Legal Beat

By MICHAEL SEAN QUINN

Liability Coverage for Breaches of Contract

Knowledgeable people think that liability insurance is for accidents. Standardized liability insurance policies—homeowners, auto and commercial general liability—are worded so that the idea of an accident is at the heart of the central coverage. Under this part of the contract, there is no coverage for the foreseeable results of intentional acts.

Mostly, liability for accidents is handled through a part of the tort law—the law of negligence. Of course, not every accident results from negligence. Some accidents just happen. But many accidents are caused by unreasonable conduct, whether by explicit action or by omission. That's negligence.

Common law roots

So far, so good. Unfortunately, the common law made a terrible mistake years back. The mistake involved a logical fallacy. Some courts observed that accidents are mostly handled through the tort law but concluded that they are hence never handled by the contract law.

Most does not mean *all*. Mostly not does not mean *never*. In effect, these courts committed this fallacy when they said that—across the board—liability insurance never covers mere breach of contract. In effect, the court said that because breach of contract is mostly for economic losses, breach of contract is never an appropriate remedy if the plaintiff wants to recover for culpable accidents. The courts committed this fallacy obliquely. They did so by saying that liability insurance for accidents did not cover breach of contract but only torts like negligence.

Not only did the courts make the mistake just discussed, they made another related one. The second error pertained precisely to the law of insurance. The insuring agreement of the CGL policy, and policies like it, extends coverage to amounts the insured is "legally obligated to pay as damages," so long as those amounts are within policy limits. With an appalling lack of logic, various courts said that one is legally obligated to pay damages only if the obligation to pay damages is imposed by law, as opposed to being imposed by agreement. In other words, the courts said that the phrase "legally obligated to pay as damages" was restricted to tort damages and, by implication, excluded damages resulting from the breach of a contract.

Years ago, some insuring agreements in liability policies spoke of coverage for "liability imposed by law," as opposed to sums an insured is "legally obligated to pay." That language is really no different than the newer verbiage.

Vandenberg vs. Calif. Superior Court

Finally, in August of last year, the California Supreme Court recognized the howler in *Vandenberg vs. Superior Court.* The court unanimously recognized, finally, that even in breach of contract cases, if a defendant becomes liable to pay damages, he becomes liable as the result of the action of a court. It enters a judgment, and the judgment becomes final. Through final judgments, the law imposes liability.

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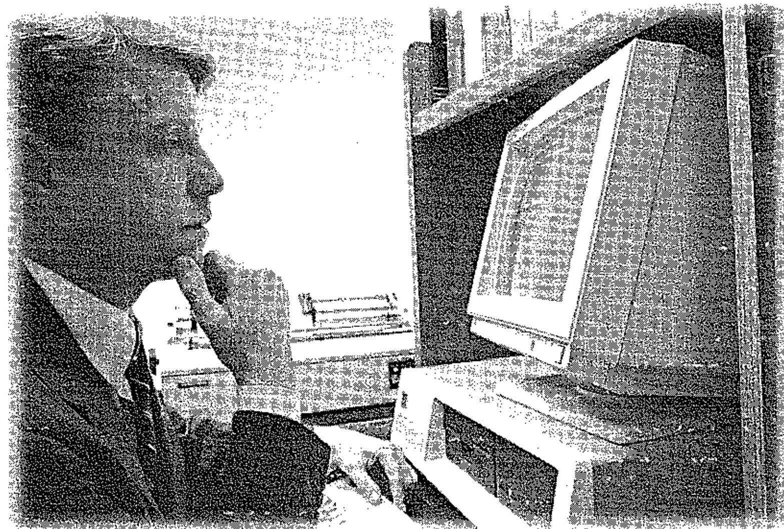
Through a final judgment, the defendant becomes legally obligated to pay a sum as damages. This fact situation conforms perfectly to the language of the insuring agreement.

In *Vandenberg*, the California Supreme Court tried to be kind to its precursors. In effect, it said that its predecessor courts had relied too heavily on a distinction that is familiar to sophisticated lawyers and judges. The Vandenberg court suggested that legal sophisticates would recognize the distinction between liability imposed ex delicto (i.e., by tort) and ex contractu (i.e., by contract). Thus, it indicated that the distinction previously relied upon between liability imposed by agreement and liability imposed by law was perfectly valid for the Initiated—for the Truly Knowledgeable—but was not appropriate for the ordinary citizenry—the Great Untaught.

