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NEWSLETTER

No Coverage for Fees and Costs Due to Loss of Contract Action

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The California Court of Appeal, applying California law in an unreported decision, held that an insurer had no obligation to pay a claim for attorney fees and costs that a policyholder was required to pay following the policyholder's loss of its breach of contract action. *R.L. Schafer & Assoc. v. Certain Underwriters at Lloyd's of London*, 2006 WL 1553601 (Cal. Ct. App. June 8, 2006).

The policyholder, a surveying firm, was covered by a claims-made-and-reported professional liability policy issued by the insurer. The policy provided that the insurer would pay, on the surveying firm's behalf, "sums which the assured shall become legally obligated to pay as damages by reason of a claim...arising out of any negligent act, error or omission in rendering or failure to render professional services."

In the underlying dispute, the surveying firm submitted a bid to a general contractor for a project governed by the Federal Highway Administration (FHWA). Because the surveying firm was not familiar with FHWA requirements regarding staking specifications, the firm underbid the project. Following the award of the subcontract, the firm commenced work, which eventually led to a dispute with the general contractor regarding the amount the firm was owed for its staking work. The firm filed suit in federal district court against the general contractor, alleging that it was owed an additional $86,374 for labor, materials, services and equipment. The district court found that the firm was owed $60,197.89 based on the work completed and the change orders, but was only paid $44,393.13 by the general contractor. However, the court concluded that the general contractor properly withheld the difference of $15,804.76 "as an offset for attorney's fees and costs generated in prosecuting the claims of [the subcontractor] with the FHWA, and in defending against [the subcontractor's] claims against [the general contractor], as expressly allowed by the subcontract." The district court then held that under the subcontract the general contractor, as the prevailing party, was entitled to reasonable attorney fees and costs. The contractor also prevailed on appeal to the Ninth Circuit, and the subcontractor was required to pay the legal fees incurred by the contractor in both the district court and on appeal.

The subcontractor subsequently filed the instant coverage action, contending that its negligent failures in calculating the bid were covered under the policy as a "negligent act, error or omission in rendering or failing to render any professional service." It sought coverage for the legal fees it had to pay to the contractor as well as for its own costs in litigating the case with the contractor.

The California appellate court first noted that the California Supreme Court had only once before addressed the issue of whether insurance coverage extends to a setoff claim. The court cited the case of *Construction Protective Services, Inc. v. TIG Specialty Insurance Co.*, 29 Cal. 4th 189 (2002), and its holding that, despite the lack of language from the actual policy at issue in the complaint, a security firm's "allegations were sufficient to allege that the setoff claim fell within the scope of the contractual obligation to defend against suits seeking damages." The court noted, however, that the California Supreme Court in *TIG Specialty Insurance Co.* did not address whether that duty would encompass the setoff claim when precise policy language was provided to the court.

Turning to the case at hand, the court assumed that the legal fees at issue constituted "damages" under the policy and focused on whether the firm's liability for the attorney fees was based on a "claim...arising out of any negligent act, error or omission in rendering or failing to render professional services." While recognizing that the term "arising out of" "broadly links a factual situation with the event creating liability, and connotes only a minimal causal connection or incidental relationship," the court nevertheless concluded that the "[g]eneral [c]ontractor's claim for attorney fees did not arise out of a negligent act or omission of [the subcontractor] in rendering services." The court noted that the insurer "did not agree to protect [the subcontractor] from claims for attorney fees and costs that [the subcontractor] must pay because it lost a contract action." Additionally, the court emphasized that the subcontractor's preparation of the bid did not constitute a rendering of professional services; rather, that action was taken for the benefit of the firm in the hope of obtaining work.