

Equitable Estoppel Claim Falls Outside Breach of Contract Exclusion

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The United States Court of Appeals for the Seventh Circuit, applying Illinois law, has held that a breach of contract exclusion does not apply to an equitable estoppel claim in the underlying action against the insured. *Illinois Sch. Dist. Agency v. Pac. Ins. Co., Ltd.*, 2006 WL 3490819 (7th Cir. Dec. 5, 2006).

The insurer issued an E&O policy to an intergovernmental cooperative comprised of Illinois school districts that provides joint self-insurance for its members (hereinafter the "Agency"). The E&O policy excluded "loss incurred for any claim... for obligations or responsibilities assumed by the Insured under any contract unless liability therefore would have attached to the Insured by reason of the Insured's negligent acts, errors, or omissions or by reason of Insured's actual or alleged breach of duty, neglect, error, misstatement, misleading statement or other act or omission in the absence of such a contract committed in the Insured's capacity as stated in the Insuring Agreements."

The Agency issued a general liability policy to one of its school district members. The school district was sued when a student took mercury home from school premises. Initially, the Agency's third-party claims administrator agreed to defend the school district. Later, the Agency hired a new third-party claims administrator, which reviewed the claim against the school district, concluded that the absolute pollution exclusion in the general liability policy applied, and withdrew the defense provided by the Agency.

The school district settled the mercury suit and filed a declaratory judgment action against the Agency. It sought a declaration that the Agency was obligated to reimburse the school district's costs in defending the mercury suit, that the Agency had acted in bad faith under Illinois law, that the Agency had waived its rights to contest coverage under the general liability policy and that it was also estopped from doing so. The Agency prevailed on summary judgment with respect to most of the claims and prevailed at trial on the estoppel claim. The Agency then sued the original third-party administrator, which had provided the school district with a defense under the general liability policy, and obtained a judgment in its favor. The third-party administrator has not made any payment on that judgment.

The Agency demanded that its insurer reimburse it for the cost of defending the school district's action under the general liability policy. The insurer argued that the claims against the Agency in the school district's action were contract claims excluded under the E&O policy.

The Seventh Circuit stated that the most reasonable reading of the exclusion in the E&O policy was that the insurer "is not liable 'for obligations or responsibilities assumed by the Insured under any contract' unless liability would have attached, independently of the contract language, to the Agency by reason of Agency's 'negligent acts, errors, or omissions.'" The court reasoned that "[i]n the case of equitable estoppel, [the] Agency's liability would arise not because it was contractually obligated to defend [the school district], but because it had taken control of [the school district's] defense to [the school district's] disadvantage." Accordingly, the court concluded that an equitable estoppel claim would not fall within the exclusion. Noting the distinction under Illinois law between contractual and equitable estoppel, the court examined the record before it and held that the claim against the Agency that went to trial in the underlying action was one for equitable estoppel.

The Seventh Circuit also rejected the insurer's argument that the Agency was required to allocate the costs incurred in defending the school district's suit when it submitted its claim under the E&O policy, stating that the insurer "point[ed] to no section of the E&O Policy mandating that Agency allocate the defense costs incurred between covered and uncovered claims." The court did note, however, that the Agency would ultimately bear the burden of proving which costs were covered on remand.

Finally, the Seventh Circuit held that the fact that the Agency had obtained a judgment against the original third-party administrator did not entitle the insurer to a setoff. The court reasoned that there was no evidence in the record of a double recovery because the insurer had not established that the Agency had received any payment on that judgment, but concluded that the insurer would be free to present evidence to the contrary on remand.