COVERAGE FOR CLAIMS ALLEGING BREACH OF A PRE-EXISTING CONTRACTUAL OR STATUTORY DUTY: THE "*EATON VANCE* RULE" AND ITS LIMITATIONS

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A significant body of case law has developed concerning the extent to which liability insurance covers claims seeking damages for amounts the policyholder allegedly had a pre-existing contractual or statutory duty to pay. One of the most frequently cited cases on this topic is *Pacific Insurance Co. v. Eaton Vance Management*.[1] In *Eaton Vance*, and the cases discussed in *Eaton Vance*, the court held that an insured cannot secure coverage for amounts paid to resolve a third party claim—whether by judgment or settlement—where the amount paid constitutes nothing more than what the contract (or statute) already required the insured to pay (referred to herein as "the *Eaton Vance* rule").[2]

1. Pac. Ins. Co. v. Eaton Vance Mgmt., 369 F.3d 584 (1st Cir. 2004).
2. As discussed herein at Section I.C, one of the cases discussed in *Eaton Vance*—*May Department Stores Co. v. Federal Insurance Co.*, 305 F.3d 597, 600 (7th Cir. 2002)—went beyond this narrow result and found no coverage even for other compensatory "expectation damages" arising from a breach of contract.

The problem that this article addresses is the manner in which some courts have misunderstood the *Eaton Vance* rule as precluding liability coverage for a much broader set of claims seeking damages of *any* type for an alleged breach of *any* pre-existing obligation. Relying on these cases, it is now relatively common for insurers to disclaim indemnity coverage for any claim seeking damages based on an alleged breach of a duty imposed by contract or statute. By way of example, the following is a representative list (taken from real coverage position letters) of the kind of overly broad coverage positions that insurers have taken in reliance on the cases discussed herein:

- "Liability policies do not cover breach of contract damages."
- "Liability insurance policies do not provide coverage for a preexisting statutory or contractual obligation."
- "There is no indemnity coverage available under the Policy for [the insured]'s liability for its alleged failure to meet contractual and/or statutory obligations."
- "Damages based on a breach of a pre-existing contractual obligation are uninsurable as a matter of Massachusetts law."
- Damages for the insured's failure to "compl[y] with statutory and regulatory obligations is not a Loss resulting from a Claim for a Wrongful Act. Defendants cannot convert such obligations to a Loss under a liability insurance policy."

Even the venerable *Holmes' Appleman on Insurance 2d* § 146.6 (2003) includes the statement that "even in the absence of an express exclusion, courts have held that a claim alleging breach of contract is not covered under a professional liability policy because there is no 'wrongful act' and no 'loss' since the insured is simply being required to pay an amount it agreed to pay."[3]

These statements are wrong. As noted, there is nothing wrong with the general rule—the *Eaton Vance* rule—that liability policies (or at least most of them) do not extend coverage to damages that the insured has or had an *established* preexisting legal obligation *to pay*. But it is not true that damages arising from the breach of *any* pre-existing duty are not covered. Such a rule would render liability coverage for "wrongful acts" illusory, since all "wrongful acts" for which an insured might be held liable involve the

3. Courts have cited this provision of *Holmes' Appleman on Insurance* for the overly broad proposition that "liability policies do not cover breach of contract damages." *See, e.g.*, *Waste Corp. of Am. Inc. v. Genesis Ins. Co.*, 382 F. Supp. 2d 1349, 1354 (S.D. Fla. 2005); *Krueger Int'l, Inc. v. Royal Indem. Co.*, 481 F.3d 993, 996 (7th Cir. 2007) (noting that "insurance policies are presumed not to insure against liability for breach of contract"); *Newman v. XL Spec. Ins. Co.*, No. C-1-06-781, 2007 U.S. Dist. LEXIS 74293, at *9, *16 (S.D. Ohio Sept. 24, 2007) (accepting insurer's argument that "liability insurance policies are not interpreted to cover breach of contract claims" and holding that, "[u]nless the insurance policy explicitly states that it covers breach of contract actions, such an interpretation should not be read into the policy").

breach of a pre-existing duty to the claimant. As the Fourth Circuit put it in a case addressing the *Eaton Vance* rule, "*Every* duty breached or violated is necessarily a preexisting duty, and it is the *breach* or *violation* of that duty which constitutes a wrongful act."[4] As discussed herein, when the claimed damages represent amounts the insured would have no liability to pay unless and until it is found liable for a "wrongful act," the *Eaton Vance* rule simply has no relevance. Such losses clearly do "result from" the claim for a wrongful act, since there is no other source for the insured's obligation to pay.

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This article begins with an in-depth look at *Eaton Vance* and the cases it relied on to ascertain the real holding in each of those cases.[5] Particular scrutiny is given to Judge Posner's decision in *May Department Stores Co. v. Federal Insurance Co.*,[6] which is the source of much of the confusion that has developed in subsequent cases purporting to apply the "*Eaton Vance* rule."[7] Relying on Judge Posner's faulty analysis in *May Department Stores*, numerous other courts have badly mischaracterized—and in some cases misapplied—the *Eaton Vance* rule.[8]

The article then addresses two fundamental limitations on application of the *Eaton Vance* rule. *First*, the rule applies only to amounts the insured had a pre-existing obligation *to pay*, not amounts that the insured may become liable to pay as a result of its breach of some other pre-existing obligation.[9] *Second*, the rule applies only when the insured's pre-existing obligation to pay has been *established or admitted*, not when the insured settles a claim merely alleging a disputed obligation.[10] Finally, the article concludes with a discussion of the so-called "moral hazard" problems that many courts have sought to address by wrongly expanding the *Eaton Vance* rule beyond its proper application. To be sure, insurers' (and courts') concerns about "moral hazard" may be legitimate, but any such problems readily can be solved through more precise policy language that insurers could, and sometimes do, include in their policies to make clear what risks they will and will not insure—e.g., settlements of claims alleging breach of a pre-existing obligation. But in the absence of such specific exclusionary language, policyholders should expect, and be willing to fight for, coverage of such claims. *See* Section IV.

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4. Republic Franklin Ins. Co. v. Albemarle Cnty. Sch. Bd., 670 F.3d 563, 566 (4th Cir. 2012) (emphasis in original).
5. *See infra* Sections I.A, I.B.
6. May Dep't Stores Co. v. Fed. Ins. Co., 305 F.3d 597, 601 (7th Cir. 2002).
7. *See infra* Section I.C.
8. *See infra* Section I.D.
9. *See infra* Section II.
10. *See infra* Section III.

I. THE *EATON VANCE* LINE OF CASES

A. *The First Circuit's Decision in* Eaton Vance

In *Eaton Vance*, the United States Court of Appeals for the First Circuit held there was no coverage under an errors and omissions liability policy for the damages an employer paid to resolve a claim that it had breached its fiduciary duties by failing to properly administer employees' profit-sharing accounts, resulting in a shortfall in those accounts.[11] The insured (Eaton Vance) received a letter from one of its employees indicating that money due him under the profit-sharing plan had not been deposited into his account.[12] Eaton Vance then sought advice from its outside ERISA counsel, who agreed that Eaton Vance should have been funding the accounts of the employee and other similarly affected individuals. Eaton Vance subsequently sent a letter to the claimant acknowledging its obligation under the plan documents and agreeing to fund the accounts.[13]

Eaton Vance then sought coverage for the payments under its E&O policy, arguing that its liability for the claim fell squarely within the policy's insuring agreement, which provided coverage for:

> loss or liability incurred by [Eaton Vance], from any claim made against [Eaton Vance] . . . by reason of any actual or alleged failure to discharge his or its duties or to act prudently within the meaning of the Employee Retirement Income Security Act of 1974 [(ERISA)] . . ., or by reason of any actual or alleged breach of fiduciary responsibility within the meaning of said Act.[14]

The United States District Court for the District of Massachusetts agreed.[15] The First Circuit, however, focused on the words "by reason of" in the insuring agreement, and sought to ascertain the reason why Eaton Vance was obligated to make the payments restoring the fund accounts' balance. The Court held that Eaton Vance was obligated to make these payments by virtue of its contractual obligations under the plan, irrespective of whether or not Eaton Vance later breached its fiduciary duties in the administration of that plan.[16] The court explained:

> [A]ny judgment for [the employee] for *back-payment of benefits wrongfully withheld under the Plan (and the hypothesized amount-of-return thereon)* necessarily would be derivative of a finding that the Plan documents themselves (together with management's discretionary decision to fund) created the underlying

11. Pac. Ins. Co. v. Eaton Vance Mgmt., 369 F.3d 584, 586–87 (1st Cir. 2004).
12. *Id.*
13. *Id.*
14. *Id.* at 587, 589–90.
15. *Id.* at 588.
16. *Id.* at 590–91 ("[T]he underlying obligation for which reimbursement is sought existed *regardless of* whether Eaton Vance first complied with its fiduciary duties or breached them.").

> financial obligation on which [the employee] sought performance— performance that was due [the employee] prior to, and irrespective of, the lawsuit.[17]

Accordingly, the liability to pay was incurred "by reason of" the contract, not by reason of any claim for breach of fiduciary duty, and was thus outside the scope of the policy's insuring agreement.[18]

B. *The Cases Relied on by the First Circuit in* Eaton Vance *and the Rule That Can Be Derived Therefrom*

In support of its holding, the First Circuit in *Eaton Vance* cited two earlier decisions by the Seventh Circuit—*Baylor Heating & Air Conditioning, Inc. v. Federated Mutual Insurance Co.*, 987 F.2d 415 (7th Cir. 1993) and *May Department Stores Co. v. Federal Insurance Co.*, 305 F.3d 597, 601 (7th Cir. 2002) (Posner, J.)—as well as *American Casualty Co. of Reading, Pa. v. Hotel & Restaurant Employees & Bartenders International Union Welfare Fund*, 942 P.2d 172, 176–77 (Nev. 1997). It also cited to *Oktibbeha County School District v. Coregis Insurance Co.*, 173 F. Supp. 2d 541, 543 (N.D. Miss. 2001), in a footnote. Like *Eaton Vance*, both *Baylor Heating* and *May Department Stores* involved an insured's failure to make payments to or from a pension or retirement fund administered for the benefit of the insured's employees.[19] *American Casualty Co. of Reading* concerned an insured's failure to pay for the defense of claims against a contractual indemnitee pursuant to the terms of a merger agreement.[20] *Oktibbeha* involved a school district's duty to pay overtime compensation because of the statutory requirements of the Fair Labor Standards Act.[21] In each case (*Eaton Vance* and the four cases on which it relied), the actual holding was that an amount the insured had an *admitted or established* pre-existing obligation *to pay* does not become a covered loss under a liability policy just because the insured commits a "wrongful act" and refuses to make the payment. None of the cases went so far as to hold that there can be no coverage for damages for any breach of contract, despite imprecise language in some of the opinions that has led other courts to mischaracterize the *Eaton Vance* rule in those terms.

17. *Id.* at 592 (emphasis in original).
18. *Id.* at 592–93.
19. *See* Baylor Heating & Air Conditioning, Inc. v. Federated Mut. Ins. Co., 987 F.2d 415, 416–17 (7th Cir. 1993); May Department Stores Co. v. Federal Insurance Co., 305 F.3d 597, 600–01 (7th Cir. 2002).
20. American Casualty Co. of Reading, Pa. v. Hotel & Restaurant Employees & Bartenders International Union Welfare Fund, 942 P.2d 172, 174–75 (Nev. 1997).
21. Oktibbeha County School District v. Coregis Insurance Co., 173 F. Supp. 2d 541, 542 (N.D. Miss. 2001).

