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7th Circ. Ruling Reveals Broad-Exclusion Risks For Insurers

By **Caroline Meneau and David Kroeger** (October 25, 2019, 3:13 PM EDT)

Caroline Meneau

David Kroeger

When an insurance policy exclusion is so broadly written that it negates any meaningful coverage, courts will use the illusory coverage doctrine to reform the policy to meet the reasonable expectations of the insured. When faced with denials of coverage under policy exceptions, policyholders may have the opportunity to use the exceptions' breadth to their own advantage, arguing that the exceptions are so broad that they swallow the bargained-for coverage.

DVO Inc. is in just the kind of business that members of the public hope is well-insured against disaster — turning cow manure into electricity. At the time that DVO agreed to design and build an anaerobic digester for a dairy farm, it was insured under an errors and omissions policy from Crum & Forster Specialty Insurance Company.

The policy provided coverage for "those sums the insured becomes legally obligated to pay as 'damages' or 'cleanup costs' because of a 'wrongful act' to which this insurance applies" — essentially, coverage for professional malpractice. Unfortunately, the dairy farm deal went bad, and the dairy farm sued DVO for breach of contract, alleging that DVO failed to properly design the structural, mechanical and operational systems of the farm's anaerobic digester, damaging the farm and eventually forcing it into bankruptcy.

Crum initially provided a defense to DVO under a reservation of rights, but later advised DVO that it would not defend the case. Crum relied on a breach of contract exclusion, which provided that the policy did not apply to claims or damages based upon or arising out of a breach of contract.

Everyone agreed that the underlying claim in the dispute with the dairy farm case was a breach of contract claim, barred by the plain language of the exclusion. But DVO had a comeback — it bought professional liability insurance, and any professional liability obligation it incurred would ultimately be based upon or arise out of a contract with a customer.

Even if some third party were injured by DVO's actions, that injury would ultimately arise out of DVO's contractual obligations to a party to whom it was providing services. Thus, DVO argued that the language in the breach of contract exclusion made the exclusion broader than the grant of coverage for professional malpractice, and thereby rendered the coverage illusory.

In Crum & Forster Speciality Insurance Co. v. DVO Inc., the U.S. Court of Appeals for the Seventh Circuit agreed with DVO and remanded the case to the district court to determine how the contract could 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."[1]

The Seventh Circuit noted that it would not be enough to reform the contract to provide coverage for professional liability to third parties (which would be no help in the dispute with the dairy farm), explaining that "there is, after all, no reason to believe that DVO in purchasing Errors and Omissions coverage to provide insurance against professional malpractice claims had a reasonable expectation that it was obtaining insurance only for claims of professional malpractice brought by third parties."[2]

Policyholders who are weary of expansive policy exclusion language can take some solace in the fact that where the overreaching is bad enough, it can become self-defeating. Crum would have had a better argument if the policy simply excluded breach of contract claims. It lost because the essentially boilerplate "based upon or arising out of" language used in the policy at issue here was argued to sweep in any conceivable claim that could have been covered under the professional liability policy, such as obligations to third parties. The Seventh Circuit's decision is useful encouragement for parties to be direct and to-the-point in their contracts — Crum lost because of excessive legalese.

Parties reviewing proposed insurance policies may find Crum useful when requesting simpler language and less wordiness, and should consider whether there is a basis for striking "relating to," "based upon," and "arising out of language" that obscures the true intent of a particular provision.

Further, in any coverage dispute, it is helpful to step back and think about what the policy was supposed to cover in the first place. DVO effectively framed its case with the court as a case about an insurer not providing agreed-upon coverage. The Seventh Circuit agreed with DVO's argument that an engineering/design firm buying professional liability coverage must expect coverage for claims that it has designed systems improperly. From that starting point, it followed logically that because all of DVO's work was contract-based, an exclusion for claims arising out of contracts could not be viable.

Caroline L. Meneau is an associate and David M. Kroeger is a partner at Jenner & Block LLP.

[1] Crum & Forster Specialty Insurance Co. v. DVO Inc., --- F.3d --- (7th Cir. Sept. 23, 2019), 2019 WL 4594229, at *5.

[2] Id.