CARLTON FIELDS

Cow Manure Meets Insurance Law: Seventh Circuit Addresses Breach of Contract Exclusions in Malpractice Insurance

October 28, 2019

Errors and omissions (E&O) and directors and officers (D&O) professional liability insurance policies commonly contain breach of contract endorsements that exclude coverage for claims "based upon or arising out of" a breach of contract. Whether this typical breach of contract exclusion is enforceable has now been called into doubt, where they are construed to exclude third-party claims. In a diversity case applying Wisconsin law, the Seventh Circuit held that such a breach of contract exclusion was so broad, when construed in accordance with Wisconsin's "arising out of" law, that it swallowed the policy coverage, rendering the E&O policy illusory. It ordered the district court on remand to decide whether and how to reform the policy to meet the reasonable expectations of the insured. This case concerned a malpractice policy procured by a company called DVO. DVO was hired to design and build an anaerobic digester that would be used to generate electricity from cow manure. When DVO was sued for breach of contract due to allegedly faulty work on the anaerobic digester, its malpractice insurer, Crum & Forster, initially defended DVO but then brought a declaratory judgment action seeking a determination that it did not have a duty to defend DVO, in light of the breach of contract exclusion to coverage. The insurer argued, and the district court agreed, that coverage under the E&O policy was not illusory because it covered third-party claims. The Seventh Circuit rejected this argument. It explained that Wisconsin courts read "based upon or arising out of" language in breach of contract exclusions broadly, to exclude third-party claims. The Seventh Circuit also rejected the district court's alternative holding that, assuming the policy did not cover third-party claims, it could be reformed to do so. The district court said that reforming the policy in this limited way would render the policy effectual rather than illusory. The Seventh Circuit explained, however, that when courts reform an illusory policy, they should focus on the insured's reasonable expectations in securing the coverage rather than reforming the policy in some more limited way: "The availability of third-party claims is irrelevant unless it is determined to be a part of

[the insured's] reasonable expectation of coverage." The Seventh Circuit remanded the case to the district court to determine, in the first instance, whether and how to reform the policy under the appropriate legal standard. Read the opinion: *Crum & Forster Specialty Ins. Co. v. DVO, Inc.*, No. 18-2571 (7th Cir. Sept. 23, 2019).

Authored By

Nathaniel G. Foell

Related Practices

Appellate & Trial Support