1. *Baylor Heating & Air Conditioning, Inc. v. Federated Mutual Insurance Co.*, 987 F.2d 415 (7th Cir. 1993)

In *Baylor Heating*, an employer intentionally decided to discontinue making payments to an employee pension fund, under the mistaken belief that it had no liability to do so under the parties' collective bargaining agreement after that agreement was terminated. The fund notified the employer that its failure to make the payments was a breach of the collective bargaining agreement and brought suit to recover the delinquent payments after the employer denied any liability.[22] The fund was successful in establishing the employer's liability and judgment entered in the amount of $93,130.68, representing the employer's liability to the fund under the collective bargaining agreement.[23] The employer's liability insurer disclaimed coverage for the judgment amount, and the employer filed suit. Focusing on the language of the insuring agreement,[24] the court framed the issue as "whether [the employer]'s failure to pay the pension fund contributions in question was a 'negligent act, error or omission' within the policy's substantive coverage."[25] The court held it was not, even if the employer had acted in good faith when it ceased making the payments and even if its breach of the contract was the result of a mistake or the negligent advice of its counsel. In so holding, the court focused heavily on the source of the alleged duty and the theory of liability, drawing a sharp "line of demarcation between negligent acts and breaches of contract," the latter of which the court deemed to be outside the scope of coverage.[26]

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22. Baylor Heating & Air Conditioning, Inc. v. Federated Mut. Ins. Co., 987 F.2d 415, 416 (7th Cir. 1993).

23. *Id.* at 416–17.

24. The policy included a multi-cover liability endorsement providing in pertinent part:

> We will pay on your behalf all sums which you become legally obligated to pay as damages arising out of any claim made by:
>
> (1) any employee or former employee; or
>
> (2) the beneficiaries or legal representatives thereof; for injury or damage caused by any negligent act, error or omission in the "administration" of your "employee benefit programs" by:
>
> (a) you; or
>
> (b) any other person for whose acts, errors or omissions you are legally liable.

25. *Baylor Heating*, 987 F.2d at 419.

26. *Id.* at 419–20 ("[The employer's] liability to the pension fund is contractual. Although at the time [the employer] refused to make fund payments it did not believe it had any contractual obligation to do so, these beliefs do not change the contractual nature of the obligation. The Fund was awarded amounts owed pursuant to the collective bargaining agreement, not damages for negligence, and these payments are not covered by Baylor's policy. . . . Under [the employer's] logic, any default arising from a mistaken assumption regarding one's contractual liability could be transformed into an insured event.").

In a footnote, however, the court clarified that it was *not* holding that all damages flowing from a breach of contract are always non-covered under a liability policy. "We agree with Baylor that a contract can create a duty the breach of which will sound in tort. But *responsibility to make payments according to a contract* is not the sort of duty that will support an action in negligence."[27] The court then offered two examples of negligent breaches of a contractual duty that could give rise to covered damages under a liability policy. First, the court asserted that if "Baylor had negligently failed to enroll an employee in the pension plan and was subsequently sued by that employee for his pension benefits, there might be an argument that Baylor had suffered damage resulting from negligence."[28] The court's second example was if the pension fund trustees failed to detect a third-party's embezzlement of fund assets, their liability would attach not because of a failure to make fund contributions as required by contract, but because of a separate negligent act in breach of their obligations under the fund documents. *Id*. Clearly, the second example describes damages flowing from a breach of contract that should be covered under a liability policy, irrespective of any "moral hazard" that could result from such coverage.[29] What both examples have in common is that the insureds would have no payment obligation to the underlying claimants "but for" their alleged breach of their contractual obligations. The contract may have imposed on the insured(s) various performance obligations of other types, but it did not require the insured(s) to pay the pension benefits or other amounts sought as damages.

2. *May Department Stores Co. v. Federal Insurance Co.*, 305 F.3d 597 (7th Cir. 2002)

In *May Department Stores*, the insured was sued in two class actions brought on behalf of plan participants. The first suit alleged that an interest rate specified in the plan violated ERISA and sought the difference between the

27. *Id*. at 420 n.8 (emphasis added).
28. *Id*.
29. Courts in many of the cases discussed herein have expressed concern about the moral hazard that would exist if there were coverage for an insured's intentional, or even negligent, breaches of contract. Those courts have suggested that allowing insurance to cover the consequences of such breaches would encourage insureds to shirk their contractual obligations, comfortable in the knowledge that the consequences of the breach will be paid by the liability insurer. But such incentives are inherent in the concept of insurance, without which many policyholders would invariably forego certain risky behavior that could prove extremely productive or profitable but also could give rise to serious liabilities. So, in the second example offered by the *Baylor* court in footnote 8, is it possible that the existence of insurance for the trustees may have encouraged them to be less vigilant and thus contributed to their failure to detect the embezzlement? Perhaps. But without the insurance, the trustees likely would not have agreed to serve in the role at all, thus exposing themselves to substantial potential liability exposure that they would have to bear on their own.

amounts actually paid to plan members and the amount that they should have received if the correct interest rate had been used. The other suit alleged that the insured had failed to notify participants of the monetary consequences of continuing to work past retirement age (i.e., a reduction in benefits) and sought "the actuarial equivalent of what their retirement benefits would have been worth had they retired earlier and thus had the use of the benefits for the intervening years."[30] The insured settled both suits and sought coverage under a policy that covered claims for "'any breach of the responsibilities, obligations or duties imposed upon fiduciaries of the Sponsored Plan by [ERISA], or by the common or statutory law of the United States, or any state or other jurisdiction anywhere in the world,' unless the breach is 'willful' or—critically—unless the loss for which liability is sought to be fastened on the insureds 'constitutes benefits due or to become due under the terms of a Benefit Program.'"[31] The insurer denied coverage, the insured filed suit, and the district court granted summary judgment for the insurer.

On appeal, the Seventh Circuit Court of Appeals affirmed, holding coverage for the settlement amounts was precluded by the policy's exclusion for damages that constitute "benefits due or to become due under the terms of a Benefit Program."[32] The court acknowledged that "the legal basis of the claims against [the insured] was not language in the plan but provisions of ERISA," but nevertheless found that the damages sought were within the scope of the exclusion because pension plans governed by ERISA contain provisions implied by law.[33] The court then attempted to explain its reasoning in the following terms, which have been quoted over and over again in future decisions (including in *Eaton Vance*):

> It would be passing strange for an insurance company to insure a pension plan (and its sponsor) against an underpayment of benefits, not only because of the enormous and unpredictable liability to which a claim for benefits on behalf of participants in or beneficiaries of a pension plan of a major employer could give rise, but also because of the acute moral hazard problem that such coverage would create. ("Moral hazard" is the term used to denote the incentive that insurance can give an insured to increase the risky behavior covered by the insurance.) Such insurance would give the plan and its sponsor an incentive to adopt aggressive (just short of willful) interpretations of ERISA designed to minimize the benefits due, safe in the belief that if, as would be likely, the interpretations were rejected by the courts, the insurance company would pick up the tab. Heads I win, tails you lose.[34]

30. May Dep't Stores Co. v. Fed. Ins. Co., 305 F.3d 597, 600–01 (7th Cir. 2002).
31. *Id*. at 600.
32. *Id*.
33. *Id*. at 601.
34. *Id*.

3. *American Casualty Co. of Reading, Pa. v. Hotel & Restaurant Employees & Bartenders International Union Welfare Fund*, 942 P.2d 172 (Nev. 1997)

The First Circuit in *Eaton Vance* also cited *American Casualty Co. of Reading, Pa. v. Hotel & Restaurant Employees & Bartenders International Union Welfare Fund*, for its holding that "[t]he refusal to pay an obligation simply is not the cause of the obligation, and the [insured's] wrongful act in this case did not result in their obligation to pay; [its] contract imposed on [it] the obligation to pay.").[35] In that case, a fund established for the benefit of members of an international culinary workers union merged with a fund established for a local union. Pursuant to the merger agreement, the trustees of the international fund agreed to defend the local trustees, but allowed the international trustees to recover from any local trustee "any costs and expenses incurred in defending any such [local] Trustee" if the local trustee was "*adjudged* in any action, suit, or proceeding to be guilty of any violation of ERISA."[36] When a suit was filed against the local trustees that included allegations of ERISA violations, the international trustees refused to defend or indemnify them.[37] The local trustees sued the international trustees for the contractual indemnification to which they were entitled, and the international trustees notified their liability insurer and sought coverage. The insurer agreed to defend the local trustees' suit, but took the position there was no indemnity coverage for the damages sought from the international trustees.[38] The local trustees prevailed on the ERISA claims against them in the underlying suit and also prevailed in their claims against the international trustees, winning a judgment for breach of the merger agreement's indemnity provision. The international trustees subsequently settled with the local trustees for $750,000 and sued their insurer seeking indemnity under the policy. The insurer argued that the judgment against the international trustees, and the ensuing settlement payment, represented an amount that cannot be properly considered a "loss" *resulting from* any "wrongful act" of the international trustees; instead, "it was merely the judicial enforcement of the international trustees' contractual obligations to the local trustees under the merger agreement."[39] The court agreed.

> Had the international trustees not committed the wrongful act of failing to defend the local trustees, *i.e.*, had the international trustees elected to honor their obligation and defend the local trustees, the international trustees would

35. Am. Cas. Co. of Reading, Pa. v. Hotel & Rest. Emps & Bartenders Int'l Union Welfare Fund, 942 P.2d 172, 176–77 (Nev. 1997).
36. *Id.*
37. *Id.* at 174.
38. *Id.* at 174–75.
39. *Id.* at 176.

> have been obligated to pay the cost of the defense, and they would not have been in a position to pass their legal obligation on to their insurance carrier. It is the cost of this defense that was reduced to a judgment in the federal action against the international trustees.
>
> The international trustees were required to pay their contractual obligation. This contractual obligation did not result from their wrongful act of refusing to satisfy it. To hold otherwise would allow an insured to turn all of its legal liabilities into insured events by the intentional act of refusing to pay them. The refusal to pay an obligation simply is not the cause of the obligation, and the international trustees' wrongful act in this case did not result in their obligation to pay; *their contract imposed on them the obligation to pay*.[40]

4. *Oktibbeha County School District v. Coregis Insurance Co.*, 173 F. Supp. 2d 541 (N.D. Miss. 2001)

Finally, in *Oktibbeha County School District v. Coregis Insurance Co.*,[41] a school district was sued by employees who argued they had been wrongly classified by the district as exempt under the Fair Labor Standards Act, which resulted in the school board underpaying paying them for overtime hours worked. The employees' suit was resolved by an agreed order in which the school district admitted that the plaintiffs should have been classified as non-exempt within the meaning and purposes of the FLSA, and, thus, the plaintiffs and others similarly situated were entitled to the overtime compensation they sought.[42] The school district then sued its insurer for coverage of the amounts owed to the plaintiff employees. The court granted the insurer's summary judgment motion, holding:

> The Court is of the opinion that the school district has not suffered a loss in accordance with the policy. *The school district had a duty to pay overtime compensation because of the statutory requirements of the FSLA, not because of any wrongful act or omission of the school district.* The school district had a pre-existing obligation to pay these employees for the overtime hours worked, an obligation that was created by the FLSA. The policy states that coverage will issue only if the school district suffered a loss by reason of a wrongful act. The duty to pay overtime is a matter of statutory law, and the obligation to pay time and a half for every hour worked over a forty hour week arose when the employees worked overtime hours. The amount owed to these employees is not a loss, but rather it is a pre-existing debt or obligation.[43]

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40. *Id.* at 176–77 (emphasis added).
41. Oktibbeha County Sch. Dist. v. Coregis Ins. Co., 173 F. Supp. 2d 541 (N.D. Miss. 2001).
42. *Id.* at 542.
43. *Id.* at 543 (emphasis added).

C. *Judge Posner's Flawed Decision in* May Department Stores

In the introductory section of this article, it was posited that two fundamental limitations should be in place for application of the *Eaton Vance* rule that many courts have ignored or glossed over: (1) an *established or admitted* pre-existing obligation, (2) *to pay* the amounts sought as damages. It also was suggested that courts have overstated the "moral hazard" risk in allowing insurance coverage for breach of contract liabilities. Unfortunately, a true legend of the judiciary (Judge Posner) made at least three mistakes in his *May Department Stores* opinion that perfectly illustrate each of these problems. And the flawed analysis in *May Department Stores* likely led to subsequent courts making the same mistakes.

