Coverage for Breach of Contract in Technology Errors and Omissions Policies

Professionals buy Professional Liability or Errors and Omissions insurance to cover them for lawsuits arising from the provision of their products or services. Generally, E and O insurance is designed to complement General Liability Insurance which usually excludes coverage for claims arising from the provision of "professional services". The exclusion is not only expressly stated, but is implied as well, in that general liability usually covers only bodily injury or property damage. Typically, when someone sues a professional for a misdeed arising from "professional services", the damages are not bodily injury or property damage, but are "economic" damages – exposing the claimant to a financial loss. Hence typically, an insured expects its GL policy to cover bodily injury and property damages, and its E and O policy to cover lawsuits brought by customers for services gone bad.

Unfortunately, E and O policies do not always provide the coverage expected by a policy holder. This is particularly true if the E and O policy fails to cover lawsuits alleging a breach of contract by a customer against an insured. The purpose of this paper is to provide some background on the "Contractual Exclusion" in E and O policies and to discuss the rulings on contract cover among some of the Courts that have considered it.

The Unique Risk of Contract Breach

Contracts are a ubiquitous part of our high technology business life. License agreements are required in virtually every transaction including hardware, software or any kind of technology service. Sometimes the agreements are negotiated between the two parties, but often they are simply included with delivery of a product or by a "click-through" license. One cannot even access a website without "agreeing" to the terms of use that exist for the website (even though most of us never even read them). Contracts that are not negotiable are expected to be written reasonably or run the risk of being dismissed by a Court. If two parties are connected by a contract, and a dispute ensues, the courts will most often look to the contract to determine the rights and obligations between the two parties.

But not every professional requires a contract before providing services. For instance, doctors may not ask their patients to sign contracts but they do ask them to sign confidentiality agreements, disclosure forms and questionnaires. While such documents may not rise to the level of being a contract, they can be evidence in the event of a lawsuit between a doctor and patient. Similarly, a contract between a lawyer and a client does not always itemize the exact type of work to be performed by the lawyer, especially a lawyer hired to litigate a matter in court. The client expects the lawyer to use his expertise and experience, something that the client lacks. Hence, the agreement defines the relationship but not necessarily the deliverable.

A difference can be seen in contracts with architects, engineers and contractors which define the deliverable to be provided (schematics, blueprints, or a structure). Even though that deliverable is defined, the process of production of the deliverable is not itemized. Rather, again, the client relies upon the professional's expertise in producing the deliverable.

Professionals and E and O Insurance

Because a professional uses his expertise to deliver the product or service, the client is often highly reliant upon the professional to perform appropriately. This reliance has been seen by the Courts as creating a special "duty" such that a professional can be sued for failing to perform that duty – also called "malpractice". The ability to sue for malpractice is important because otherwise, a professional may be able to convince a client to sign a contract that limits the professional's liability such that the client can never be made whole. Because the client doesn't know precisely what goes into the provision of the professional services (relying on the expert), they can't be expected to agree to limit their liability for the professional's failure to perform. Hence, an individual that seeks to sue a professional for failures rising from their professional services can bring an action for breach of contract (if a contract existed between them) or can sue for a breach of duty, whether a contract existed or not.

But professionals aren't the only ones buying E and O insurance. Most notably, technology companies procure E and O as well. And even though the insurance may be called "professional liability" insurance, the Courts have uniformly distinguished technology companies from "professionals" like lawyers, doctors, architects and engineers. And that distinction is important, because the difference between a "professional" and a non-professional is significant as respects E and O insurance, particularly for non-professionals that regularly sell their good and services by way of a contract – like technology companies.

Exclusions for Breach of Contract

Even though most companies sell their goods and services under a contract, both CGL and E and O polices often exclude coverage for actions arising from breach of contract. Of interest is the fact that even though the two policies cover two different kinds of injuries, the contractual exclusion (and exceptions to the exclusion) is sometimes identical.

