id.* The electricity then would be sold to an electric power utility. *Id.* Unfortunately, WTE claimed that the digesters did not work as intended and sued DVO for breach of contract. *Id.* WTE alleged that DVO failed to fulfill its design duties, responsibilities, and obligations under the contract in that it did not properly design the digesters. *Id.* WTE went into bankruptcy and the bankruptcy court ultimately

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found in favor of WTE and ordered DVO to pay damages and attorneys' fees. *Id.*

Crum & Forster Specialty Insurance Company had issued a policy to DVO that included E&O insurance for damages because of a "wrongful act." *Id.* at 3. The policy defined "wrongful act" as including a failure to render "professional services," and defined "professional services" as "those functions performed for others by you or by others on your behalf that are related to your practice as a consultant, engineer, [or] architect." *Id.*

Crum & Forster initially agreed to defend DVO in WTE's lawsuit, but subsequently denied coverage based on a breach of contract exclusion in the E&O policy. *Id.* at 2. That exclusion read as follows:

Id. at 5.

In the coverage lawsuit between Crum & Forster and DVO, the parties did not dispute that the WTE lawsuit alleged a "wrongful act" and failure to render "professional services," nor that the breach of contract exclusion applied because the damages and suit were based upon or arose out of DVO's contract with WTE. DVO argued that the E&O policy had to be reformed because as written, the breach of contract exclusion was so broad that it rendered the policy's coverage illusory.

The Seventh Circuit agreed with DVO. The court noted that under Wisconsin law, the phrase "arising out of" as used in insurance policies is broad and reaches "any conduct that has at least some causal relationship between the injury and the event not covered." *Id.* at 8. The breadth of this phrase is problematic in the context of insurance intended to cover liability based on an insured's professional services, because when an insured provides such services, it does so pursuant to a contract with a third party. *Id.* Consequently, even tort claims asserted against the insured "arise out of" the insured's

contract: "The claims of professional negligence will fall within the contract exclusion because they necessarily arise out of the express, oral or implied contract under which DVO rendered the professional services.... The overlap between claims of professional malpractice and breach of contract is complete, because the professional malpractice necessarily involves the contractual relationship." *Id.* at 8, 10. No claims could be made against the insured that were not excluded by the breach of contract exclusion, rendering the E&O policy's coverage illusory. *Id.* at 10.

The remedy for the illusory coverage was to reform the E&O policy to meet DVO's reasonable expectations. *Id.* at 11. The court provided guidelines for how to reform the policy but remanded the matter to the district court so that it could determine the precise contours of the reformed policy:

Id. at 11-12.

As noted, breach of contract exclusions in E&O policies have always been problematic because insureds only provide professional services pursuant to contracts. Thus, as the Seventh Circuit found, broad exclusions for damages "arising out of" contracts essentially swallow the insuring agreements, leaving insureds with little or no coverage. One solution has been to attempt to negotiate for narrower exclusionary language when purchasing or renewing policies. For example, an insured can seek to add an exception to a breach of contract exclusion for "liability that would have attached to the insured in the absence of such contract or agreement." However, many insurers are reluctant to limit exclusions. The Seventh Circuit's decision in *Crum & Forster* gives insureds new leverage to obtain better language by warning insurers of the risk that their policies may be reformed if they do not rein in overbroad exclusions.

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