First, the decision in *May Department Stores* was unlike *Eaton Vance* and many of the others discussed herein in that it was principally grounded in express exclusionary language in the definition of "Loss" for amounts which "constitute benefits due or to become due under a Benefits Program."[44] Because he determined in the first instance that the settlement payments were expressly excluded by that language, Judge Posner never discussed whether the policy's insuring agreement requirements were met—*i.e.*, whether the loss was "because of" a claim for a wrongful act. But how was Judge Posner able to assert so confidently that the amounts the insured paid to settle the two claims against it *actually* constituted "benefits due or to become due" under the benefits program at issue? In both suits, the insured disputed that the amounts claimed were actually due to the plaintiffs; it never admitted any obligation to pay those amounts, and no judgment was ever entered declaring that the insured had a pre-existing legal obligation to pay. Without an admission or a judgment that the amounts claimed were actually due, Judge Posner had no basis to hold that the amounts paid in settlement actually "constituted benefits due." For sure, such amounts constituted benefits "*allegedly* due," but the exclusionary wording at issue in the Loss definition was not so broad as to preclude coverage for amounts that "allegedly" constituted benefits due. Similarly, the *Eaton Vance* rule should apply only when it has been established or admitted that the insured *in fact* had a pre-existing obligation to pay the amounts for which coverage is sought. The rule loses its rationale if the insured's pre-existing obligation is still in doubt.[45]

Second, the insured in *May Department Stores* sought coverage for settlements of two different suits against it. While the first suit clearly did seek recovery of amounts *claimed* to be due under the benefits program, the second suit did not. The second suit sought damages for the amounts that *would have been due* to the plaintiffs under their benefits program *if* they

44. May Dep't Stores Co. v. Fed. Ins. Co., 305 F.3d 597, 600 (7th Cir. 2002).
45. *See infra* Section III.

had retired earlier, which they allegedly did not do because of the insured's misrepresentations. There was thus no dispute that the amounts claimed were not *actually due* to the plaintiffs under the terms of the benefits program, because they had not retired in time to earn such benefits. Rather, the insured's alleged obligation to pay the claimed amounts arose exclusively out of its wrongful acts—the misrepresentations—without which the plaintiffs would have retired earlier and earned the benefits at issue. Accordingly, this second suit was actually quite similar to the examples offered by the court in *Baylor Heating* of the types of contract damages that should be covered by a liability policy.[46] The distinction that Judge Posner failed to appreciate is between an insured's breach of a pre-existing obligation *to pay* the amount claimed, on the one hand, versus an insured's breach of a pre-existing obligation to do something which then results in monetary loss to the plaintiff, on the other. Cases alleging the latter type of breach (like the second suit in *May Department Stores*) are what liability insurance is all about, and settlement payments or judgments resolving such claims should be covered.[47]

Finally, Judge Posner's decision in *May Department Stores* was clearly driven in large part by his concern about the moral hazard inherent in allowing insurance to cover damages resulting from willful or intentional refusals to pay.[48] But there was no indication in *May Department Stores* that the insured's actions were actually willful or intentional; to the contrary, the insured disputed that it had any liability to the plaintiffs at all. Virtually all liability policies already include express exclusions for damages arising out of the insured's willful, intentional, or fraudulent misconduct, but such exclusions typically apply only when there is a final adjudication establishing the excluded conduct. Such exclusionary wording offers insurers all the protection that they need against the moral hazard issues that troubled Judge Posner, but his opinion in *May Department Stores* did not address the impact of such "conduct exclusions." Moreover, a rule precluding coverage for settlements of claims alleging a disputed obligation to pay would present serious moral hazard and public policy concerns of its own. In virtually every state in the United States, public policy favors settling disputed claims. But that public policy would be significantly undermined if defendant-insureds knew that, when a claim is made, their choices are either to settle the case

46. Baylor Heating & Air Conditioning, Inc. v. Federated Mut. Ins. Co., 987 F.2d 415, 420 n.8 (7th Cir. 1993) (If "Baylor had negligently failed to enroll an employee in the pension plan and was subsequently sued by that employee for his pension benefits, there might be an argument that Baylor had suffered damage resulting from negligence.").

47. *See infra* Section II.A.

48. *May Dep't Stores*, 305 F.3d at 601.

on their own dime without insurer funding or litigate the case to conclusion (on the insurer's tab) in hopes of a defense judgment.[49]

In 2007, Judge Posner's opinion in *Krueger International, Inc. v. Royal Indemnity Co.*,[50] added to the confusion that he helped create five years earlier. In that case, Judge Posner appeared to walk back some of his broad pronouncements in *May Department Stores*. Judge Posner first commented, in dicta, that "insurance policies are presumed not to insure against liability for breach of contract," citing *Eaton Vance* and himself in *May Department Stores*. But then he explained:

> [T]he presumption against liability for breach of contract is stated too broadly. If the act that precipitates the insured's liability is negligent and therefore tortious, the fact that it's also a breach of contract does not preclude coverage, since coverage is based on the specific acts insured against rather than on the particular remedy sought by the person harmed by the act.[51]

True enough, but it is difficult to reconcile this statement with Judge Posner's concern five years earlier in *May Department Stores* that allowing coverage for even negligent breaches of a contractual obligation to pay would present moral hazard issues. Doesn't Judge Posner's analysis in *Krueger* undercut the force of his reasoning in *May Department Stores*?

Judge Posner went on:

> We also don't agree with Royal that since Olsen's promise conferred a contractual entitlement on the departing employees, Krueger's refusal to honor the entitlement, forcing them to sue, must have been just the kind of deliberate breach of contract that insurance companies do not insure against. Krueger's refusal to honor Olsen's promise was the only way it could challenge his authority to bind the company. An insured who broke an oral employment contract would be forced to pay damages for the breach, yet we know that it would be entitled to be indemnified by the insurance company.[52]

But if Krueger were held liable to pay the amount claimed under the contract, wouldn't it be known at that point that the amount claimed *actually was* a pre-existing obligation and thus not a Loss "because of" a Wrongful Act? Judge Posner's analysis in *Krueger* seems to be allowing for the possibility of coverage for such damages *even after* a finding that the insured had a pre-existing contractual obligation to pay the amount in question. Again, how can such a rule be reconciled with Judge Posner's reasoning in *May Department Stores*?

49. *See infra* Section IV.
50. Krueger Int'l, Inc. v. Royal Indem. Co., 481 F.3d 993, 996 (7th Cir. 2007).
51. *Id.*
52. *Id.* at 997.

It is evident that when Judge Posner decided *May Department Stores*, he had not fully considered all of the considerations underlying his seemingly contradictory opinion in *Krueger*. Unfortunately for policyholders, Judge Posner's overly broad pronunciations of the law in *May Department Stores* have been repeated by subsequent courts on so many occasions that insurers are now emboldened to disclaim coverage for *any* claim that arises out of an insured's alleged breach of a contractual or statutory duty. Examples of some of these decisions are cited in Section I.D, below.

D. *Subsequent Decisions Mis-applying the* Eaton Vance *Rule*

In the years since *Eaton Vance*, numerous other courts assessing coverage for claims alleging breach of contract or violation of a statutory duty have cited to and relied on *Eaton Vance*, *May Department Stores* and the other cases discussed above. As noted, many of them have gotten the analysis wrong in one or more respects, often in reliance on the faulty reasoning of *May Department Stores*.

- *Waste Corp. of America, Inc. v. Genesis Insurance Co.*,[53] (citing *Eaton Vance*, *May Department Stores* and *Baylor Heating*, among other cases, for the broad proposition that public policy prohibits insuring damages for breach of contract because "allowing one to insure against a breach of contract would surely encourage parties to voluntarily abandon performance with little or no consequence," though the court's ensuing discussion suggests the rule only applies to foreclose coverage for intentional, voluntary breaches of contract);
- *August Entertainment, Inc. v. Philadelphia Indemnity Insurance Co.*,[54] (discussing *Baylor Heating*, *Waste Corp.*, *American Casualty*, *Eaton Vance* and *May Department Stores* and holding that "[i]n short, an insured's alleged or actual refusal to make payment under a contract does not give rise to a loss caused by a wrongful act"; "it would create a moral hazard problem, encouraging corporations to risk a breach of their contractual obligations, knowing that, in the event of a breach, the D&O insurer would ultimately be responsible for paying the debt");
- *Newman v. XL Specialty Insurance Co.*,[55] (discussing *Baylor Heating*, *Waste Corp.*, *American Casualty*, *Eaton Vance* and *May Department Stores* and mischaracterizing their holdings as "[c]ourts have consistently held that there is no wrongful act involved in a breach of contract

53. Waste Corp. of Am. Inc. v. Genesis Ins. Co., 382 F. Supp. 2d 1349, 1354–56, 1358–60 (S.D. Fla. 2005).
54. August Entm't, Inc. v. Phila. Indem. Ins. Co., 52 Cal. Rptr. 3d 908, 915–20 (Ct. App. 2007).
55. Newman v. XL Spec. Ins. Co., No. C-1-06-781, 2007 U.S. Dist. LEXIS 74293, at *12 (S.D. Ohio Sept. 24, 2007).

claim as the claim arises out of the legal and voluntary action of creating a contract");

- *Health Net, Inc. v. RLI Insurance Co.*,[56] (relying on the foregoing cases and holding insured "was *contractually obligated to pay its participants and beneficiaries the full benefits to which they were entitled under their health plans*. These costs cannot be passed on to [the] insurers simply because [the insured] may have committed a wrongful act in its failure to pay them. In short, '[p]erformance of a contractual obligation . . . is a debt the [insured] voluntarily accepted. It is not a loss resulting from a wrongful act within the meaning of the policy'");
- *Kittansett Club v. Philadelphia Indemnity Insurance Co.*,[57] (noting no coverage under D&O policy for amounts paid to settle a claim that the insured had failed to distribute the full proceeds of gratuities to its employees, as required by state law, because the settlement amounts were "restitution payments made to fulfill a preexisting obligation," which "are not losses resulting from a wrongful act in breach of that obligation");
- *Entitle Insurance Co. v. Darwin Select Insurance Co.*[58] (quoting the excerpt from *Newman*, noted above);
- *Hartford Casualty Insurance Co. v. Karlin, Fleisher & Falkenberg, LLC*[59] (citing *Baylor Heating* and *Krueger* for the proposition that "insurance policies are presumed not to insure against liability for breach of contract" because of moral hazard concerns).

II. THE *EATON VANCE* RULE APPLIES ONLY TO *THE INSURED'S* PRE-EXISTING *PAYMENT* OBLIGATIONS, NOT TO ALL BREACH OF CONTRACT DAMAGES OR DAMAGES ARISING FROM THE INSURED'S BREACH OF OTHER PRE-EXISTING OBLIGATIONS

One unfortunate consequence of the loose language some courts have employed to describe the *Eaton Vance* rule is that insurers have been furnished with authorities to cite for their oft-repeated (but wrong) assertion that "liability policies do not cover breach of contract damages." But there is no rule against liability insurance for breach of contract damages or damages arising out of a breach of a pre-existing obligation, generally. As discussed herein at Section II.A, the *Eaton Vance* rule against coverage

56. Health Net, Inc. v. RLI Ins. Co., 141 Cal. Rptr. 649 (Ct. App. 2012).

57. Kittansett Club v. Phila. Indem. Ins. Co., 2012 U.S. Dist. LEXIS 127939 (D. Mass. Sept. 10, 2012).

58. Entitle Ins. Co. v. Darwin Select Ins. Co., No. 11-1193, 2013 WL 422712 (N.D. Ohio Feb. 1, 2013), *aff'd*, 2014 WL 304497 (6th Cir. 2014).

59. Hartford Cas. Ins. Co. v. Karlin, Fleisher & Falkenberg, LLC, 822 F.3d 358, 359–60 (7th Cir. 2016).

applies only to an insured's refusal *to pay* an amount it had an actual pre-existing obligation *to pay*. Moreover, when applying this rule, it is critical to ascertain precisely *who* was under the pre-existing obligation to pay. If the insured had no pre-existing payment obligation itself, but rather, its wrongful acts caused another entity to fail to pay amounts due under a contract or statute, there is no basis for denying the insured coverage for its own liability flowing from its wrongful acts.[60]

A. *Payment Obligations vs. Other Pre-existing Contractual or Statutory Duties*

In *Eaton Vance* itself, the damages for which the insured sought coverage were amounts the insured admitted it was obligated to pay to its employees under the terms of their profit-sharing plans.[61] The pre-existing contractual obligation that Eaton Vance had breached was a payment obligation. The same is true of all four of cases cited in *Eaton Vance*: *Baylor Heating*, *American Casualty*, *Oktibbeha County*, and *May Department Stores*, at least in part.[62] Indeed, the court in *Baylor Heating* expressly drew the distinction between payment obligations and other types of obligations imposed by a contract: "We agree with Baylor that a contract can create a duty the breach of which will sound in tort. But responsibility to make payments according to a contract is not the sort of duty that will support an action in negligence."[63] Of the cases cited favorably in *Eaton Vance*, only Judge Posner in *May Department Stores* went beyond this narrow proposition, finding no coverage for amounts paid by the insured to settle one of the two suits against it for damages arising out of the insured's alleged failure to perform—rather than its failure to pay—under a contract.[64]

Following the lead of Judge Posner in *May Department Stores*, subsequent decisions purporting to apply the *Eaton Vance* rule have struggled to appreciate the distinction between damages that *arise from* a breach of a pre-existing performance obligation (covered under *Eaton Vance*) and damages that *constitute* an amount the insured had a pre-existing obligation to pay (not covered). The worst and perhaps most-cited of such decisions is *Waste Corp. of America Inc. v. Genesis Insurance Co.*[65] An example of a case

60. *See infra* Section II.B.