In CGL policies, a breach of contract exclusion is entirely appropriate. The policy is designed to cover liability arising from the breach of a common law duty, not liability created by contract. Accordingly, general liability policies cover actions that sound in tort – usually negligence actions. Also, they will describe the losses or the damages as "bodily injury" or "property damage". A breach of contract exclusion in a CGL policy usually excludes cover for damages arising from "breach of contract" or arising from the "assumption of liability in a contract or agreement" .[1]

Assuming Liability under a Contract

Virtually everyone who enters into a contract effectively understands that they may be liable if they breach that contract. But what does it mean for a party to "assume liability" in a contract? Does one "assume liability" in a contract just by signing it – that is to say, by agreeing to perform some act? If so, then every time that a contract is signed, liability is "assumed" and there would be no cover due to the exclusion - a pretty harsh result for the insured. But that is in fact what one court decided – stating that if the assumption of liability was intended to apply only to a third party contract then the policy would ability "assumed" under contract, which was every contract that the insured signed. Other

courts have disagreed with that interpretation, however, and have insisted that an assumption of liability must by definition involve an agreement to assume the liability of a third party. [3]

But it's disheartening to know that even the words "liability assumed in a contract" can be interpreted differently by two or more Courts. In a country of 51 separate jurisdictions, this lack of predictability should be a point of concern for insureds. The one thing that can be said for sure by examining this line of cases is that policies that offer explicit coverage for contractual liability will not have to endure a legal analysis of whether liability was "assumed under contract". If a policy covers actions for breach of contract, a protracted coverage battle over that issue can likely be avoided.

Liability in the Absence of a Contract

Often a contractual liability exclusion will include a carve-back that provides cover for liability that exists "in the absence of a contract". That is to say that even though a breach of contract action is not covered, if there is any other theory upon which liability can be based, coverage is provided (if not otherwise excluded). Generally however, in the absence of a contractual relationship a party can be held liable for its acts, errors or omissions only if it owes a duty to that party. [4] Hence, the question becomes, in what circumstances does an insured owe a "duty" such that there is liability in the absence of a contract?

This exception has been the subject of much discussion among the various courts, most notably in Texas and usually involving the application of the language in CGL policies. Citing cases that relate back several years, a recent Court found no duty, and hence no coverage in a case alleging errors in the construction of a tennis court. [5] In that case, the insured asked the court to rule that its CGL policy covered claims asserted against it for breach of contract and negligence. The CGL carrier objected, citing an exclusion against actions for breach of contract and arguing that all of the claims "arose" from the breach of the contract.

The court first determined that the contractual exclusion was valid, and next evaluated whether the exception for "liability in the absence of a contract" applied. Looking closely at the types of damages alleged by the property owner, the court held that the property owner's claim sounded "only in contract, not tort" and thus, would not exist in the absence of the contract. Hence, there was no coverage under the CGL.

Cover for Breach of Contract in Professional Liability Policies

Of course, E and O policies are not the same as CGL policies, but the application of the contractual exclusion is similar. If an insured does not have express cover for breach of contract actions, the insured must envision claim scenarios where liability may exist "in the absence of a contract". Accordingly, it must determine whether it owes a "duty" to its customers. As stated above, "professionals" such as doctors and lawyers can be held liable for breach of duty, but what about other occupations that may not rise to the level of a "professional" such as computer consultants? Generally, Courts have held that technology companies do not owe a "duty" to their customers that buy products or services under a contract. [6] Similarly, the courts have stated expressly that there is no tort for "computer malpractice". In fact, the court in Heidtmann Steel

Products Inc., v. Compuware Corp stated that "computer consultants can not be held liable for malpractice" and "Courts in other jurisdictions that have contemplated treating computer consultants as professionals have almost uniformly declined to do so".

In the absence of a claim for malpractice or negligence, what assurance does an insured have that it can rely upon a policy that provides cover only if there is "liability in the absence of a contract"? The answer lies in the type of cover that they insured seeks. Most policies require an insurance carrier to provide a defense when an insured is sued for a covered offense. If the lawsuit involves both covered and uncovered actions, then the carrier may still be required to provide a defense, but only so long as a covered cause of action is alleged. If the covered cause of action is removed from the lawsuit, the carrier's obligation to provide a defense ends as well. [7] Similarly, the presence of covered and uncovered claims cause tensions in efforts to settle a case, as the carrier may take the position that it is liable for only a portion of the settlement, to resolve only the covered actions. Furthermore, if a matter moves to trial, and a jury is asked to rule on both covered and uncovered claims, an insured won't know whether it will be covered for potential damages until after the jury has returned a verdict.

