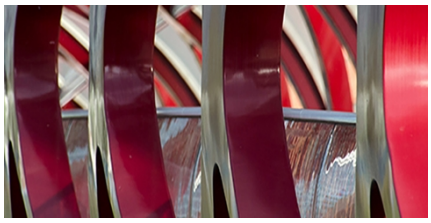
masuda funai



News & Types: 商事／競争／取引関連情報

裁判所により保険の補償範囲が「実体のないもの」であったと判断された保険会社が敗訴

10/1/2019

Practices: コーポレート／ファイナンス／M&A, 商事／競争／取引, 訴訟

DVO, Inc. (“DVO”) designs and builds anaerobic digesters that use microorganisms to break down biodegradable materials to create biogas. DVO designed and build a digester for its customer, WTE-S&S AG Enterprise LLC (“WTE”). But WTE was not happy and sued DVO for more than $2 million for breach of contract, alleging that DVO failed to design the digester properly.

DVO tendered the claim to Crum, its insurer. At first, Crum defended DVO under a reservation of rights. But Crum changed its mind and declined coverage and declined to defend the claim. Crum cited the exclusion for claims or damages based upon or arising out of breach of contract.

WTE filed for bankruptcy and pursued its claim against DVO in the bankruptcy court. WTE won its claim against DVO and was awarded $65,000 in damages and $198,000 in attorneys’ fee. DVO turned back to Crum, challenging its denial of coverage. Crum prevailed in the district court, but not at the 7th Circuit Court of Appeals. (*Crum & Forster Specialty Insurance Company v. DVO, Inc*., No. 18-2571, September 23, 2019) The opinion was written by Judge Rovner, who is apparently the “go to” justice in the 7th Circuit on complex insurance litigation. A year ago, we reported on another opinion written by Judge Rovner in a difficult insurance case (link).

Crum issued primary and excess insurance policies to DVO covering the period in which WTE’s claim occurred. The appeal to the 7th Circuit covered two provisions. The first was the errors and omissions (E&O) coverage which required Crum to pay “those sums the insured becomes legally obligated to pay as ‘damages’ or ‘cleanup costs’ because of a ‘wrongful act’ to which this insurance applies.” The second provision was the breach of contract exclusion added as an endorsement, which provided that the insurance policy did not apply to claims or damages based upon or arising out of breach of contract.

DVO argued that the exclusion was so broad as to render the E&O coverage “illusory”, and could not be enforced to preclude the duty to defend. The district court viewed it differently. It found that the coverage was not illusory because it would still apply to third party claims, and that even if it was determined to be illusory, the remedy would be to reform the contract to allow coverage for third party claims.

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Noted Judge Rovner, “In the insurance context, [i]llusory policy language defines coverage in a manner that coverage will never actually be triggered.” If the coverage is illusory, then a court can reform the policy to meet the insured’s reasonable expectation of coverage.

Judge Rovner then discussed the application of the duty to defend in an insurance policy. It involves a three part inquiry:

1. whether the type of claim asserted against DVO is the type for which coverage is provided by the policy;
2. whether an exclusion provision in the policy precludes coverage; and
3. if an exclusion applies, whether that exclusion contains any exceptions that would reinstate coverage.

The answer to the first inquiry was yes. DVO and WTE had a contract and DVO allegedly failed to perform under that contract. Under the policy, Crum agreed to insure for a “wrongful act”, which was defined to include a failure to render professional services. In turn, “professional services” was defined 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 . . .” Judge Rovner viewed this as covering professional malpractice. Both Crum and DVO agreed that DVO’s conduct fell within this provision.

But the policy contained a breach of contract exclusion, which excluded damages or losses 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 contracts [sic], regardless of whether “bodily injury”, “property damage”, “personal and advertising injury” or a “wrongful act” is alleged.”

Following Wisconsin law (the applicable law) Judge Rovner focused on the incident that gave rise to the coverage, not the theory of liability. The claim against DVO alleged that DVO breached its contract because of the improper design of the anaerobic digester. So, based on the language in the exclusion, WTE’s claim against DVO would appear excluded. Said Judge Rovner, “The sole issue, then, is whether the language in that breach of contract exclusion renders the exclusion broader than the grant of coverage, and therefore renders the coverage illusory.”

To find the language illusory would have catastrophic consequences to Crum, the insurance company. If it was determined that coverage was illusory, a court could reform the policy to “meet the insured’s reasonable expectations of coverage.” But even Judge Rovner conceded that reformation is “an extraordinary remedy not lightly taken.” Did it apply in this case? It did, held Judge Rovner.

First, go back to the district court, which held the coverage was not illusory because it covered third party claims. So injury or damage to a third party could arguably be covered by the policy, even though the third party would have no contractual relationship with DVO.

As in last year’s update, referenced above, Judge Rovner examined the policy language very closely. “The language in the exclusion is very broad. It includes claims “based upon *or arising out of*” the contract, thus including a class of claims more expansive than those based upon the contract.” (Judge Rovner’s emphasis)

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As would be expected (and probably intended by the drafter), Wisconsin courts interpret “arising out of” language broadly. “All that is required is some causal relationship between the injury and the event not covered.” Judge Rovner discussed cases in which Wisconsin courts upheld exclusions of coverage for claims arising out of breach of contract, even when the claim was a third party claim that was only tangentially related to the contract.

“Under Wisconsin law, therefore, the term “arising out of” has been 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. And the “event not covered” in the policy here is itself quite expansive, explicitly applying the breach of contract exclusion to all contracts whether express or oral, and even including contracts implied in law or fact. Given that broad language, the exclusion would include even the claims of third parties. As to those third parties, 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.”

So with respect to E&O coverage, what was left for Crum to cover? Nothing, suggests Judge Rovner. “The overlap between claims of professional malpractice and breach of contract is complete, because the professional malpractice necessarily involves the contractual relationship.”

So Judge Rovner applied in the holding what Judge Rovner acknowledged as “an extraordinary remedy.”

“ . . . . [W]e hold that the breach of contract exclusion in this case rendered the professional liability coverage in the E&O policy illusory.”

Judge Rovner acknowledged that the district court recognized the possibility of total negation of coverage, but felt the policy could be reformed. But this conclusion is not consistent with the broad “arising out of” language in the policy, “which would exclude all claims for professional liability whether or not brought by third-parties.”

This result was a disaster for Crum. Before the focus was on the policy language and the exclusion, drafted by Crum. But Judge Rovner turned the focus “on the reasonable expectation of coverage of the insured in securing the policy”, in other words, what DVO’s expectations of coverage actually were when it procured the policy. So “the contract should be reformed so as to meet the reasonable expectations of DVO as to the E&O policy’s coverage for liability arising out of negligence, omissions, mistakes and errors inherent in the practice of the profession.”

The contractual exclusion was in an endorsement to the entire policy, and applied not just to E&O coverage but the other parts of the policy, such as contractors pollution, commercial general liability, third party pollution, and onsite cleanup coverage. Judge Rovner suggested one possible way to reform the policy would be to delete the applicability of the endorsement to the E&O coverage only, leaving the endorsement in place for the other parts of the policy. But Judge Rovner left the ultimate determination to the district court.

Probably Crum did not view its E&O coverage as illusory. But in drafting the coverage, Crum created the exception that swallowed up the rule, enabling Judge Rovner to find the coverage illusory. So the takeaway in this case is the same as last year’s opinion by Judge Rovner in an insurance case (cited above): “So, as Judge

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Rovner repeatedly emphasized in the opinion, in insurance indemnification cases the focus is on the policy language and a detailed analysis of the background and facts of the loss triggering the indemnification claim."

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