61. Pac. Ins. Co. v. Eaton Vance Mgmt., 369 F.3d 584, 586–87 (1st Cir. 2004).

62. *See supra* Sections I.B and I.C.

63. Baylor Heating & Air Conditioning, Inc. v. Federated Mut. Ins. Co., 987 F.2d 415, 420 n.8 (7th Cir. 1993); *see also* Genzyme Corp. v. Fed. Ins. Co., 622 F.3d 62, 71 (1st Cir. 2010) (distinguishing *Eaton Vance* and holding: "Genzyme had no concrete and identifiable preexisting contractual obligation to pay the amount of the settlement. Rather, the underlying complaint made clear that the alleged cause of the injury was in fact the *breach* of Genzyme's applicable fiduciary duties and/or contractual obligations.").

64. *See supra* Section I.C.

65. Waste Corp. of Am. Inc. v. Genesis Ins. Co., 382 F. Supp. 2d 1349 (S.D. Fla. 2005); *see infra* Section II.A.1.

which gets the analysis right is *Republic Franklin Insurance Co. v. Albemarle County School Board*.[66] Adding to the confusion, some courts have correctly applied the *Eaton Vance* rule to pre-existing payment obligations but then improperly described that rule as having broader applicability.[67]

1. *Waste Corp. of America Inc. v. Genesis Insurance Co.*, 382 F. Supp. 2d 1349 (S.D. Fla. 2005)

In *Waste Corp.*, the insured bought stock from three individuals under an agreement that required the insured to pay $150,000 at closing, followed by a series of royalty and earnout payments to the sellers over the next three years. The sellers alleged the insured had breached the stock purchase agreement by (1) failing to allow the sellers to operate the company in a reasonable and prudent manner, (2) operating the companies improperly, and (3) improperly charging amounts against the earnout calculations, thereby reducing the payments to which they were entitled.[68] The complaint included counts for breach of contract, fraud, and negligent misrepresentation. Two of the sellers settled their claims in exchange for a contingent stream of the royalty payments in an amount that the insured agreed was properly due to them under the stock purchase agreement ($156,081.10). The third seller proceeded to trial, where he won a $3 million verdict on his breach of contract claim (as the tort claims had been dismissed). After a post-trial mediation, the parties settled for $2 million, and the insured sought coverage under its D&O policy for $1,843,918.90 (*i.e.*, the $2 million settlement minus the $156,081.10 the insured conceded was due under the SPA).[69] The insurer disclaimed coverage, arguing that the policy did not cover breach of contract damages, which would be against public policy. [70] In the ensuing coverage action, the parties cross-moved for summary judgment.

The court began its discussion on a strong note—by correctly stating that its analysis must begin with the language of the insuring agreement, pursuant to which the insurer promised to pay "Loss arising from

66. Republic Franklin Ins. Co. v. Albemarle Cnty. Sch. Bd., 670 F.3d 563 (4th Cir. 2012); *see infra* Section II.A.2.

67. *See* August Entm't, Inc. v. Phila. Indem. Ins. Co., 52 Cal. Rptr. 3d 908, 915–20 (Ct. App. 2007), discussed at Section II.A.3, *infra*; *see also* Newman v. XL Spec. Ins. Co., No. C-1-06-781, 2007 U.S. Dist. LEXIS 74293, at *16 (S.D. Ohio Sept. 24, 2007) (Although *Eaton Vance* rule properly applied to facts of the case, court erroneously described the rule as "[u]nless the insurance policy explicitly states that it covers breach of contract actions, such an interpretation should not be read into the policy."); Entitle Ins. Co. v. Darwin Select Ins. Co., No. 11-1193, 2013 WL 422712 (N.D. Ohio Feb. 1, 2013) (same).

68. *Waste Corp.* 382 F. Supp. 2d at 1351.

69. *Id.*

70. *Id.* at 1352.

Securities Claims . . . for a Wrongful Act." From there, however, the court's analysis was seriously flawed.

The first error was the court's statement that "[g]enerally, liability policies do not cover breach of contract damages, instead providing coverage for unforeseen events, not those within the insured's control."[71] And then the court erroneously framed the threshold question as "whether claims based on breaches of contract should be read into the insuring agreement, despite the absence of such a coverage clause, based on the policy's definition of 'loss,' the requirement of a 'wrongful act,' and public policy considerations."[72] The court thus set itself up for failure by (1) wrongly assuming there should be no cover for breach of contract damages, irrespective of the actual policy language, and (2) relieving the insurer of its burden to draft clear and unmistakable language excluding breach of contract damages if that was its intent.

The court then turned its attention to what it characterized (again, erroneously) as a "strong public policy against insuring [breaches of contract]." Relying on *May Department Stores*, the court stated:

> Allowing an insured to control whether it will be covered for its act of breaching a contract places the insured in the unique posture of *voluntarily choosing* to do some act for which he knows an insurance company will compensate him even if he chooses wrongly. Who wouldn't buy insurance if he could decide whether to perform or decline to perform some act which would give him coverage for that action? Such a premise eliminates all risk to a potential insured. He could enter into a contract safe in the assumption that if he later decides to engage in an act which might be considered a breach, the insurance company will step forward to cover the consequences of his act if he was wrong; and if he was right, he still walks away with no consequence to himself. Such a practice is inimical to the entire concept of insurance.
>
> There would be nothing to stop an insured from trying his hand and betting all his chips on a breach if he could be assured that the consequences of such an act had no impact on him. . . .
>
> [A]llowing one to insure against a breach of contract would surely encourage parties to *voluntarily abandon performance* with little or no consequence. It requires little clairvoyance to foresee how a party who enters into what turns out to be a bad bargain might *choose to act* if he knows he will be covered regardless of the choice and regardless of the outcome of the choice. It wouldn't even require a bad bargain; if he can see a better potential by refusing to perform, why not give it a try?[73]

71. *Id.* at 1354.
72. *Id.*
73. *Id.* at 1354–56 (emphasis added).

Although the court correctly noted that such public policy considerations "stem from the general prohibition against permitting insurance to cover *intentional* conduct,"[74] it nevertheless fashioned a rule against coverage that would apply to negligent and intentional conduct alike.[75] Indeed, the seller's claims against Waste Corp. were clearly premised on Waste Corp.'s alleged *negligence* in mismanaging the company, not any intentional misconduct.

Next, the court (finally) turned its attention to the policy language which, as previously noted, provided coverage for loss arising from a securities claim as a result of a wrongful act.[76] The policy defined loss as any amount the insured is "legally obligated to pay" because of a claim. The court then discussed *Data Specialists, Inc. v. Transcontinental Insurance Co.*,[77] in which it was held that the phrase "legally obligated to pay as damages" in the insuring agreement of a CGL policy referred only to tort-based obligations, not breach of contract damages. The court acknowledged that *Data Specialists* was construing a CGL policy rather than a D&O policy, but held there was no reason that the same logic should not apply to all liability policies.[78] This was yet another error in the court's reasoning, as, in fact, good reasons exist to distinguish the liability coverage provided by CGL policies—which apply to claims based on an "occurrence"—from the coverage provided by other types of liability policies that apply to claims based on any "Wrongful Act." The court's discussion of this issue in *Verticalnet, Inc. v. U.S. Specialty Insurance Co.*[79] is instructive. In that case, the insurer relied on a number of decisions upholding disclaimers of coverage for breach of contract claims under CGL policies to argue that breach of contract damages constitute uninsurable loss.[80] The court disagreed, observing: "The courts in these cases found that the insureds were not entitled to coverage because their underlying breaches of contract were not an 'occurrence' or 'accident.'"[81] But a D&O liability policy does not provide coverage only for "occurrences"; "it expressly provides insurance for securities claims without limiting coverage of such claims to those that do not arise from breaches of contract."[82] The CGL cases thus provide no support for the proposition that an expressly covered securities claim is

74. *Id.* at 1355 (emphasis added).
75. *Id.* at 1359–60 (distinguishing cases cited by the insured on basis that the breaches of contract at issue did not involve intentional breaches).
76. *Id.* at 1356–57.
77. Data Specialists, Inc. v. Transcont'l Ins. Co., 125 F.3d 909 (5th Cir. 1997).
78. Waste Corp. of Am. Inc. v. Genesis Ins. Co., 382 F. Supp. 2d 1349, 1357 (S.D. Fla. 2005).
79. Verticalnet, Inc. v. U.S. Specialty Ins. Co., 492 F. Supp. 2d 452, 457–59 (E.D. Pa. 2007).
80. *Id.* at 456.
81. *Id.* at 458.
82. *Id.*

uninsurable because it is also contract-based; those cases were decided on the specific policy language presented, not based on public policy against insuring breaches of contract.[83]

Perhaps recognizing that reliance on rules developed in the context of CGL policies with different policy language was a flimsy reed on which to stand, the court's discussion then turned to the *Eaton Vance* rule. Specifically, the court noted that, in both *American Casualty* and *Eaton Vance*, the courts held that where an insured pays an amount it is required to pay by contract, that payment (even if it is a settlement or a judgment) is not a loss "because of" or "resulting from" a Wrongful Act. Rather, it results from the pre-existing contractual obligation to pay the sum in question, irrespective of any breach or other Wrongful Act.[84] In each case, "the acts of failing to fund were not covered by the policy.[85]

So far, so good. But it does not follow from that proposition that damages arising from *any* breach of contract—*i.e.*, a negligent breach other

83. To be sure, sometimes CGL policies provide coverage for only tort damages and not damages arising out of breach of contract, as previously noted. *See*, *e.g.*, Data Specialists, Inc. v. Transcont'l Ins. Co., 125 F.3d 909, 913 (5th Cir. 1997); Aetna Cas. & Sur. Co. v. Spancrete of Ill., Inc., 726 F. Supp. 204, 206 (N.D. Ill. 1989); Action Ads, Inc. v. Great Am. Ins. Co., 685 P.2d 42, 44 (Wyo. 1984). But these courts mean only that a breach of contract claim for purely economic loss—*i.e.*, the cost to repair defective work, or the diminished value of the property—do not allege an "accident" or "occurrence" and do not seek "damages because of property damage" within the scope of a CGL policy. It is of course entirely possible for a property damage claim to be asserted under a breach of contract theory, and such claims are covered unless specifically excluded in the policy. *See*, *e.g.*, Desert Mt. Props. L.P. v. Liberty Mut. Fire Ins. Co., 236 P.3d 421 ¶ 32 (2010) ("While there is some appeal to the notion that a breach of contract is not the sort of accidental risk to which liability insurance is designed to apply, we are reluctant to read such a limitation into a CGL policy when the parties have not chosen to write it for themselves."); Lamar Homes, Inc. v. Mid-Continent Cas. Co., 242 S.W.3d 1, 13 (Tex. 2007) ("Any preconceived notion that a CGL policy is only for tort liability must yield to the policy's actual language."); Vandenberg v. Superior Court, 982 P.2d 229, 246 (Cal. 1999) (insurer "cannot avoid coverage for damages awarded against [an insured] solely on grounds the damages were assessed on a contractual theory;" the phrase "legally obligated to pay" refers "to any obligation which is binding and enforceable under the law, whether pursuant to contract or tort liability."); Am. Family Mut. Ins. Co. v. Am. Girl, Inc., 673 N.W.2d 65, ¶ 39 (Wis. 2004) (noting that although "CGL policies generally do not cover contract claims arising out of the insured's defective work or product, . . . this is by operation of the CGL's business risk exclusions, not because a loss actionable only in contract can never be the result of an 'occurrence' within the meaning of the CGL's initial grant of coverage"); *see also* Verticalnet, Inc. v. U.S. Specialty Ins. Co., 492 F. Supp. 2d 452, 457–58 (E.D. Pa. 2007) (explaining that, while a contract breach may not be an occurrence or accident for purposes of a CGL policy, it does constitute a Wrongful Act for purposes of other liability policies); Nat'l Cas. Co. v. Fulton County, 2018 U.S. Dist. LEXIS 51037, at *29 (N.D. Ga. Mar. 28, 2018) (CGL cases standing for the "settled notion that CGL coverage generally is intended to insure against liabilities to third parties for injury to property or person, but not mere liabilities for the repair or correction of the faulty workmanship of the insured" do not support any generally applicable rule against coverage for breaches of contract).

