SANDBERG PHOENIX

PROFESSIONAL LIABILITY BLOG

Seventh Circuit Finds E&O Coverage Illusory

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The underlying contract claim was brought against the insured that designs and builds anaerobic digesters used to create biogas. The insured was to design and build an anaerobic digester for the plaintiff in the underlying breach of contract suit but allegedly failed to fulfill its design duties, responsibilities, and obligations under the contract in that it did not properly design substantial portions of the system. The insurer defended the insured under the reservation of rights, but later decided it would no longer provide a defense and eventually judgment was entered against the insured for approximately $275,000 in damages and attorneys' fees.

The E&O coverage part included a breach of contract exclusion that was added by endorsement which provided the policy did not apply to claims or damages based upon or arising out of breach of contract. The insured argued the breach of contract exclusion was so broad it rendered the E&O professional liability coverage illusory and therefore could not be enforced. The district court declared the professional liability 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, not to allow coverage for all professional liability claims

The Seventh Circuit disagreed and found the exclusion at issue was extremely broad. It focused on the use of the phrase "based upon or arising out of" the contract which included a class of claims more expansive than those based upon the contracts. Applying Wisconsin law, it found that the term "arising out of" has been interpreted so broadly to reach any conduct that has at least some causal relationship between the injury and the event not covered, which would include third party claims as well. Moreover, the breach of contract exclusion would apply to all contracts whether express or oral and even including implied contracts. Because the exclusion would include claims of third parties, claims of professional negligence would fall within the contract exclusion because they necessarily arise out of the express, oral, or implied contract under which the insured rendered professional services.

When a policy's coverage proves to be illusory, the policy then may be reformed to meet an insured's reasonable expectation of coverage. Here, the court found there was no reason to believe the insured in purchasing E&O coverage to provide insurance against professional malpractice claims had a reasonable expectation that it was obtaining insurance only for claims for professional malpractice brought by third-parties. The 7th Circuit noted an E&O policy is professional liability insurance which is designed to insure members of professional groups from liability arising out of the special risk such as negligence, omissions, mistakes and errors inherent in the practice of their profession. Thus, the policy should be reformed so as to meet the reasonable expectations of the insured as to E&O policy's coverage for liability arising out of negligence, omissions, mistakes, and errors inherent to the profession. The 7th Circuit reversed and remanded for further proceedings as to how the policy should be reformed.

Professionals who have E&O insurance should be mindful of broad exclusions which may render coverage illusory. On the other hand, insurers who issue professional liability E&O policies need to make sure the exclusions are not so broad to take away the very coverage which the insured intended to purchase.