The Application of the "Economic Loss Rule"

The reluctance of the Courts to find that a duty exists independent of a contract is most pronounced in those states that follow the majority view of the "economic loss rule". That rule, articulated by the US Supreme Court, [8] provides that where a relationship is governed by a contract limiting remedies to "economic losses", then the only recourse for a wronged party is to sue under the contract. The rule disallows recovery under a theory of negligence or strict liability. Of course, a plaintiff may still allege a cause of action for fraud or other intentional torts, but those actions are often excluded themselves in an E and O policy. [9] Hence, absent a duty between the parties, the economic loss rule will bar a party in privity of contract with another from bringing a separate negligence action. For an insured that holds a policy that covers negligence but that excludes or limits actions based on contract, the practical application of the contractual exclusion, and its exceptions, balanced against the opportunity to limit claims under the economic loss rule, can cause headaches for its attorney whose job is to try and limit their client's exposure.

The Practical Problem with the Contractual Exclusion

Generally, a lawyer for an insured that is a party to a contract will want to defend the contract, because the contract excludes and/or limits certain damages. In line with that, the lawyer will seek to exclude any other causes of action that are not based on the contract. If the claim filed against his client asserts a negligence claim, and the claim is brought in a jurisdiction that follows the majority view of the economic loss rule, the lawyer will have a good opportunity to have that negligence claim removed from the action. But if the carrier provides a defense for only covered claims, and excludes claims for breach of contract, then the prospect of relying solely on the contract can be a practical problem for the insured and its counsel who must balance the advantage of removing non-contractual claims from the lawsuit with the potential disadvantage

arising from the removal of claims that provide insurance coverage. If the policy provides explicit cover for breach of contract, the insured can fashion a defense that is based on the contract, with its attendant limitations and restrictions of damages, without the worry of whether the express or underlying causes of action are covered.

Conclusion

The Breach of Contract exclusion can come in various forms and could have a limited application in E and O policies. And, like every policy exclusion, it will be examined carefully by courts whenever a carrier relies upon it to deny coverage. But its very presence creates confusion and uncertainty for an insured. Brokers should evaluate their client's business practices to determine the effect of a contractual exclusion, and any exceptions to the exclusion under specific claims scenarios. Of course, the absence of a contractual exclusion, or even better, explicit contractual cover, will offer a clearer picture of the insured's coverage under its E and O policy.

*"**David L. Chavez***

is a shareholder with AlvaradoSmith and the Partner in Charge of the San Francisco Office. He is the practice leader for the Insurance and Information Security practice groups providing insurance coverage, insurance defense and data breach response services."

dchavez@AlvaradoSmith.com

1. Sometimes the language "liability assumed in a contract" is added to a policy as an exception to an exclusion for contract actions. That is to say, policies exclude breach of contract, but carve-back coverage for liability "assumed under contract". Regardless of whether the language is stated as en exclusion or as an exception to an exclusion, the its very presence sows doubt and confusion regarding the applicability of the language to a given claim.
2. Gilbert Texas Construction Company L.P., v Underwriters at Lloyd's London 327 SW 3d 118 (2010)
3. American Family Mutual Insurance Company v. American Girl Inc. 268 Wisconsin 2d 16 (2004)
4. Notable exceptions to this general statement are actions for fraud and for statutory violations.
5. Ewing Construction Co. Inc., v. Amerisure Ins. Co.(2011) WL 1627047
6. Heidtman Steel Products v. Compuware Corp. 2000 WL 621144, (ND OH, 2000) and cases cited therein.
7. Hugo Boss Fashions Inc. v. Federal Ins. Co. 252 F3d 608 (2d Cir. 2001).
8. East River S.S. Corp. v. Transamerica Delaval, Inc. 476 U.S. 858, 106 S.Ct. 2295, 90 L. Ed. 2d 865 (1986)
9. Some Courts have also held that an independent action for negligent misrepresentation may survive the application of the economic loss rule.