84. Waste Corp. of Am. Inc. v. Genesis Ins. Co., 382 F. Supp. 2d 1349, 1357–58 (S.D. Fla. 2005).

85. *Id.* at 1358.

than a "failure to fund"—also cannot be covered, irrespective of policy language. Notably, Waste Corp. made this exact point in its motion papers, but the court simply failed to appreciate the distinction between amounts *due under* a contract and damages *arising from* a breach of contract. Waste Corp. argued:

> To prevent insurers from becoming surrogate guarantors on contracts, courts have determined that an insured's non-payment of an actual contractual obligation is insufficient to satisfy the requisite "wrongful act" necessary to trigger insurance coverage. Genesis' authorities so state and WASTE CORP. does not take issue with the limited application of that principle. . . .
>
> There is [] a critical difference between the DeStaven and Leon settlements—which paid them amounts equal to what they were owed under the stock purchase agreement—and the McNamara settlement which far exceeded what he was otherwise due under the contract [because it included additional alleged damages arising from Waste Corp.'s alleged mismanagement of the company]. This is precisely why WASTE CORP. is dropping its claims for the DeStaven and Leon settlements.[86]

But the court saw no difference between the various settlements. Instead, the court held that Waste Corp.'s concession that "the policy here does not cover amounts due under a contract" meant there could be no coverage for the amount that it paid in settlement of the mismanagement claim unless "it constituted something other than contract damages."[87]

Assessing that question, the court noted that, even the mismanagement claims were rooted in alleged breaches of the stock purchase agreement—specifically, its provisions requiring Waste Corp. to manage the operations of the company. The damages awarded by the jury against Waste Corp. were thus "damages based on breach of contract." According to the court, such "contract expectation" damages were not covered even though they did not represent a "liquidated sum" that was specifically due under the contract.[88] Thus, the court's analysis concluded in the same place it had started—the assumption that liability policies do not cover *any* breach of contract damages.

It is, of course, not true that liability policies may not cover breach of contract damages. Many companies—particularly professional services companies—conduct their business through contractual engagements. Unless specifically excluded, liabilities arising out of those contractual duties are covered by errors and omissions, directors and officers, and commercial general liability policies, among others. An example that most readers of this article will appreciate—professional liability insurance for

86. *Id.* at 1360–61.
87. *Id.* at 1361.
88. *Id.* at 1361–62.

lawyers—illustrates the point perfectly. When lawyers agree to represent a client, they enter into an engagement agreement that defines the scope of the services. When a client sues a lawyer for professional malpractice, the claim is one for professional negligence but it arises out of the contractual relationship between the parties. The duty the lawyer is alleged to have breached is one which arises exclusively out of the contract into which they entered. Would any lawyer really expect that his or her professional liability insurer would be entitled to disclaim coverage for such a malpractice claim solely on the basis that the claim arises out of a breach of contract? Of course not.

2. *Republic Franklin Insurance Co. v. Albemarle County School Board*, 670 F.3d 563 (4th Cir. 2012)

If *Waste Corp.* is an example of a court getting the *Eaton Vance* rule exactly wrong, the Fourth Circuit's decision in *Albemarle County* is an example of a court getting the analysis exactly right. In that case, employees of a Virginia school board commenced a class action against the Board for violations of the Fair Labor Standards Act, alleging that the Board had failed to pay them for all the work that they had done and failed to pay them the overtime rate when they worked over forty hours in a week.[89] The employees sought damages for the unpaid wages and overtime pay that they alleged were due, plus liquidated damages and attorneys' fees authorized by the FLSA. The school board's insurer commenced a declaratory judgment action seeking an order that it had no duty to defend or indemnify the board for the suit. The insurer argued, and the district court agreed, "that the insured's negligent, willful, or intentional failure to honor a pre-existing obligation to pay money is not a 'wrongful act' as that term is used in the policy. . . . To find otherwise could encourage parties to routinely circumvent the requirements of the FLSA—whether negligently, willfully, or intentionally—because they have nothing to lose."[90] The district court also found that, because the claim for back wages was not a claim for covered loss, the claim for liquidated damages and attorneys' fees also did not seek a covered loss "because that claim did not exist independently of the claim for back wages."[91] Finally, the court concluded, "if the failure to pay wages does not constitute a 'wrongful act' under the policy, it follows that the statutory remedies allowable in connection with any failure to pay those wages do not result from a claim for a wrongful act."[92] The School Board appealed, arguing only that the claims for liquidated damages and attorneys' fees

89. Republic Franklin Ins. Co. v. Albemarle Cnty. Sch. Bd., 670 F.3d 563, 564 (4th Cir. 2012).
90. *Id.* at 565.
91. *Id.*
92. *Id.*

were covered by the policy because liquidated damages and attorneys' fees were not preexisting obligations but damages resulting specifically from its wrongful acts in not paying the wages required by the FLSA.

The Fourth Circuit started by addressing whether the insured's failure to pay wages and overtime as required by the FLSA was a "wrongful act." The court rejected the insurer's argument that "the School Board's failure to comply with the FLSA cannot be a wrongful act because the School Board had a preexisting duty to comply with the Act."[93] The court explained:

> While a preexisting duty might be relevant to whether an insured suffers an insurable *loss*, it cannot be relevant to whether the insured is the subject of a claim for a *wrongful act*. *Every* duty breached or violated is necessarily a preexisting duty, and it is the *breach* or *violation* of that duty which constitutes a wrongful act. . . . The School Board's alleged failures are thus breaches of the duty imposed by the FLSA and therefore wrongful acts. By its plain language, the policy covers claims for the wrongful acts alleged in the underlying complaint.[94]

In other words, the relevant coverage issue was not whether the FLSA violation was a wrongful act; it was. Rather, the issue was whether the resulting obligation of the school board to pay back wages was a loss "resulting from" the claim for a wrongful act. Citing *Eaton Vance*, *May Department Stores* and *Oktibbeha County*, the court observed that "[s]uch loss could only arise if the failure to fulfill the preexisting duty to pay wages caused 'damages' *apart from* the back wages not paid."[95] The question is thus whether the insured's "loss" was caused by the fact that a claim had been made against it for a wrongful act or whether the insured was already liable to pay that "loss" because of its pre-existing contractual or statutory obligation. The court then summarized the *Eaton Vance* rule (accurately) as follows:

> In sum, these cases—*Pacific Insurance*, *May Department Stores*, and *Oktibbeha County*—stand for the proposition that a judgment ordering an insured to pay money that the insured was already obligated to pay, either by contract or by statute, is not a "loss" covered under an insurance policy that requires that the loss be caused by a "wrongful act." The alleged "loss" in such cases arises from the contract or the statute itself, not from the failure to abide by it. These cases do not stand for the proposition that the failure to comply with a preexisting duty cannot be a "wrongful act." Such a rule would not only be incompatible with the definition of "wrongful act" in such policies—defined broadly to include "any breach of duty"—but also is counterintuitive because no violation of the law could ever be a "wrongful act" as there would always be a preexisting duty to follow the law.[96]

93. *Id.* at 566.
94. *Id.* at 566–67 (emphasis in original).
95. *Id.* at 567.
96. *Id.* at 567–68.

With the relevant rule properly defined, the court then turned to the question of what part of the school board's loss, if any, was caused by the FLSA violation (and resulting claim), rather than the pre-existing payment obligation under the FLSA. Notably, the school board conceded that the obligation to pay back wages and overtime pay was a preexisting duty that was not the result of its wrongful act in allegedly violating the FLSA. But the school board also paid liquidated damages and attorneys' fees, which it maintained were covered because such losses only could have resulted from its wrongful acts.[97] The court agreed:

> [T]he liquidated damages and attorneys' fees would not be payable because of any preexisting duty, and thus they *do* meet the policy's requirement that they "result[] from a claim for a wrongful act." . . . Because the underlying FLSA complaint against the School Board asserts claims for liquidated damages and attorneys' fees arising, not from a preexisting duty, but because of the School Board's alleged wrongful acts, we conclude that they are damages resulting from a claim for the alleged wrongful act and therefore are covered losses[98]

In so holding, the court rejected the insurer's argument that the liquidated damages and attorneys' fees should not be covered because they were so intertwined with, and derivative of, the claims for back wages and overtime pay.[99]

3. *August Entertainment, Inc. v. Philadelphia Indemnity Insurance Co.*, 146 Cal. App. 4th 565, 52 Cal. Rptr. 908 (Ct. App. 2007)

Since the First Circuit decided *Eaton Vance*, courts purporting to characterize or apply its central holding have done so with mixed success. Most cases involved coverage for an amount the insured had a pre-existing obligation to pay, and thus, application of the *Eaton Vance* rule was appropriate. But some cases have attempted to extend the *Eaton Vance* rule beyond that limited reach, or at least have described their holdings in terms that can be easily misconstrued as such.

For example, in *August Entertainment*, the coverage dispute involved a $2 million guaranteed payment that the insured officer allegedly was personally liable to pay under a film distribution contract.[100] Following

97. *Id.* at 568.

98. *Id.* at 568–69.

99. *Id.*; *see also* YMCA of Plattsburgh v. Phila. Indem. Ins. Co., 2018 U.S. Dist. LEXIS 202818, at *9–14 (N.D.N.Y. Nov. 30, 2018) (distinguishing between amounts employer had pre-existing contractual obligation pay to employee retirement fund and amounts it became legally obligated to pay only because of its wrongful acts in administering the fund).

100. August Entm't, Inc. v. Phila. Indem. Ins. Co., 52 Cal. Rptr. 3d 908, 909 (Ct. App. 2007). The decision in *August Entertainment* arose under highly unusual circumstances. The settlement agreement and consent judgment resolving the underlying case sought to impose personal liability on the officer who entered into the contract (and relieved the company of any liability) solely for purposes of trying to get insurance coverage—i.e., avoiding the

an extended discussion of *American Casualty*, the court held: "In short, an insured's alleged or actual *refusal to make payment under a contract* does not give rise to a loss caused by a wrongful act."[101] The court then discussed *Baylor Heating*, *Eaton Vance*, and *May Department Stores* at length,[102] before reaching its decision on whether the $2 million payment at issue was a covered loss resulting from a claim for a wrongful act. The court held:

> Based on the foregoing authorities, we conclude that, under the policy in this case, the insurer was not liable for the underlying settlement or judgment. To hold otherwise would make it a de facto party to a corporate contract and require it to pay the *full* contract price (plus interest), letting the corporation completely off the hook. Performance of a contractual obligation—here the payment of $2 million—is a debt the corporation voluntarily accepted. It is not a loss resulting from a wrongful act within the meaning of the policy.[103]

These holdings correctly state the *Eaton Vance* rule, which focused on whether the payment obligation for which the insured seeks coverage was the result of a claim for a wrongful act or whether it results from a preexisting obligation to make the payment, irrespective of any wrongful act. If the insured would have no liability to pay the damages sought "but for" its breach of another obligation or duty, such damages should be covered (unless expressly excluded by the policy language).

