# 7 Claims-Made and First-Party Policies

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# I. [7.1] ERRORS AND OMISSIONS INSURANCE

Errors and omissions (E & O) insurance policies are a type of professional liability policy intended to insure against risks inherent in particular professions. 9A Lee R. Russ and Thomas F. Segalla, COUCH ON INSURANCE 3D §131:38 (2008). One of the most common types of E & O policies is "malpractice insurance," carried by attorneys and doctors as required by law and the Rules of Professional Conduct. E & O policies are commonly also purchased by accountants, engineers, architects, insurance brokers, and anyone for whom providing a professional, information-based service is central to their occupation. *See, e.g., General Insurance Company of America v. Robert B. McManus, Inc.*, 272 Ill.App.3d 510, 650 N.E.2d 1080, 209 Ill.Dec. 107 (1st Dist. 1995); *Management Support Associates v. Union Indemnity Insurance Company of New York*, 129 Ill.App.3d 1089, 473 N.E.2d 405, 409, 85 Ill.Dec. 37 (1st Dist. 1984).

Unlike commercial general liability (CGL) insurance policies, there is no standard form for an E & O policy. However, the format of E & O policies tends to be relatively uniform, beginning with an insuring agreement providing coverage for a "wrongful act" occurring on or after the "retroactive date" if the claim is made and reported during the policy period.

E & O policies also commonly are subject to a self-insured retention endorsement or a deductible, which is usually listed on the declarations page of the policy.

The precise language of E & O policies varies, but the insuring agreements of most E & O policies provide something like the following:

**We will pay on your behalf those amounts, in excess of retention, you are legally obligated to pay as damages resulting from a claim first made against you and reported to us during a policy period or Extended Reporting Period (if applicable) for your wrongful act in rendering or failing to render professional services for others, but only if such wrongful act first occurs on or after the retroactive date and prior to the end of the policy period.**

## A. Prerequisites for Coverage Under an E & O Policy

### 1. [7.2] Claims-Made vs. Occurrence-Based

Like other professional liability coverage, E & O coverage is normally provided on a "claims-made" basis, meaning that the claims must be made against the insured and also reported to the insurer during the policy period. Claims made after a policy has expired are not covered unless notice is given during the policy term of facts or circumstances that might give rise to a claim. As with all insurance policies, it is important to check the policy itself to determine the extent of coverage. Some E & O policies provide "prior acts" coverage, for claims occurring prior to the policy inception, or "tail acts" coverage, for claims occurring after the policy has expired, but such coverage extensions entail higher premiums.

A "claim" is generally defined in an E & O policy as "a demand for money or services including a suit arising from your wrongful act." To the extent that a policy fails to define the

term "claim," courts have interpreted it as a specific demand for relief. *Insurance Corporation of America v. Dillon, Hardamon & Cohen,* 725 F.Supp. 1461, 1468 (N.D.Ind. 1988); *Home Insurance Co. v. Law Offices of Jonathan DeYoung, P.C.,* 32 F.Supp.2d 219, 226 (E.D.Pa. 1998); *Phoenix Insurance Co. v. Sukut Construction Co.,* 136 Cal.App.3d 673, 186 Cal.Rptr. 513, 515 (1982). A "claim" is distinguished from an "occurrence" in that a claim is brought by a third-party against the insured. *General Insurance Company of America v. Robert B. McManus, Inc.,* 272 Ill.App.3d 510, 650 N.E.2d 1080, 1083, 209 Ill.Dec. 107 (1st Dist. 1995). Courts recognize that the purpose of a claims-made policy is for the insurer's underwriter to be able to limit the risk to a particular time period; therefore, reporting the claim during the policy period is generally considered a condition precedent to coverage. *Continental Casualty Co. v. Cuda,* 306 Ill.App.3d 340, 715 N.E.2d 663, 669, 239 Ill.Dec. 909 (1st Dist. 1999); *Esmailzadeh v. Johnson & Speakman,* 869 F.2d 422, 424 – 425 (8th Cir. 1989) (applying Minnesota law); *EmCode Reimbursement Solutions, Inc. v. Nutmeg Insurance Co.,* 512 F.Supp.2d 603, 606 (N.D.Tex. 2007) (applying Texas law). *But cf. Lexington Insurance Co. v. Rugg & Knopp, Inc.,* 165 F.3d 1087 (7th Cir. 1999) (applying Wisconsin law, requiring insurer to show prejudice under claims-made-and-reported policy due to public policy of Wisconsin).

