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Seventh Circuit Holds "Breach of Contract" Exclusion in Professional Liability Policy Renders Coverage Illusory

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Most professional liability policies include a "breach of contract" exclusion precluding coverage for claims or damages arising out of breach of contract. How to apply such broad exclusions to claims brought by clients of the insured (or others with whom the insured has contracted) can be difficult because most professional relationships necessarily involve an underlying contract. On the one hand, arguably every claim against an insured professional "arises out of" the contract where but for the contract there would be no relationship between the claimant and insured. That interpretation of the exclusion, however, is seemingly too broad. But, what about claims that could be brought in both contract and tort? Or, does the exclusion limit coverage only to claims brought by third parties with whom the insured has not contract? Just as "breach of contract" exclusions vary, courts are mixed.

In *Crum & Forster Specialty Insurance Company v. DVO, Inc.*, 2019 WL 4594229 (7th Cir. Sept. 23, 2019), the Seventh Circuit addressed whether the E&O coverage of the primary and excess insurance policies issued to DVO cover a state court claim for contract violations in light of the policies' broad "breach of contract" exclusion. In applying Wisconsin law, the Seventh Circuit found that the language in the "breach of contract" made the exclusion broader than the grant of coverage, and therefore, rendered coverage illusory.

In *DVO, Inc.,* the underlying contract claim was brought by WTE pursuant to Standard Form Agreement under which DVO agreed to design and build an anaerobic digester for WTE to be used to generate electricity from cow manure which would then be sold to the electric power utility. WTE sued DVO for breach of contract alleging that DVO failed to fulfill its design duties, responsibilities, and obligations under the contract in that it did not properly design substantial portions of the structural, mechanical, and operational systems of the digester, resulting in substantial damages to WTE. WTE sought over $2 million in damages and fees.

Crum & Forster initially offered a defense under primary and excess policies providing a combination of commercial general liability, pollution liability, E&O and other coverages. The issue on appeal concerned the E&O coverage, and more specifically, whether the policies' "breach of contract" exclusion barred coverage. The exclusion precluded coverage for damages and costs "based upon or arising out of: breach of contract, whether express or oral, nor any 'claim' for breach of an implied in law or an implied in fact contract[]…." DVO argued that the "breach of contract" exclusion was so broad as to render the E&O professional liability coverage illusory, and therefore, could not be enforced to preclude a duty to defend. The District Court held that the professional liability coverage was not illusory because it would still apply to third party claims, and even if it was, the remedy would be to reform the contract to allow coverage for third party claims against the insured, not to allow coverage for all professional liability claims. The Seventh Circuit reversed.

The Seventh Circuit began its analysis with familiar tenants of Wisconsin insurance law. First, a determination of whether the exclusion applies must focus on the incident that allegedly gave rise to the coverage, not the theory of liability. *See e.g., 1325 North Van Buren*, *LLC v. T-3 Group, Ltd.* (noting that claims of negligence in the failure to provide competent professional services could raise both tort and contract claims). Therefore, according to the Court, even a claim that purports to be a tort claim can be excluded under the "breach of contract" exclusion if it arises out of that contract.

Second, the Seventh Circuit reiterated that the "arising out of" language, even in an exclusion, is broadly construed. The phrase is broad, general, and comprehensive, and it is ordinarily understood to mean "originating from, growing out of, or flowing from." Therefore, under Wisconsin law, "the term 'arising out of' is interpreted broadly to reach any conduct that has at least some causal relationship between the injury and the event not covered, which sweeps in third-party claims as well when so related." *DVO, Inc*., 2019 WL 4594229 at *8.

In *DVO, Inc.,* the underlying state court complaint alleged that DVO was contracted to design and construct the anaerobic digester and, because of its faulty design, damages were incurred. As such, the complaint alleged a claim that arose out of the contract, and therefore, fell within the exclusion language. According to the Seventh Circuit, the "event not covered" in the policy was itself quite expansive, explicitly applying "breach of contract" to all contracts whether express or oral, and even including contracts implied in law or fact. The Seventh Circuit rejected the District Court's attempt to distinguish between direct claims between contracting parties based on the contract, and third-party claims based on the insured's failure to exercise reasonable professional care where the claimant has no contractual relationship with the insured. While the Seventh Circuit conceded that more tailored language may support the District Court's reasoning, the "breach of contract" exclusion at issue was extremely broad: it included claims "based upon or *arising out of*" the contract, thus including a class of claims more expansive than those based solely upon the contract. Given that broad language, the exclusion would include even the claims of third parties. As to those third parties, the claims of professional negligence against DVO fell within the "breach of contract" exclusion because they necessarily "arose out of" the express, oral, or implied contract under which DVO rendered professional services on the project.

Based on the above analysis, the Seventh Circuit reasoned that the "breach of contract" exclusion rendered the professional liability coverage in the E&O policy illusory. In the insurance context, "[i]llusory policy language defines coverage in a manner that coverage will never actually be triggered." *Id*. *6. While the Seventh Circuit recognized that if the purported coverage in a policy proves to be illusory a court may reform the policy to meet the insured's reasonable expectation of coverage, the Court disagreed with the District Court's attempt to reform the contract. The District Court reasoned that even if the coverage was illusory, the remedy would be reform the contract to allow coverage for third party claims (and not those brought directly by parties with whom the insured contracted). The Seventh Circuit, however, held that the District Court's focus on the hypothetical third-party action was misplaced. Rather, the focus should be on the "reasonable expectation" of coverage of the insured in securing the policy. Although the Seventh Circuit's analysis of hypothetical third-party claims under the "breach of contract" exclusion might foreshadow the likely outcome in this case, ultimately the Seventh Circuit declined making a determination on the reasonable expectations of the insured and remanded the case back to the District Court to consider.