The court went on to say that insurance contracts are to be interpreted as the "reasonable layperson" would understand them. It went on to hold that the reasonable lay person would surely believe that any obligation enforceable under the law was in fact imposed by the law. The reasonable layperson would surely believe that this idea was what was intended by the phrase "legally obligated to pay as damages."

The California Supreme Court was being too kind. If insurance companies, and the state commissions regulating them, had wanted insurance coverage to be restricted to tort matters, they could have easily said so. The agreement could say "legally obligated to pay as damages because of the commission of a tort," "legally obligated to pay as damages because of negligence," or "posed by the law of non-intentional torts." All of these are alternative wordings for the insuring agreement which would have accomplished the purpose the insurers never actually had, but subsequently wished for.



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Contract cases vs. negligence cases

There are all sorts of reasons to handle accidents through the law of negligence, rather than the law of contract. First, contract cases are harder to prove. Contracts contain all sorts of technicalities that can easily trip up a lawyer. Negligence is very simple. Contract cases are like steep, narrow, rocky paths, whereas negligence cases are like broad, gentle, easy flowing rivers.

Second, damages can be limited by contract. That issue just simply does not arise in negligence cases. Indeed, contracts can actually eliminate any right to damages. This almost never happens in negligence cases.

Third, it is possible to obtain punitive damages in negligence cases, by pleading and proving gross negligence. The phrase "gross negligence" really refers to conduct which is almost (even quasi-) deliberate. In trial, however, one can argue that gross negligence is negligence which is really egregious, i.e., negligence which is really gross (the kind of negligence which makes you want to throw up when you hear about it).

Still, even though breach of contract is not the usual way to get at accident claims, sometimes it's the best way to proceed. It is almost never helpful in dealing with a highway accident. Contracts are almost never involved there. On the other hand, in the context of construction litigation, parties may want to proceed in contract, and they may be entitled to recovery under contracts for damages caused by accidents. Why should there not be insurance for this?

Economic Loss Rule

Of course, not every expenditure required by contract is covered. In 1997, the Fifth Circuit applying Texas law decided *Data Specialties, Inc. v. Transcontinental Insurance Company.* The insured had spent extra money finishing a job, as it was contractually required to do, after a defective circuit breaker caused an explosion. The court held that there was no coverage for the

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insured, because the phrase "legally obligated to pay as damages" extended only to tort damages.

The Fifth Circuit got this holding wrong. Fortunately, no harm was done, because there was a sound reason why coverage should have been denied. The insured was not legally obligated to pay anything as damages. It hadn't done anything wrong. If it was legally obligated to do anything, it was legally obligated to clean up after somebody else's screw up, and that it was legally obligated to do because of the contract, not because it had inflicted damages. The insured made a bad deal; it did screw up the job it had.

Negligence is very simple. Contract cases are like steep, narrow, rocky paths, whereas negligence cases are like broad, gentle, easy flowing rivers.

The deep issue here has nothing to do with whether contract or tort law is used to recover. The real issue is whether there should be insurance coverage for economic losses that are not the result of some sort of bodily injury or property damages. In general, negligence may not be used to recover for losses that are solely economic in nature. This is true in Texas, just as it is in many other states. Lawyers call this the "Economic Loss Rule."

Breach of contract is the way to recover for purely economic losses, when they are caused by accident. This fact does not imply that breach of contract cannot be used to recover for physical injuries.

Of course, many contracts eliminate liability for such losses, e.g., lost profits. In those situations, either the parties have negotiated on how the risk of economic losses is to be allocated, or the much stronger party has imposed its will upon the weaker party, which is willing to swallow the danger because it wants the deal.

Notice, however, that the Economic Loss Rule is not at all the same as saying that there cannot be liability insurance coverage for breach of contract. To be sure, purely economic losses are not covered under the accident portions of standard general liability contracts. But that is because these insurance contracts are restricted to property damage and bodily injury, not because coverage for breach of contract is excluded from their coverage. IJ

Quinn is an Austin shareholder in the law firm of Sheinfeld, Maley & Kay. He litigates and testifies on insurance related problems and is currently the chair of the Insurance Section of the State Bar of Texas. He also is a Visiting Professor of Law at the University of Texas-Austin.

Season's Greetings

from Insurance Journal