

Court Narrowly Interprets Breach of Contract and Prior or Pending Litigation Exclusions

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The United States District Court for the Southern District of California, applying California law, has held that the breach of contract and prior or pending litigation exclusions in a non-profit professional liability policy should be interpreted narrowly in light of the broad coverage grants in the policy. *Church Mut. Ins. Co. v. U.S. Liab. Ins. Co.*, (S.D. Cal. Apr. 23, 2004).

The first insurer issued a general liability policy to a church, and the second insurer issued a non-profit professional liability policy to the church. The professional liability policy provided coverage for "Wrongful Acts," which was defined as "any actual or alleged act, error, omission, misstatement, misleading statement, neglect or breach of duties." The professional liability policy also contained a breach of contract exclusion, which stated "The Company shall not be liable to make payment for Loss or Defense Costs in connection with any Claim made against any Insured arising out of, directly or indirectly resulting from or in consequence of, or in any way involving any actual or alleged breach of contract." In addition, the professional liability policy contained an exclusion barring coverage for "any pending or prior litigation, administrative or regulatory proceeding, claim demand, arbitration, decree or judgment of which an Insured has written notice before the inception date of this Policy."

The underlying suit was brought against the church by a contractor alleging, among other things, breach of contract and two counts of fraud (intentional misrepresentation and concealment and negligent misrepresentation). After the professional liability insurer disclaimed coverage, the general liability carrier agreed to provide a defense and ultimately settled the underlying lawsuit by paying under its policy. The general liability insurer then sued the professional liability carrier, seeking reimbursement for defense and indemnity payments made on behalf of the church on the grounds that the second insurer breached its duty to defend as to the fraud counts in the underlying action. The general liability insurer conceded that coverage was unavailable for the breach of contract count.

The district court first rejected the professional liability insurer's contention that the breach of contract exclusion, when read in conjunction with its broad prefatory language, barred coverage for the underlying fraud counts. The court held that this paragraph applied only to breach of contract claims. The court rejected the insurer's argument that the prefatory phrase "in any way involving" barred coverage for the fraud allegations because the fraud was in connection with a contract, reasoning that this language conflicted with

the broad grant of coverage for "Wrongful Acts" in the policy. The court opined that this difference in language created ambiguity, and the language should be construed against the insurer. The court also asserted that the broad interpretation of the breach of contract exclusion urged by the insurer would "eviscerate" coverage and frustrate the reasonable expectations of the church.

The court also held that the prior or pending litigation exclusion did not unambiguously preclude coverage for the underlying action even though the underlying lawsuit included a cause of action to enforce a mechanic's lien that had been recorded prior to the inception of the policy. The court reasoned, as it did in its breach of contract analysis, that the prefatory language in the exclusions section of the policy was inconsistent with the broad grant of coverage in the definition of "Wrongful Acts." Thus, while the breach of contract exclusion barred coverage for the cause of action to enforce the lien, it did not preclude coverage for the fraud allegation. The court also reasoned that a mechanic's lien filed against the church prior to the inception date of the policy was not sufficient to trigger application of the prior or pending litigation exclusion because "the gravamen of [the underlying plaintiff's] claims against [the church] is fraud, rather than failure to pay for construction work."

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