

# DO CGL POLICIES PROVIDE COVERAGE FOR BREACH OF CONTRACT DAMAGES?

For many years, a “general rule” has existed in insurance law that damages for breach of contract are not covered by CGL insurance policies. The reasoning behind this “general rule” was that CGL policies afforded coverage for tort liability but not contractual liability. See, e.g., International Surplus Lines Ins. Co. v. Devonshire Coverage Corp. (1979) 93 Cal.App.3d 601, 610-11 [”’legally obligated to pay’ refers to liability arising ex delicto.”]; Fireman’s Fund Ins. Co. v. City of Turlock (1985) 170 Cal.App.3d 988, 995 [”’legally obligated to pay as damages’” covers only tort liabilities and not contract liabilities]. Insurance carriers have long relied on these cases to deny coverage when insureds were sued for breach of contract damages, even when the complaint alleged the insured acted negligently in breaching the contract.

California courts construed the phrase “legally obligated to pay as damages” commonly found in CGL policies as describing liability that was based upon a breach of a duty imposed by law (tort liability) rather than by contract. Wilmington Liquid Bulk Terminals, Inc. v. Somerset Marine Inc. (1997) 53 Cal.App.4th 186.

In its much anticipated decision, the California Supreme Court recently held that an insurer can be obligated to indemnify its insured for damages arising out of a breach of contract.<sup>//</sup> Vandenberg v. Superior Court (1999) 21 Cal.4th 815, 88 Cal.Rptr.2d 366.

## 1. Background of the Case

The underlying litigation involved damages to land that Vandenberg had once used as an auto sales and service facility. Vandenberg had leased the property from its owner for a period of 30 years. After Vandenberg terminated its lease, the owner (Boyd) removed underground waste oil storage tanks and discovered that the groundwater was contaminated. Boyd sued Vandenberg for, inter alia, breach of contract. 88 Cal.Rptr.2d at 372.

The suit was tendered to numerous insurance carriers, only one of whom agreed to defend. Thereafter, an agreement was reached whereby Boyd gave up all claims it had against Vandenberg except those based on the breach of the lease agreements. The claim was thereafter arbitrated and the owner was awarded over \$4 million based upon Vandenberg’s breach of contract. Vandenberg’s tender of the award for indemnification to its insurers was rejected, resulting in the litigation leading to the court’s opinion. Id. at 372-373.

The trial court granted the insurance carriers’ summary judgment motion on the ground that the arbitrator’s award represented damages for a breach of lease, and that breach of contract

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<sup>//</sup> As an indication of the significance of its decision, no less than 38 separate companies, insurance carriers or other groups filed amicus curie briefs in support of or against the Court of Appeal’s decision.

damages were not covered by the CGL policies at issue.<sup>//</sup> Id. The Court of Appeal reversed, holding that coverage under the policies could not be determined simply by reference to the “general rule” that contract damages are not covered. The Appellate Court stated that the inquiry should focus on “the nature of the risk or peril that caused the injury and the specific policy language. . .” Id. at 374.

## 2. History of the “General Rule”

The Supreme Court granted review. In its analysis, the Court traced the origins of the “general rule” precluding coverage for contract claims to the seminal 1955 decision of Ritchie v. Anchor Casualty Co. (1955) 135 Cal.App.2d 245.

In Ritchie, the court analyzed whether the term ‘liability imposed by law,’ the precursor to ‘legally obligated to pay,’ included coverage for liability arising from contract. (Citation) This phrase had usually been construed to mean liability imposed in a definite sum by a final judgment against the assured. (Citation) But the policy before the Ritchie court contained a distinction; coverage A applied to ‘liability imposed . . . by law or by written contract,’ whereas Coverage B applied to ‘liability imposed . . . by law.’ (Citation) The court concluded that the omission of the term ‘or by written contract’ in Coverage B, the portion at issue in Ritchie, ‘is persuasive that the phrase “imposed upon him by law” as used in this policy . . . relates to the nature of the liability to be defended rather than the result of the lawsuit. . . .’ (Citation)

Vandenberg, supra, 88 Cal.Rptr.2d at 383.

Without picking up on the contractual language distinction, the appeal’s court in International Surplus, supra, 93 Cal.App.3d 601, 611, found the phrase ‘legally obligated to pay as damages,’ to be synonymous with ‘damages for a liability imposed by law,’ the policy language that was discussed in the Ritchie case.

Without further discussion, the court then held that the ‘latter phrase has been uniformly interpreted as referring to a liability arising ex delicto as distinguished from ex contractu. (Citation)

Vandenberg, supra, 88 Cal.Rptr.2d at 383.

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<sup>//</sup> The trial court also granted summary judgment based on the argument that the insured was precluded from relitigating issues ruled upon by the arbitrator under the collateral estoppel rule. The first and most lengthy portion of the Supreme Court’s decision in Vandenberg addresses important issues related to arbitration awards and their collateral estoppel effect.