Unfortunately, the court muddied the waters when it later suggested that "'wrongful act,' as defined in part one of the D&O liability insurance, did not include a breach of contract of any kind."[104] That statement was not true. As in most D&O policies, the term "wrongful act" was defined as "any actual or alleged error, misstatement, misleading statement, act, omission, neglect, or breach of duty," without regard for whether the duty breached was contractual or otherwise. The breach of the payment obligation was thus unquestionably a "wrongful act"; the coverage question turned on whether that wrongful act was the cause of the insured's "loss."[105] The court

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Policy's exclusion for "actual or alleged liability of the Company under any express contract or agreement." As the trial court observed, "[w]hat plaintiff is seeking to do is have an insurance company pay for a business debt under an [errors and omissions] policy where the alleged wrongful act of the officer consists of signing a contract without indicating he is signing as an officer of the corporation." *Id.* at 912.

101. *Id*. at 917 (emphasis added).

102. *Id.* at 918–20.

103. *Id*. at 919.

104. *Id*. at 920.

105. *See* Republic Franklin Ins. Co. v. Albemarle Cnty. Sch. Bd., 670 F.3d 563, 566–67 (4th Cir. 2012) ("*Every* duty breached or violated is necessarily a preexisting duty, and it is the *breach* or *violation* of that duty which constitutes a wrongful act.") (emphasis in original); Am. Cas. Co. of Reading, Pa. v. Hotel & Rest. Emps & Bartenders Int'l Union Welfare Fund, 942 P.2d 172, 175–77 (Nev. 1997) (insured's breach of contractual duty to pay for indemnitee's defense was a "wrongful act" but that wrongful act was not the cause of the insured's loss); Kittansett Club v. Phila. Indem. Ins. Co., 2012 U.S. Dist. LEXIS 127939 (D. Mass. Sept. 10,

also engaged in an unnecessary discussion of the "moral hazard" issues that so heavily influenced the decisions in *May Department Stores* and *Waste Corp.*, concluding with the following statement that fails to clearly distinguish between insuring breaches of contractual payment obligations versus other breaches: "[I]t would create a moral hazard problem, encouraging corporations to risk a breach of their contractual obligations, knowing that, in the event of a breach, the D&O insurer would ultimately be responsible for paying the debt." *Id.* at 582.

B. *Amounts the* Insured *Has a Pre-existing Obligation to Pay vs. Amounts a* Third Party *Would Have Had an Obligation to Pay "But For" the Insured's Wrongful Acts*

A separate but related question involving applicability of the *Eaton Vance* rule sometimes arises when the underlying claimant seeks damages from more than one insured entity—or from both insureds and non-insureds—and the basis for liability against each defendant is different. Where multiple defendants act in a manner that causes *one of them* to breach a pre-existing payment obligation to the claimant, the *Eaton Vance* rule should eliminate coverage only for the insured entity that actually had the pre-existing payment obligation. The other defendants, if insureds under the policy, should have coverage for their separate liabilities arising out of their wrongful acts that led to the claimant's damages. Again, courts have had mixed success in appreciating this distinction.

1. *Health Net, Inc. v. RLI Insurance Co.*, 141 Cal. Rptr. 3d 649 (Ct. App. 2012)

In *Health Net*,[106] Health Net and various of its subsidiaries sought coverage for two underlying class actions brought by beneficiaries of health plans that were administered and insured by the various Health Net entities. According to Health Net, the parent company did not actually insure or administer any of the plans; rather, various subsidiaries did that work. But Health Net did not provide any evidence for this configuration in the record, nor did it apparently specify which of its subsidiaries were insurers of the plans and which of them administered the plans.[107] The class actions both concerned Health Net's practices of calculating the amounts that it reimbursed beneficiaries for out-of-network medical services, which the plaintiffs alleged led to underpayment of benefits due under the plans.[108] In

2012) (insured's failure to remit gratuities to food servers as required by law was a wrongful act, but it was the statutory obligation to pay rather than the wrongful act that caused most of the insured's settlement payment "loss").

106. Health Net, Inc. v. RLI Ins. Co., 141 Cal. Rptr. 3d 649 (Ct. App. 2012).

107. *Id.* at 654 n.3.

108. *Id.* at 654–57.

addition to the plan benefits allegedly due, the plaintiffs also sought damages for their actual out-of-pocket expenses (excess of the amount covered by the plan), extra-contractual damages for alleged disclosure violations of ERISA, and awards of attorney fees based on those covered wrongful acts.[109] Health Net (on behalf of all of its subsidiaries) settled the claims for $215 million, out of which $69.7 million was awarded as attorneys' fees.[110] Health Net's insurers disclaimed coverage on a variety of bases, including that the damages sought "were for unpaid policy benefits for which liability insurance was not available as a matter of law."[111] The trial court granted summary judgment for the insurers (on the basis of a policy exclusion), and Health Net appealed.[112]

Before addressing the applicability of the exclusion, the appellate court correctly focused on whether the claims against Health Net and its subsidiaries fell within the scope of the policy's insuring agreement.[113] The claims alleged errors by Health Net entities in reviewing and approving coverage for benefit claims under the plans and thus clearly alleged "Wrongful Acts," as defined by the policies.[114] The court then broached the key issue—application of the *Eaton Vance* rule to the amounts Health Net paid to settle the claims against it. The court correctly framed the issue as "if benefits due insureds under their health plans are amounts the insurer is legally obligated to pay *as the result of a Wrongful Act*, or if they are amounts the [insured] entities are obligated to pay their insureds *by contract*, independent of any Wrongful Act."[115] The court found that most, but not all, of the amounts paid to settle the underlying claims by plan beneficiaries fell into the latter category and thus were not covered. The court explained that "regardless of whether [the insured] committed any wrongful act . . ., the fact remains that [the insured] was *contractually obligated to pay its participants and beneficiaries the full benefits to which they were entitled under their health plans*. These costs cannot be passed on to [the] insurers simply because [the insured] may have committed a wrongful act in its failure to pay them."[116] But insofar as the settlement also resolved claims seeking extra-contractual damages and awards of attorney fees based thereon, those amounts were covered.[117] Because those "damages"

109. *Id*. at 668.
110. *Id*. at 660.
111. *Id*. at 662.
112. *Id*. at 653.
113. *Id*. at 654.
114. *Id*.
115. *Id*. at 665 (emphasis in original) (citing *August Entertainment*).
116. *Id*. at 666 (emphasis in original) (citing *Eaton Vance* and *Baylor*).
117. *Id*. at 666–69.

did not represent amounts the insureds were contractually obligated to pay, they were covered loss "resulting from" the insureds' wrongful acts.[118]

All of the foregoing is a correct and faithful application of the *Eaton Vance* rule, with two exceptions. The first is that the court applied the *Eaton Vance* rule even without any admission or finding of fact that the insureds *actually* had a pre-existing obligation to pay the amounts allegedly due under the plans. This is the subject of Section III, *infra*. The second apparent error is the court's assumption that the *Eaton Vance* rule would preclude coverage for *all* of the Health Net entities, even though only some of them actually had any obligation to pay benefits due under the plans as the insurers of those plans. For the insured entities who did not actually insure the plans—but rather, were involved in administering them and implementing them by reviewing data, processing claims and ultimately reporting to the insurer the amount that it should pay—*those entities* never had any pre-existing contractual obligation to pay the benefits claimed. What basis could there be for applying the *Eaton Vance* rule to those insureds whose liability to pay damages could have arisen only from their alleged wrongful acts in administering the plan?[119]

It is odd that the court failed to distinguish the basis of each insured's alleged liability and assess whether the *Eaton Vance* rule would apply, even as it did painstakingly analyze all of the different types of damages claimed in the complaint to assess whether or not they would be subject to the *Eaton Vance* rule.[120] If the court had done so, presumably an allocation would have been necessary to determine how much of the settlement was paid to resolve the claims against subsidiaries that were administrators of the plans (covered) and how much was allocable to claims against the subsidiaries that were insurers of the plans (not covered). And if such an allocation had been performed, one would think that most if not all of the settlement amount should be allocated to the covered claims against administrators based on their alleged wrongful acts in using outdated data, etc., which resulted in the insurers underpaying the benefits due. But for

118. *Id.*; *accord* Republic Franklin Ins. Co. v. Albemarle Cnty. Sch. Bd., 670 F.3d 563, 568–69 (4th Cir. 2012); Kittansett Club v. Phila. Indem. Ins. Co., 2012 U.S. Dist. LEXIS 127939, at *19–20 (D. Mass. Sept. 10, 2012) (while restitution for gratuities owed did not constitute loss resulting from a wrongful act, other payments such as statutory liquidated damages and attorney fees did). *But see* Screen Actors Guild-Am. Fed'n of TV & Radio Artists v. Fed. Ins. Co., 636 F. App'x 409, 409 (9th Cir. 2015).

119. *Health Net, Inc.* 141 Cal. Rptr. 3d 654 n.3 (noting that the named insured was the parent company of numerous subsidiaries, some of which insured the plans at issue and others of which administered those plans).

120. *Id.* at 666–69; *see also id.* at 659 n.14 (noting that, although the parent company paid the entire settlement, if the underlying cases had gone to trial, damages would have been awarded against each of the culpable subsidiaries for their separate and independent wrongful acts).

the administrators' wrongful acts, there never would have been any under-payment of benefits under the plans.

2. *Erickson-Hall Construction Co. v. Hartford Fire Insurance Co.*, 800 F. App'x 559 (9th Cir. 2020)

The distinction that the *Health Net* court failed to appreciate was critical to the Ninth Circuit Court of Appeals' decision in *Erickson-Hall Construction. Co. v. Hartford Fire Insurance Co.*,[121]), another coverage case involving underlying claims for amounts allegedly due under employee benefit plans. In that case, the district court discussed *Eaton Vance*, *Baylor Heating*, *May Department Stores*, and *Health Net*, among other cases, and held the insured employer had no coverage for claims against it seeking benefits allegedly due under the terms of certain benefit plans that the insured had purchased for its employees from a third-party insurance company.[122] The insured employer was responsible for administering the plans in certain respects, including by informing employees about the plans, enrolling them, and managing the payment of premiums directly from employees' paychecks.[123] The insured, however, failed to pay the required premiums, coverage terminated, and the insured failed to communicate that fact to its employees, which prevented them from renewing coverage and receiving the benefits to which they otherwise would have been entitled.[124] The insured settled the employees' claims without litigation, essentially paying each of them the amount that they would have received under the plans if they had been properly maintained.[125] In granting the insurers' motions to dismiss the suit for coverage of those amounts, the district court held the insured's liability to pay was "a liability borne out of a breach of a contractual obligation, rather than a Wrongful Act or an Employee Benefits Injury."[126] In the district court's eyes:

> [the insured] had undertaken to provide [employees] with paid EHCC Benefit Plans, a responsibility it defaulted on. . . . [T]he nature of the damage was contractual, and the risk involved stemmed from the failure to meet contractual promises. . . . [T]he responsibility on EHCC to pay the benefits under the EHCC Benefits Plans arose not because of any negligent acts or breaches of fiduciary duty by the Controller, but because of an independent, contractual obligation to provide its Employees with EHCC Benefit Plans.[127]

121. Erickson-Hall Constr. Co. v. Hartford Fire Ins. Co., 800 F. App'x 559 (9th Cir. 2020),

122. Erickson-Hall Constr. Co. v. Scottsdale Ins. Co., 369 F. Supp. 3d 1022, 1035–38 (S.D. Cal. 2019).

123. *Id.* at 1026.

124. *Id.* at 1028.

125. *Id.*

126. *Id.* at 1034–35.

127. *Id.* at 1035–37.