### 2. [7.3] Wrongful Acts Committed in the Performance of Professional Services

Under E & O policies, "wrongful act" is generally defined as "any actual or alleged negligent act, error or omission, misstatement or misleading statement committed solely in your performance of Professional Services."

"Professional services" is generally defined by a description of activities contained on the declarations page of the policy. Generally, the professional services covered are those that distinguish a particular occupation from other occupations due to specialized training or experience different from the ordinary activities of other businesses. Whether a particular act is a professional service is different for each occupation. 9A Lee R. Russ and Thomas F. Segalla, COUCH ON INSURANCE 3D §131:38 (2008). Generally, whether a particular act is a professional service will depend on whether the act utilizes the specialized training or learning of the profession, as distinguished from other ordinary activities common to all businesses such as paying bills, hiring staff, collecting accounts receivable, or maintaining files. *Medical Records Associates, Inc. v. American Empire Surplus Lines Insurance Co.,* 142 F.3d 512, 514 – 515 (1st Cir. 1998) (applying Massachusetts law; setting fees for medical records was not professional service of medical records company); *Visiting Nurse Association of Greater Philadelphia v. St. Paul Fire & Marine Insurance Co.,* 65 F.3d 1097, 1101 – 1102 (3d Cir. 1995) (applying Pennsylvania law; discharge planners do not provide hospital with "professional services"); *Crum & Forster Managers Corp. v. Resolution Trust Corp.,* 156 Ill.2d 384, 620 N.E.2d 1073, 1079, 189 Ill.Dec. 756 (1993) (actions of setting up competing real estate business were not "professional services" of real estate professionals).

To qualify for coverage, the claims must be caused by the "wrongful act," or, as the Illinois Supreme Court has stated, "the claims made against the insureds by the underlying plaintiff must arise *because of* an act, error, or omission in the insured's performance of [professional services]." [Emphasis in original.] *Crum & Forster Managers, supra.* Also, the wrongful act must first occur on or after the retroactive date of the policy.

## B. [7.4] E & O Policy Exclusions

E & O policies contain coverage exclusions both within the insuring language of the policy and within endorsements following the main body of the policy. As with CGL policies, courts construe exclusions on professional liability policies narrowly in favor of coverage. Some exclusions are profession-specific, but there are also standard exclusions that are common to almost all E & O policies. As with CGL policies, courts will apply exclusions to bar coverage under an E & O policy only when their application is "clear and free from doubt" (*General Insurance Company of America v. Robert B. McManus, Inc.*, 272 Ill.App.3d 510, 650 N.E.2d 1080, 1083, 209 Ill.Dec. 107 (1st Dist. 1995)), and ambiguities will be resolved in favor of coverage (*Smith v. Neumann*, 289 Ill.App.3d 1056, 682 N.E.2d 1245, 1251, 225 Ill.Dec. 168 (2d Dist. 1997)).

### 1. [7.5] Damages Typically Covered by Other Policies

E & O policies generally exclude coverage for claims or occurrences that are typically covered by CGL or other insurance policies. For example, E & O policies typically exclude coverage for bodily injury, personal injury, and advertising injury.

### 2. [7.6] Insured Versus Insured

E & O policies also exclude coverage for claims made by one insured against another. For example, legal professional liability policies ordinarily do not cover claims by one attorney in a law firm against another attorney in the same firm.

### 3. [7.7] Governmental Agency Action

E & O policies also usually exclude coverage for claims brought by a governmental agency against the insured.

