

New Jersey District Court Holds that Lawsuits, and Not Counts Alleged within Lawsuits, Constitute "Claims" and Applies Breach of Contract Exclusion to Bar Coverage under E&O Policies

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The United States District Court for the District of New Jersey, applying New Jersey law, has held that an E&O policy exclusion for claims arising out of breach of contract applied to three lawsuits filed against a school board. *N. Plainfield Bd. of Educ. v. Zurich Am. Ins. Co.*, 2008 WL 2074013 (D.N.J. May 15, 2008). The court also held that, pursuant to the exclusion's provision requiring the insurer to pay defense costs up to an aggregate limit of \$100,000 for each breach of contract "Claim," the insurer was required to pay the costs of defending each of the three lawsuits up to that amount.

The insurer issued three consecutive one-year E&O policies to the school board. The policies obligated the insurer to pay on behalf of the school board all sums the board became legally obligated to pay as damages resulting from any "Claim." The policies defined a "Claim," in relevant part, as "a judicial proceeding alleging a 'Wrongful Act' and seeking damages." A "Wrongful Act," in turn, included "an [i]nsured's actual or alleged breach of duty, neglect, error, misstatement or omission." The policies contained a breach of contract exclusion that barred coverage for any "Claim" "arising out of breach of contract," but provided that the insurer must defend such a claim subject to an aggregate limit of \$100,000.

The school board was named as a defendant in three lawsuits after it terminated a general construction contractor that had successfully bid on a project to renovate and expand five schools. The general construction contractor sued in federal court; after the court ruled on summary judgment motions, eight of the contractor's causes of action remained, including breach of contract, tortious interference, fraudulent inducement, and retaliation for exercise of First Amendment rights. An electrical contractor sued in state court alleging, *inter alia*, breach of contract, breach of the implied covenant of good faith and fair dealing, and unjust enrichment. A surety that, pursuant to the project contracts, was secured by the general contractor also sued in state court, alleging breach of three takeover agreements reached between the surety and the school board as well as breach of the covenants of good faith and fair dealing implied in those agreements. The

school board tendered all three suits to the insurer, which in turn invoked the breach of contract exclusion. In the coverage action, the school board moved separately for summary judgment on the state and federal actions, asserting, *inter alia*, that the insurer wrongfully refused to indemnify and honor its defense obligations with respect to the "non-breach of contract claims." The court denied both motions.

As an initial matter, the court concluded that each judicial proceeding commenced against the board constituted a single "Claim," while individual causes of action asserted in the proceedings constituted "Wrongful Acts." As a result, the court rejected the school board's argument that the insurer should pay defense costs up to the \$100,000 limit for each separate breach of contract asserted in the various lawsuits. Instead, the court held that the insurer was obligated to pay only one \$100,000 limit per lawsuit.

With respect to the breach of contract exclusion, the court noted that New Jersey courts interpret the phrase "arising out of" broadly to mean "originating from, growing out of, or having a substantial nexus with the activity for which coverage is provided" and, citing *Houbigant, Inc. v. Federal Insurance Co.*, 374 F.3d 192, 202-03 (3d Cir. 2004), that the Third Circuit has adopted a New Jersey court's "but for" test applied to a policy exclusion for "advertising injury arising out of breach of contract." Turning to the specific counts asserted in the two state court actions, the court noted that the covenant of good faith and fair dealing, which is implied in every contract in New Jersey, requires the existence and breach of a contract. Regarding quantum meruit, the court noted that New Jersey law requires, *inter alia*, a showing that a party was enriched beyond its contractual rights. Because both causes of action require either a contractual or quasi-contractual relationship, the court noted that the "same conduct used to establish a breach of contract claim would be used to establish either of these types of claims." As such, the court held that those causes of action had a "substantial nexus with" the alleged breach of contract. The court also held that the injuries alleged by the electrical contractor and surety would not have occurred "but for" the alleged breach of contract. As such, the court held that the exclusion applied because all of the state court causes of action "originated from" or "grew out of" the school board's alleged breach of contract.

The court similarly concluded that the breach of contract exclusion applied to the federal court action because all of the general contractor's counts against the school board grew out of the same conduct underlying the alleged breach of contract. The court also held that the alleged injuries forming the basis of the counts in the federal action would not have occurred but for the school board's breach.

Additionally, the court also held, pursuant to the language of the exclusion, that the insurer was required to pay defense costs in the federal action up to the \$100,000 limit. In so holding, the court rejected the school board's argument that the insurer was required to pay defense costs up to \$300,000 because it held three separate contracts with the general contractor. For similar reasons, the court also rejected the school board's argument that, because events giving rise to the breach of contract took place at two different times and during two different policy periods, the insurer should be required to pay defense costs up to the \$100,000 limit under each of those policies. The court reasoned that because the "Claim"—the action against the school board—took place in only one policy period, the insurer's obligation was limited to only one \$100,000 limit.