### 3. Principles of Insurance Contract Interpretation

In resolving the issue before it, the Vandenberg Court discussed the long-standing principles of insurance contract interpretation. Included is the principle that insurance contracts are to be construed in accordance with the parties' mutual intent. Montrose Chemical Corp. v. Admiral Ins. Co. (1995) 10 Cal.4th 645, 666. In addition, if the meaning a layperson attributes to insurance contract language is not ambiguous, courts will apply that meaning. AIU Ins. Co. v. Superior Court (1990) 51 Cal.3d 807, 822. Most importantly, ambiguities attributed to an insurance contract phrase as resolved in favor of coverage. Id. at 825.

The Court also cited to its ruling in AIU wherein it had rejected "the claim of non-coverage based upon the fact that the forms of relief sought against the insured by third party suits were equitable and therefore the insured was not legally obligated to pay under the terms of the subject insurance policy. Vandenberg, supra, 88 Cal.Rptr.2d at 383.

### 4. The Policy Language at Issue

Turning to the language of Vandenberg's CGL policies, the Court noted that nothing about the language suggested "any special or legalistic meaning to the phrase 'legally obligated to pay as damages.'"

A reasonable layperson would certainly understand 'legally obligated to pay' to refer to any obligation which is binding and enforceable under the law, whether pursuant to contract or tort liability. Further, a reasonable layperson, cognizant that he or she is purchasing a 'general liability' insurance policy, would not conclude such coverage term only refers to liability pled in tort, and thus entirely excludes liability pled on a theory of breach of contract.

Vandenberg, supra, 88 Cal.Rptr.2d at 383-384.

The Court's decision is consistent with other holdings where, for example, the Court considered the distinction between contract and tort recoveries arbitrary when viewed in light of the reality that the same act may constitute both a breach of contract and a tort. See, e.g., Eads v. Marks (1952) 39 Cal.2d 807, 809-811. "Predicating coverage upon an injured party's choice of remedy or the form of action sought is not the law of this state." Vandenberg, supra, 88 Cal.Rptr.2d at 384.

Citing to the Court of Appeal's opinion, the Supreme Court outlined the factors that should be considered in determining whether coverage was or was not afforded for a particular claim. The focus of coverage for property damage should be the property itself. Coverage is not determined by the form of action selected by the injured party. Finally, coverage should be decided based upon "the nature of [the] property, the injury, and the risk that caused the injury, in light of the particular provisions of each applicable insurance policy." Id. at 382.

The Court then disapproved of the long line of cases that had precluded coverage for

breach of contract damages, holding,

We therefore conclude that the International Surplus rationale, distinguishing contract from tort liability for purposes of the CGL insurance coverage phrase ‘legally obligated to pay as damages,’ is incorrect. Accordingly, we uphold the Court of Appeal’s determination that Vandenberg’s insurers cannot avoid coverage for damages awarded against Vandenberg solely on grounds the damages were assessed on a contractual theory.

Id. at 384-385.

## 5. Implications

The Vandenberg decision is consistent with the holdings of courts in other parts of the country. See, e.g., Cheek v. Williams-McWilliams Co., 697 F.2d 649 (5<sup>th</sup> Cir. 1983) [“it would be a strained and technical construction of this policy to hold that an allegation of tort liability was not within the scope of coverage merely because the alleged tort was related in some way to a contract”]; American Casualty Co. v. Timmons, 352 F.2d 563 (6<sup>th</sup> Cir. 1965) [“The very purpose of the insurance policy was to protect against liability arising from . . . negligence” for breach of contract.]

The result of the Vandenberg holding is that technical pleading distinctions will not defeat indemnification for a covered claim. Thus, not only will the insurer’s duty to defend potentially be triggered in a broader array of cases, but the insured’s expectations of coverage for “liability imposed by law” will also be honored. In essence, there may now be one less coverage defense available to carriers.

However, where the Vandenberg holding stops may take years to determine. For instance, to fully appreciate the breadth of the Supreme Court’s ruling, one must first consider the long line of cases that were disapproved by the Court. For example, Old Republic Ins. Co., *supra*, and Bernstein v. Consolidated American Ins. Co. (1995) 37 Cal.App.4th 763, both involved express exceptions to the standard exclusion for contractually assumed liability. Wilmington, *supra*, involved a loss of use claim arising from property damage. Fragomeno v. Insurance Co. of the West (1989) 207 Cal.App.3d 822 involved an unlawful detainer claim against the insured. Do each of these claims now give rise to a duty to defend and/or indemnify?

Further, the Supreme Court’s articulated analysis of when coverage is triggered must be considered in evaluating instances where the insured has been sued for a claim that in past was assumed not to be covered but now may in fact be at least a possibly covered claim.