### 4. [7.8] "Prior-Acts" Exclusion

E & O policies usually include "prior-acts" exclusions. Under such exclusions, there is no coverage if an insured knows or has reason to know of a potential claim prior to the inception of the policy period. Most jurisdictions, including Illinois, apply these exclusions based on what the insured should have known based on an objective standard, rather than a subjective standard. *Smith v. Neumann*, 289 Ill.App.3d 1056, 682 N.E.2d 1245, 1254 – 1255, 225 Ill.Dec. 168 (2d Dist. 1997) (applying objective standard, attorney had basis to believe his drafting errors might result in claim prior to policy period, so coverage was excluded under prior-acts exclusion). *See also Mt. Airy Insurance Co. v. Thomas*, 954 F.Supp. 1073, 1079 (W.D.Pa. 1997). In contrast, a minority of courts look to what facts were actually and subjectively known by the insured. *Westport Insurance Corp. v. Atchley, Russel, Waldrop & Hlavinka, L.L.P.*, 267 F.Supp.2d 601 (E.D.Tex. 2003). Ordinarily, in this context, knowledge of an employee may not be imputed to the employer, if the employee alone had actual knowledge of the wrongful act. 9A Lee R. Russ and Thomas F. Segalla, COUCH ON INSURANCE 3D §131:38 (2008), citing *American Financial Corp. v. Fireman's Fund Insurance Co.*, 15 Ohio St.2d 171, 239 N.E.2d 33, 44 Ohio Op.2d 147 (1968).

### 5. [7.9] Prior-Policies Exclusion

Many E & O policies prevent "stacking" of insurance policies by excluding claims covered by a previous professional liability policy. *Smith v. Neumann,* 289 Ill.App.3d 1056, 682 N.E.2d 1245, 225 Ill.Dec. 168 (2d Dist. 1997) (found to be valid exclusion to coverage).

### 6. Exclusions Addressing Particular Types of Conduct

#### *a. [7.10] Dishonesty/Fraud/Criminal or Malicious-Conduct Exclusion*

Dishonesty/fraud/criminal or malicious conduct is excluded from coverage under E & O policies. 9A Lee R. Russ and Thomas F. Segalla, COUCH ON INSURANCE 3D §131:38 (2008). Depending on the jurisdiction and the language of the exclusion, a court may require the allegedly dishonest or fraudulent act to be intentional to come under the policy exclusion. *Compare Continental Casualty Co. v. Reed,* 306 F.Supp. 1072 (D.Minn. 1969) (for exclusion to apply, act must have been actually intentional), *with Northland Insurance Co. v. Stewart Title Guaranty Co.,* 327 F.3d 448 (6th Cir. 2003) (exclusion applied regardless of whether intentional or negligent conduct was alleged).

#### *b. [7.11] Personal-Gain Exclusion*

"Personal gain," *i.e.,* the insured gaining a profit or advantage to which he or she was not legally entitled, is excluded from coverage. However, this exclusion may not apply to an insured corporation. *Commercial Union Insurance Co. v. Auto Europe, L.L.C.,* No. 01 C 6961, 2002 U.S.Dist. LEXIS 3319 at **10 – 11 (N.D.Ill. Feb. 26, 2002); *Brown & LaCounte, L.L.P. v. Westport Insurance Corp.,* 307 F.3d 660 (7th Cir. 2002).

#### *c. [7.12] Business-Enterprise Exclusion*

The business-enterprise exclusion excludes coverage for the insured's ownership of or interest in ventures outside of the insured firm.

#### *d. [7.13] Contract Exclusion*

The contract exclusion excludes coverage for liability that arises solely because of a contract when the insured would not be liable absent the contract.

## C. [7.14] Special Issues Under E & O Policies

When the claim is made and when the claim is reported are critical issues with respect to coverage under an E & O insurance policy. Unlike CGL policies, which generally provide coverage for events occurring during the policy period, E & O policies require that claims be made and reported during the policy period. Both requirements must be met. A claim first must be made against the insured during the policy period, and, in addition, reporting the claim during the policy period is a condition precedent to coverage. In addition, the "wrongful act" must first occur on or after the retroactive date of the policy.

Another unique issue in applying E & O policies (in contrast with standard CGL policies) involves the actor's state of mind that gives rise to the claim. Courts are split as to whether E & O policies cover errors or omissions that are not negligent. *Compare New Hampshire Insurance Co. v. Westlake Hardware, Inc.*, 11 F.Supp.2d 1298, 1301 (D.Kan. 1998) (coverage only for negligent acts), *with USM Corp. v. First State Insurance Co.*, 420 Mass. 865, 652 N.E.2d 613 (1995). Some courts find that whether a policy provides coverage for intentional acts, as well as negligent acts, depends on the language of the policy. *Continental Casualty Co. v. Cole,* 809 F.2d 891, 896 (D.C.Cir. 1987) (finding potential for coverage for both negligent and intentional acts because of policy language covering any "error, negligent omission or negligent act"); *Independent School District No. 697, Eveleth, Minnesota v. St. Paul Fire & Marine Insurance Co.*, 515 N.W.2d 576, 579 (Minn. 1994) (finding potential for coverage for intentional acts when policy language covered "an error or omission, negligence, breach of duty"); *Corporate Realty, Inc. v. Gulf Insurance Co.*, No. 04-2933 SECTION "L"(2), 2005 U.S.Dist. LEXIS 1394 at *18 (E.D.La. Jan. 28, 2005) (holding there was potential for coverage for intentional acts when policy language covered any "errors, omissions, or negligent acts").