On appeal, the Ninth Circuit reversed in a succinct opinion that got right to the point:

> [I]t is not correct that Erickson-Hall's claimed losses were amounts it owed under a preexisting contractual obligation. Erickson-Hall contracted with its employees to administer the Employee Benefits Plans (which were issued by third-party insurers), not to make benefit payments under the Employee Benefits Plans when coverage is owed. Thus, Erickson-Hall's claimed losses were not "amounts [Erickson-Hall was] obligated to pay [its employees] by contract, independent of any Wrongful Act." . . . To the contrary, *but for* the allegedly negligent acts of Erickson-Hall's Controller, the premiums would have been paid, the Employee Benefits Plans would have been in effect, and the employees' benefits would have been paid by third-party insurers. In the absence of such alleged negligence, Erickson-Hall would never have been liable for the claimed loss amounts. . . . Thus, the "nature of the damage and the risk" that Erickson-Hall sought to cover, . . . was exactly that which did in fact transpire: The Employee Benefit Plans were negligently administered, resulting in a loss to Erickson-Hall.[128]

The Ninth Circuit also criticized the district court's suggestion that losses arising out of a breach of contract are not insurable loss, which is contrary to California law (and the law of most states under most circumstances).[129]

The Ninth Circuit's decision in *Erickson-Hall* thus perfectly illustrates the distinction that the *Health Net* court should have made between (1) the insured entities that are contractually liable to make payments under the plan, and (2) insured entities whose liability could arise only from wrongful acts in administering or implementing the plan.[130]

In situations where multiple insureds are defendants and the damages sought from some of them are subject to the *Eaton Vance* rule but the damages sought from other insureds are not, no basis exists for diminishing the coverage to which the covered insureds are entitled simply because the suit also includes non-covered claims against others.[131] Similarly, where

128. *Erickson Hall*, 800 F. App'x at 558–60 (citation omitted).

129. *Id*. at 560.

130. The facts of *Erickson-Hall* also closely resemble the first example given by the Seventh Circuit in *Baylor Heating* of performance-based contract claims against an insured that fall outside the scope of the *Eaton Vance* rule and should be covered. *See* Baylor Heating & Air Conditioning, Inc. v. Federated Mut. Ins. Co., 987 F.2d 415, at 420 n.8 (7th Cir. 1993); *see also* Cultural Care, Inc. v. AXA Ins. Co., 2018 U.S. Dist. LEXIS 100679, at *28–29 (D. Colo. June 15, 2018) (rejecting application of *Eaton Vance* rule to claim for higher wages that could have been negotiated from au pairs' host families but for the insured's alleged misrepresentations because the wages "would have been paid by the host families rather than by [the insured]").

131. *See* Arch Ins. Co. v. Murdock, 2020 Del. Super. LEXIS 156, at *19–20 (Del. Super. Ct. Jan. 17, 2020), *aff'd*, 248 A.3d 887, 909 (Del. 2021). In *Murdock*, the court explained:

> The Policies cover all Loss that the Insured(s) become legally obligated to pay. Such language implies that a complete indemnity for Loss regardless of who else might be at fault for similar actions. The Policies do not limit coverage because

multiple causes of action are asserted against an insured and the damages flowing from some of them would be subject to the *Eaton Vance* rule but the damages flowing from others would not, the fact that the covered and non-covered damages would be overlapping does not diminish the insured's coverage.[132]

III. THE *EATON VANCE* RULE SHOULD NOT PRECLUDE COVERAGE FOR SETTLEMENTS WHERE THE INSURED'S PRE-EXISTING OBLIGATION TO THE CLAIMANT HAS NOT BEEN ESTABLISHED OR ADMITTED

At its core, the *Eaton Vance* rule is about making sure that a policyholder cannot shift responsibility for its contractual or statutory debts to its insurers simply by refusing to pay those debts. This is the "moral hazard" problem discussed in so many of the decisions addressed herein and that so troubled Judge Posner in *May Department Stores*. But if the policyholder has no liability to pay an alleged debt that is the subject of a third-party claim—for example, because it disputes the validity of the contract or has valid defenses to payment—there is no moral hazard in its having insurance coverage for defense of the claim after it refuses to pay. Indeed, if the insured vigorously defends the claim and wins, its refusal to pay would be entirely vindicated. Surely there would be coverage for the costs of defending such a claim even though it alleged breach of a pre-existing payment obligation. The *Eaton Vance* rule thus makes sense only if and when the "pre-existing obligation" already has been established by judgment or admitted by the insured. If the claim is settled while the insured is legitimately disputing the existence of any obligation to pay, the rule against coverage should not apply.

This limitation on applicability of the *Eaton Vance* rule is consistent with the holding in *Eaton Vance* itself and in most of the other cases discussed

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> of the activities of others that might overlap the claims against the Insureds. Any type of *pro rata* or relative exposure analysis seems contrary to the language of the Policies. . . . In a situation where an insured is jointly and severally liable, the insured would be legally and financially liable for the entire amount of any judgment. And, absent contribution (voluntarily or by way of a cross-claim) from any other defendant, the insured would have to pay the entire amount of the judgment. The insured would be entitled to full indemnification if that amount is an insured loss.

132. *See* Providence Health & Servs. v. Certain Underwriters at Lloyd's, 440 F. Supp. 3d 1223, 1229 (W.D. Wash. 2002) (rejecting insurers' request for "allocation of damages to a non-covered claim where, as here, the damages in question were recoverable both under a covered theory and an uncovered theory"); Winbrook Comm' Servs., Inc. v. United States Specialty Ins. Co., 52 N.E.3d 195, 200 (Mass. App. Ct. 2016) (insured entitled to coverage for damages from covered negligence claim even though "those damages also might be similar or equivalent to contract damages").

herein.[133] In each of those cases, the insured's pre-existing contractual or statutory obligation was either undisputed or already had been established by judgment or other adjudication. Thus, it could be said without hesitation that the insureds in those cases *in fact* had an obligation to pay the amounts at issue irrespective of whether a claim had been made against them. The same cannot be said when the insured vigorously disputes that it has or ever had any obligation to pay the damages sought in the underlying claim.

The proposed limitation on applicability of the *Eaton Vance* rule also is consistent with the wording of most liability policies, which already include exclusions that expressly apply to the sort of intentional misconduct that lies at the heart of the "moral hazard" problem. So-called "conduct exclusions" in policies typically exclude coverage for claims arising out of the insured's intentional, deliberate, or willful acts or omissions only if such misconduct is established by a final adjudication, or sometimes if admitted by the insured. Similarly, most policies also exclude coverage for claims arising out of the insured's gaining any profit or financial advantage or remuneration to which it is not legally entitled, but again, only if it is established (or admitted) that the insured is not entitled to keep the funds at issue. In the absence of such an adjudication or admission, it is clear from the wording of those policies that settlements of claims merely alleging such misconduct or improper "profit" are covered.

Cases involving coverage for settlements of claims seeking restitution or disgorgement are instructive on both of these points. The issue in those cases is typically framed as whether (1) settlement of a claim for restitution is a "loss" for purposes of the policy, or (2) restitution is uninsurable as a matter of public policy. Beginning with *Level 3 Communications*, *Inc. v.*

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133. *See*, *e.g.*, Pac. Ins. Co. v. Eaton Vance Mgmt., 369 F.3d 584, 586–87, 591 (1st Cir. 2004) (noting that the insured admitted its contractual obligation under the Plan documents); *Baylor Heating*, 987 F.2d at 415; Republic Franklin Ins. Co. v. Albemarle Cnty. Sch. Bd., 670 F.3d 563, 568 (4th Cir. 2012) (holding did not address settlements of contested claims and was limited to "any judgment against the [insured]" and, moreover, court noted that the insured "concedes that the obligation to pay back wages and over-time pay is a preexisting duty that was not the result of its wrongful act in allegedly violating the FLSA"); Waste Corp. of Am. Inc. v. Genesis Ins. Co., 382 F. Supp. 2d 1349 (S.D. Fla. 2005) (settlement entered into after jury verdict finding insured liable for breach of contract); August Entm't, Inc. v. Phila. Indem. Ins. Co., 52 Cal. Rptr. 3d 908, 911 (Ct. App. 2007) (insured admitted in the underlying settlement agreement that it owed the amount claimed under the contract and agreed to a stipulated judgment; policy excluded liability for breach of contract); Newman v. XL Spec. Ins. Co., No. C-1-06-781, 2007 U.S. Dist. LEXIS 74293, at *2 (S.D. Ohio Sept. 24, 2007) (judgment creditor of insured sought coverage for amounts insured already had been held contractually liable to pay; court noted absence of policy language extending coverage to breach of contract claims); Am. Cas. Co. of Reading, Pa. v. Hotel & Rest. Emps & Bartenders Int'l Union Welfare Fund, 942 P.2d 172, 175–77 (Nev. 1997) (settlement for which coverage was sought followed a judgment establishing the insured's legal liability).

Federal Insurance Co.,[134] numerous courts have held that "a 'loss' within the meaning of an insurance contract does not include the restoration of an ill-gotten gain."[135] The analog between that rule and the *Eaton Vance* rule is obvious. The *Eaton Vance* rule applies in cases where the insured refuses to pay an amount it allegedly had a contractual or statutory duty to pay—in other words, the insured is accused of having wrongfully retained money for itself that the law requires it to disgorge to the plaintiff. It is thus no surprise that insurers often assert both the *Eaton Vance* and *Level 3* arguments together when disclaiming coverage for settlements of such claims.

In cases addressing the *Level 3* issue (whether settlements of restitution claims are a "loss" that is insurable), there has been a significant trend in recent years toward finding such settlements covered, at least where there has been no admission or finding of fact that the insured *actually* wrongfully withheld funds which it then returned via its settlement payment. Some of these courts have based their holdings on the fact that, unless and until it has been determined that some amount was wrongfully withheld, the settlement payment cannot be characterized as restitution or disgorgement.[136] The rule against insuring restitution or disgorgement simply does not apply if the settlement payment is not *in fact* restitution or disgorgement. As the court in *Indian Harbor* explained: "If allegations of unlawful activity are never determined to be true, a payment to dispose of those allegations is not restitution because restitution can only occur if that which is being returned was wrongfully taken."[137] "The Court emphasizes that it will not automatically presume—as the Insurers do—that the settlement constitutes restitution because it resolved claims alleging ill-gotten gains and seeking disgorgement of those gains."[138]

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134. Level 3 Commc'ns, Inc. v. Fed. Ins. Co., 272 F.3d 908 (7th Cir. 2001),

135. *Id.* at 910–11 ("An insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return.").

136. *See*, *e.g.*, U.S. Bank N.A. v. Indian Harbor Ins. Co., 68 F. Supp. 3d 1044, 1049–52 (D. Minn. 2013) (settlement payment resolving claim for restitution was covered and not uninsurable because there had been no adjudication determining the alleged wrongful conduct and ordering restitution of the sums at issue); TIAA-CREF v. Ill. Nat'l Ins. Co., 2016 Del. Super. LEXIS 545, at *31–35 (Oct. 20, 2016) ("TIAA-CREF settled and expressly denied any liability. The Court finds no conclusive link between the settlements in the Underlying Actions and wrongdoing by TIAA-CREF that would render the settlement agreements uninsurable disgorgement."); Axis Reins. Co. v. Northrop Grumman Corp., 975 F.3d 840 (9th Cir. 2020) (public policy rules against the insurability of restitution and disgorgement "may not be applicable where, as here, there was no final adjudication of" the insured's liability).

137. *Indian Harbor*, 68 F. Supp. 3d at 1052.