However, Illinois courts thus far have found there is no potential for coverage for intentional acts under an E & O policy, regardless of the policy language. *Management Support Associates v. Union Indemnity Insurance Company of New York,* 129 Ill.App.3d 1089, 473 N.E.2d 405, 410, 85 Ill.Dec. 37 (1st Dist. 1984). Courts are also currently split as to whether E & O policies cover claims couched in terms of breach of contract, although it appears those claims may be covered in Illinois, at least when they arguably arise out of negligent conduct. *Management Support, supra,* 473 N.E.2d at 411 – 412.

## II. [7.15] DIRECTORS AND OFFICERS INSURANCE

Directors and officers (D & O) insurance provides protection for the directors and officers of corporations when they are sued in connection with their duties to the company. Due to caselaw extensions of the scope of D & O coverage, D & O policies have evolved toward expressly providing coverage to the corporation in addition to and to the same extent that they provide coverage to the directors and officers, should such coverage be desired.

### A. [7.16] Prerequisites for Coverage Under D & O Policies

D & O insurance provides coverage that is similar in some ways to E & O insurance. D & O policies cover "claims" for "wrongful acts" taking place during or prior to the policy period. More than almost any other type of policy, the language of D & O policies varies greatly from policy to policy. This is partially due to the relative newness of this type of coverage and is a reflection of the bargaining power of the corporations purchasing those policies. Because D & O coverage is relatively expensive, the companies purchasing D & O policies often negotiate language specific to their own needs.

Generally, D & O policies encompass the following alternative coverages:

**Coverage A for liability for the directors and officers.** Coverage A provides coverage for claims when the corporation is not legally bound or is otherwise unable or unwilling to indemnify its officers and directors, such as situations in which public policy or corporate bylaws prohibit indemnification, or the current board decides against permissive indemnification.

**Coverage B for liability of the corporation itself, to the extent it must indemnify directors and officers.** Coverage B provides coverage for the corporation to the extent it indemnifies its officers and directors for a covered claim. It generally covers both permissive and mandatory indemnification.

**Coverage C for liability of the corporation to the extent it is liable for a violation of federal securities law.** Coverage C provides coverage for the company to the extent it is held individually responsible.

### 1. [7.17] "Wrongful Act" Requirement

D & O policies provide coverage for "wrongful acts" resulting in "claims." D & O policy language varies in its definition of "wrongful acts." The most prevalent definition of "wrongful acts" contained in D & O policies and quoted in cases is "any negligent act, error, omission, misstatement or misleading statement." *See, e.g., Golf Course Superintendents Association of America v. Underwriters of Lloyd's, London,* 761 F.Supp. 1485, 1489 (D.Kan. 1991). *Accord Florists' Mutual Insurance Co. v. Ludy Greenhouse Manufacturing Corp.,* 521 F.Supp.2d 661, 686 (S.D. Ohio 2007); *Waste Corporation of America, Inc. v. Genesis Insurance Co.,* 382 F.Supp.2d 1349, 1352 (S.D.Fla. 2005) (excluding coverage for intentional acts based on public policy and not policy language). Another typical definition of "wrongful acts" is "any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the Directors or Officers while acting in their individual or collective capacities, or any matter, not excluded by the terms and conditions of the policy, claimed against them solely by reason of their being Directors or Officers of the Company." *See Ratcliffe v. International Surplus Lines Insurance Co.,* 194 Ill.App.3d 18, 550 N.E.2d 1052, 1059 – 1060, 141 Ill.Dec. 6 (1st Dist. 1990) (language from D & O policy issued by International Surplus Lines Insurance Company). *See also Federal Insurance Co. v. Kozlowski,* 18 A.D.3d 33, 792 N.Y.S.2d 397, 399 (2005) (quoting similar language).

### 2. [7.18] Wrongful Act v. Business Decision

A "wrongful act" is potentially covered by a D & O policy, but a "business decision" is not. However, distinguishing between the two can be a challenge. *New Madrid County Reorganized School District No. 1, Enlarged v. Continental Casualty Co.,* 904 F.2d 1236 (8th Cir. 1990).

### 3. [7.19] Requirement of a "Claim"

In D & O policies, a "claim" is generally defined as a written demand, suit, or formal administrative or regulatory proceedings. Earlier D & O policies failed to define a "claim," and

courts interpreted a "claim" to mean an assertion of a legal right, broader than a lawsuit but not including informal inquiries. *See National Union Fire Insurance Company of Pittsburgh, Pa. v. Continental Illinois Corp.*, 673 F.Supp. 300, 307 (N.D.Ill. 1987) (distinguishing "claim" from "loss"); *Olson v. Federal Insurance Co.*, 219 Cal.App.3d 252, 268 Cal.Rptr. 90 (1990); *Murray Industries, Inc. v. Federal Insurance Co. (In re Murray Industries, Inc.)*, 122 B.R. 135 (Bankr. M.D.Fla. 1990). Depending on the language of a policy, an administrative investigation (for example, a Securities and Exchange Commission investigation) may constitute a "claim." *Minuteman International, Inc. v. Great American Insurance Co.*, No. 03 C 6067, 2004 U.S.Dist. LEXIS 4660 (N.D.Ill. Mar. 18, 2004) (noting, however, "losses" do not encompass equitable relief).

### 4. [7.20] Notice and Reporting

D & O polices generally require claims to be made within a particular policy period to be covered, and they also require notice "as soon as practicable" of potential claims. Most D & O policies also contain a so-called "claim substitute" clause. A claim substitute clause allows the insured to report "any circumstances which may subsequently give rise to a claim," and if such an anticipatory report is made, coverage will be provided under the policy period during which the report was made, even though a formal claim arising from those circumstances might not be made until a subsequent policy period. *See, e.g., California Union Insurance Co. v. American Diversified Savings Bank*, 914 F.2d 1271 (9th Cir. 1990); *American Casualty Company of Reading, Pennsylvania v. Federal Deposit Insurance Corp.*, 944 F.2d 455 (8th Cir. 1991).

### 5. [7.21] Severability Clauses

D & O polices usually provide coverage for several separate insureds, including multiple officers and directors, all of whom may be named in a third-party lawsuit even if each did not have actual knowledge of the facts out of which the same claim could arise at the time of the policy application. To avoid the overly harsh result of allowing an insurer to rescind an entire D & O policy on the basis of one of several insureds' knowledge, D & O policies typically also contain a "severability clause" in the application, stating that the knowledge of one of the insureds shall not be imputed to the other insureds. See, *e.g.*, the severability clause referenced in *Travelers Indemnity Co. v. Bally Total Fitness Holding Corp.*, 448 F.Supp.2d 976, 983 (N.D.Ill. 2006). Therefore, a D & O policy may not provide coverage to a director or officer who knew of a potential claim but failed to disclose it, but coverage remains available to other directors and officers if they had no knowledge of the potential wrongful act. *In re HealthSouth Corporation Insurance Litigation*, 308 F.Supp.2d 1253 (N.D.Ala. 2004). However, it should be noted that coverage for the company itself may be rescinded due to a material misrepresentation on the policy by one of the directors or officers. *See, e.g., ClearOne Communications, Inc. v. National Union Fire Insurance Company of Pittsburgh, Pennsylvania*, 494 F.3d 1238 (10th Cir. 2007) (applying Pennsylvania law).

### 6. [7.22] Payment of "Loss"

D & O policies generally undertake to pay "loss" on behalf of the insured(s). *Mortenson v. National Union Fire Insurance Co.*, No. 99 C 2419, 1999 U.S.Dist. LEXIS 12275 at *2 (N.D.Ill.

1999). A "loss" may be defined as "any amount which the insureds are legally obligated to pay for a claim or claims against them for Wrongful Acts . . . provided that such subject of loss shall not include fines or penalties imposed by law or other matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed." *Id.* Other policies provide a similar definition of loss, but provide the types of losses excluded from coverage in the exclusions rather than the insuring agreement. See, *e.g.*, the policy at issue in *Florists' Mutual Insurance Co. v. Ludy Greenhouse Manufacturing Corp.*, 521 F.Supp.2d 661 (S.D. Ohio 2007).