138. *Id.* at 1050. Even the cases that have denied coverage for settlement payments deemed to be "restitution" or "disgorgement" have emphasized the importance of the linkage between the payment and its amount and the improper activity / ill-gotten gain alleged. Where such a linkage is absent, or when the amount of the settlement payment cannot be tied back to the amount by which the insured allegedly profited, the payment cannot be characterized as restitution or disgorgement. *See*, *e.g.*, *Level 3 Commc'ns*, 272 F.3d at 911–12 (noting that the

Other courts have based their holdings on the policy wording as a whole, which clearly contemplates that settlements of restitution and disgorgement claims are not excluded. As noted, the typical "conduct" and "illegal profit" exclusions preclude coverage for restitution damages only when there has been a final adjudication establishing the excluded conduct. If settlements of claims seeking restitution or disgorgement were nevertheless excluded under the policies' "loss" provisions, an irreconcilable conflict would arise that effectively renders the "final adjudication" requirement meaningless.[139] The Delaware Superior Court in *Sycamore*, explained:

> Insurance companies are free to sell insurance that expressly excludes coverage for cases in which restitution or disgorgement damages or settlements are obtained. In fact, that is what the Insurers tried to do in these Policies, but they cabined the exclusion to cases in which a claimant obtained a "final,

insured never argued it was entitled to keep the funds at issue and refusing to decide whether "[i]f Level 3 *had* shown that the fraud suit was groundless, that there was no ill-gotten gain that insurance would enable it to keep, would the $12 million be a 'loss' within the meaning of the policy?"); Vigilant Ins. Co. v. Credit Suisse First Boston Corp., 800 N.Y.S.2d 358 (Sup. Ct. 2003) ("The final judgment *specifically links* the disgorgement payment to the improper activity that the SEC complaint alleged. This is not merely a case in which a party settled an action without admitting liability. . . . A different outcome [in which disgorgement payments are deemed insurable] might result when parties settle under different circumstances."); Phila. Indem. Ins. Co. v. Sabal Ins. Grp., Inc., 786 F. App'x 167, at *12–16, 19–20 (11th Cir. Aug. 26, 2019)) (disagreeing with the insured's argument that an insurer could only deny coverage for ill-gotten gains if it was determined by a final non-appealable judgment or adjudication, and determining that the carve-out from the definition of Loss and personal profit exclusion are not duplicative, but nevertheless holding "the amount of the Donation, $100,000, does not have a clear connection to the $235,192.13 that Sabal allegedly stole beyond the statute of limitations period. For these reasons, the Donation is not restitution"); Local 705 Int'l Bhd. of Teamsters Health & Welfare Fund v. Five Star Managers, L.L.C., 735 N.E.2d 679, 681 (Ill. App. Ct. 2000) (settlement was for the entire amount claimed by the underlying plaintiffs, plus interest, and judgment enforcing that settlement was issued on the grounds that the money had been taken from the claimants in violation of ERISA); Millennium Partners, L.P. v. Select Ins. Co., 882 N.Y.S.2d 849 (Sup. Ct. 2009) (slip op.), *aff'd*, 889 N.Y.S.2d 575 (App. Div. 2009) ("[T]he SEC Order established a conclusive link between disgorgement and the improperly acquired funds. Even though Millennium Partnership settled and did not admit to the SEC's findings, the Court found no other reasonable interpretation of, or rationale for, the settlement."); J.P. Morgan Securities Inc. v. Vigilant Ins. Co., 936 N.Y.S.2d 102, 103 (App. Div. 2011) ("*J.P. Morgan I*"), *rev'd*, 992 N.E.2d 1076 (N.Y. 2013) ("*J.P. Morgan II*") ("Here, too [like *Millennium Partners*], read as a whole, the offer of settlement, [and] the SEC Order . . . are not reasonably susceptible to an interpretation other than that Bear Stearns knowingly and intentionally facilitated illegal late trading for preferred customers, and that the relief provisions of the SEC Order required disgorgement of funds gained through that illegal activity.").

139. *See, e.g.*, Gallup, Inc. v. Greenwich Ins. Co., 2015 Del. Super. LEXIS 129, at *28–30 (Feb. 25, 2015) ("Defendant contemplated coverage for restitution and specifically decided that reimbursement for restitution would only be precluded upon a final adjudication that the money Plaintiff received was actually restitution."); U.S. Bank N.A. v. Indian Harbor Ins. Co., 68 F. Supp. 3d 1044, 1050 (D. Minn. 2013 ("The policies unambiguously require that a final adjudication in the underlying action determine that a payment is restitution before the payment is barred from coverage as restitution."); Sycamore Partners Mgmt., L.P. v. Endurance Am. Ins. Co., C.A. No. N18C-09-211, 2021 Del. Super. LEXIS 182, at *26–29 (Feb. 26, 2021) (same).

non-appealable" decision in the underlying litigation establishing that Sycamore gained personal profit or remuneration to which it was not entitled.[140]

The same reasoning applies equally with respect to settlement payments resolving claims for an amount the insured allegedly had a pre-existing obligation to pay. Just as the courts in *Indian Harbor*, *TIAA-CREF*, and *Northrop Grumman* held, unless and until the insured's actual liability is determined (by adjudication or otherwise), it cannot be said that the settlement payment actually constitutes an amount the insured had a pre-existing obligation to pay. Under those circumstances, the settlement payment is a "loss" "because of" or "resulting from" a claim for a "wrongful act," and thus falls squarely within the policy's insuring agreement. Moreover, without a finding or admission of actual liability to pay, there is no moral hazard to protect against by denying the insured coverage for its settlement of the claim.

Similarly, just as the courts in *Sycamore*, *Gallup*, and *Indian Harbor* explained, there would be an irreconcilable conflict between the "final adjudication" requirement in the policies' conduct / illegal profit exclusions and the insuring agreement's "loss" provisions if the latter were construed to preclude coverage for settlements of claims alleging breach of a pre-existing payment obligation without any admission or finding of liability. Clearly, insurers know how to write an exclusion that would unambiguously preclude coverage for such settlements. When an insurance policy includes exclusionary language that specifically carves out settlements from its scope, the insurer must be held to the bargain it struck.

Only a handful of decisions have applied the *Eaton Vance* rule to a settlement payment resolving a claim where the existence of the insured's duty to pay was seriously in dispute.[141] In those cases, the courts seem to have based their expansion of the *Eaton Vance* rule to disputed settlements on the basis that failure to do so would worsen the moral hazard problem.

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140. *Sycamore P'ners*, 2021 Del. Super. LEXIS 182, at *26–29. *But see* Phila. Indem. Ins. Co. v. Sabal Ins. Grp., Inc., 786 F. App'x 167, at *12–16 (11th Cir. Aug. 26, 2019) (disagreeing with the insured's argument that an insurer could only deny coverage for ill-gotten gains if it was determined by a final non-appealable judgment or adjudication, and determining that the carve-out from the definition of Loss and personal profit exclusion are not duplicative).

141. *See, e.g.*, Health Net, Inc. v. RLI Ins. Co., 141 Cal. Rptr. 3d 649 (Ct. App. 2012). In Kittansett Club v. Phila. Indem. Ins. Co., 2012 U.S. Dist. LEXIS 127939, at *19 (D. Mass. Sept. 10, 2012), the court's opinion does not indicate whether or not the insured contested the allegation that it had wrongfully withheld gratuities that it had a duty to pay under Mass. Gen. Law. c. 149, § 152A. The court in the coverage action seemingly decided for itself that the settlement payment constituted restitution to fulfill a pre-existing obligation the insured actually owed. *Kittansett Club*, 2012 U.S. Dist. LEXIS 127939, at *19–22. As discussed herein, where the policy includes a "conduct exclusion" that requires a final adjudication in the underlying case establishing the allegations of excluded conduct, it would be improper for a court in an ensuing coverage action to reach such a factual determination for itself. The opinion in *Kittansett* does not indicate whether the policy included a conduct exclusion with "final adjudication" language of the type described herein.

For example, in *Health Net*, the insureds apparently argued "in passing" that their agreement to settle the claims did not establish that the amount paid was actually owed under the contract terms. In a footnote, the court rejected that argument, holding that coverage for the settlement is determined based on the allegations in the complaint, not the actual facts. The *Health Net* court explained its reasoning as follows:

> To the extent the underlying actions sought coverage for unpaid benefits, the underlying actions were not covered by the policy—thus no amounts paid to settle those claims were covered by the policy. *An insured cannot transform an uncovered contract claim into a potentially covered one simply by settling it prior to any decision being made on its merits*."[142]

The *Health Net* court's apparent concern about moral hazard—*i.e.*, an insured intentionally refusing to pay its contractual obligations while offering a pre-textual reason for doing so, forcing a lawsuit, and then "settling" for the full amount required under the contract—seems overblown and not grounded in the facts of the case. There was no evidence that Health Net was attempting to "game the system" in that fashion. Moreover, as discussed in Section IV, below, an insurer can easily protect itself against such risks by drafting specific exclusionary language that applies to settlements of such claims. In the absence of such exclusionary language, the *Eaton Vance* rule furnishes no independent basis for precluding coverage of such settlements.

IV. THE PURPORTED "MORAL HAZARD" PROBLEM IS EASILY ADDRESSED BY MORE PRECISE POLICY LANGUAGE EXCLUDING THOSE RISKS THAT INSURERS DO NOT WISH TO UNDERWRITE

As discussed herein, the purported "moral hazard" problem presented by insuring against an insured's settlement of a claim alleging breach of a pre-existing obligation to pay is actually quite limited.[143] The moral hazard

142. *Health Net*, 141 Cal. Rptr. 3d at 666 n.24 (emphasis added); *see also Level 3*, 272 F.3d at 911 (declaring that it "can't be right" that coverage for restitution could pivot on whether it was made by way of settlement or judgment because the insured, "seeing the handwriting on the wall," could simply agree "to pay the plaintiffs in the fraud suit all they were asking for" and then "retain the profit it had made from a fraud" through a coverage reimbursement).

143. Moreover, a rule precluding coverage for all such settlements on public policy grounds, irrespective of policy language, would create moral hazard problems of its own. For example, it may be more difficult for companies to persuade qualified directors and officers to serve in those roles if it is impossible to procure insurance for broad categories of claims that might be asserted against those persons. And, if insureds know that there will be no coverage for even a reasonable settlement of the claim against them, it disincentivizes settlements and encourages insureds to unreasonably take the case to trial in hopes of a defense verdict, however unlikely. Finally, given that the public policy rationale for the *Eaton Vance* rule depends on the insured actually having a pre-existing payment obligation, if the rule were expanded to preclude coverage for settlements of disputed claims, it would effectively encourage insurers

exists only if the insured *in fact* had a pre-existing obligation to pay the amount claimed, and even then, the public policy rationale against insuring such damages is really only meant to deter intentional breaches, not good-faith negligent ones.

Nevertheless, the concern expressed by Judge Posner in *May Department Stores* and the California appellate court in *August Entertainment*—that an insured might enter into a contract, baselessly decide not to make payment on it, settle the ensuing lawsuit for the full amount owed, and then look to its insurer for a bailout—is real. But an insurer who wishes to exclude coverage for such settlements can easily draft unambiguous policy language that accomplishes that end. Insurance is a creature of contract, and the policy language controls. In the absence of clear exclusionary wording, courts should not effectively re-write policies on public policy grounds, thus defeating policyholders' reasonable expectations of the coverage that they purchased.[144]

It is not difficult to imagine policy language that would ensure the results that many insurers seek to achieve through improper expansion of the *Eaton Vance* rule. Insurers who wish to exclude coverage for all breach of contract liabilities should include an express breach of contract exclusion that applies to any claim for actual or alleged liability under a contract (typically, unless the insured would have been liable even in the absence of the contract).[145] Insurers who are willing to cover some breach of contract liabilities but not an insured's breach of a pre-existing payment obligation can exclude from the definition of loss "restitution," "disgorgement," or "amounts due under a contract." And insurers who wish to exclude coverage even for settlements of claims seeking such damages can include specific exclusionary wording to that effect—either in the exclusions section of the policy or in the definition of Loss"—or they could reserve for themselves the right to establish the pre-existing obligation in a subsequent coverage action. (This reservation would be a modification of the standard "conduct exclusion" language, which requires that the excluded conduct be established by a final adjudication in the underlying proceeding.)

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to side against their insureds, crediting the allegations against them rather than seeking to assist in the defense against those allegations.

144. *See, e.g.*, KICC-Alcan Gen. v. Crum & Forster Specialty Ins. Co., 242 F. Supp. 3d 869, 879 (D. Alaska 2017) ("Like all insurance, this policy does create some moral hazard. But that hazard can be mitigated by changing the policy language, and the Court will not distort the plain language of this contract to achieve a policy result.").

145. *See, e.g.*, Verticalnet, Inc. v. U.S. Specialty Ins. Co., 492 F. Supp. 2d 452, 458–60 (E.D. Pa. 2007) (rejecting insurer's moral hazard argument and noting that insurers who do not wish to underwrite such risks can easily include language in their policies that excludes coverage for breach of contract claims; many policies do just that); *Nat'l Cas. Co. v. Fulton Cnty.*, 2018 U.S. Dist. LEXIS 51037, at *35 (N.D. Ga. Mar. 28, 2018) (moral hazard concerns cannot override the express policy language).

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It is hoped that courts, policyholders, and even insurers will find this article useful in delineating the boundaries of the *Eaton Vance* rule. In particular, policyholders should not be shy about advancing the arguments presented herein when faced with a coverage disclaimer based on an erroneous application of *Eaton Vance*. These issues will likely continue to be more fully litigated, reported decisions will help clarify the landscape, and, eventually, more precise policy language will be crafted that eliminates the ambiguity that has persisted to date.