### 7. [7.23] No Duty To Defend

Most D & O policies do not create a duty to defend the insured since they are "indemnification" rather than "liability" policies. *In re WorldCom, Inc. Securities Litigation,* 354 F.Supp.2d 455, 469 (S.D.N.Y. 2005). The insured normally controls the defense, and the policy provides for reimbursement of the defense costs. The defense costs must be paid as they are incurred. *Id.; Bernstein v. Genesis Insurance Co.,* 28 Fed.Appx. 560, 562 (7th Cir. 2002); However, most D & O policies are "burning limits" policies in which the defense costs reduce the amount available for indemnification.

In states adopting the "reasonably related rule," all costs reasonably related to the loss are recoverable. *Continental Casualty Co. v. Board of Education of Charles County, Maryland,* 302 Md. 516, 489 A.2d 536, 544 (1985). However, the majority rule applied by most courts is that only the amounts the insured is "legally obligated to pay" are recoverable. *Telxon Corp. v. Federal Insurance Co.,* 309 F.3d 386, 393 (6th Cir. 2002).

### 8. [7.24] Claims Made and Reported

Claims must be made and reported in the same policy period. That the claim be made during the policy period is generally an absolute prerequisite to coverage.

### 9. [7.25] Disclosures of Potential Claims

Illinois courts interpret the disclosure of a potential claim under an objective standard, not a subjective standard. *Ratcliffe v. International Surplus Lines Insurance Co.,* 194 Ill.App.3d 18, 550 N.E.2d 1052, 141 Ill.Dec. 6 (1st Dist. 1990). However, a minority of courts from other jurisdictions apply a subjective standard. *Liebling v. Garden State Indemnity,* 337 N.J.Super. 447, 767 A.2d 515, 519 (2001); *Citizens Bank of Jonesboro, Arkansas v. Western Employers Insurance Co.,* 865 F.2d 964 (8th Cir. 1989) (applying Arkansas law).

### 10. [7.26] Are the Acts Covered?

Depending on the language of the D & O policy, it may or may not provide coverage for acts related to, but not solely within, the official capacity of the directors and officers. *Ratcliffe v. International Surplus Lines Insurance Co.,* 194 Ill.App.3d 18, 550 N.E.2d 1052, 141 Ill.Dec. 6 (1st Dist. 1990).

## B. [7.27] Common D & O Policy Exclusions

D & O policies contain exclusions in the insuring agreement and in separate endorsements. Some of the common exclusions are discussed in §§7.28 – 7.34 below.

### 1. [7.28] Exclusions for Coverage That Is Provided by Other Policies

As is the case with many other "specialty" policies, D & O policies generally exclude claims for bodily injury, property damage, and personal or advertising injury because those claims could or should be covered by other policies. They also typically exclude environmental claims for the same reason.

### 2. [7.29] Exclusions for Prior or Pending Claims

D & O policies ordinarily exclude claims for litigation pending prior to the inception of the policy period, as well as any losses "in any way related to" claims pending prior to the inception of the policy period.

### 3. [7.30] Exclusions for Deliberate Acts

D & O policies also typically exclude claims for deliberate, fraudulent, or malicious acts or omissions, but courts require that the acts be truly deliberate before that exclusion will be given effect. *Citizens First National Bank of Princeton v. Cincinnati Insurance Co.*, 200 F.3d 1102 (7th Cir. 2000) (must actually be deliberate for exclusion to apply).

### 4. [7.31] Insured Versus Insured

D & O policies also exclude coverage for litigation between the officers and directors or between the officers and directors and the company. It has been noted that a literal application of the insured-versus-insured exclusion might bar coverage even for lawsuits in which the insured is a minor party, or in which another party is bringing the claim in the place of the insured. *Federal Deposit Insurance Corp. v. Zaborac*, 773 F.Supp. 137, 143 – 144 (C.D.Ill. 1991) (strictly applying insured-versus-insured exclusion to bar claims by FDIC standing in shoes of insured, although finding exclusion inapplicable with respect to claim by FDIC standing in shoes of shareholder); *Bernstein v. Genesis Insurance Co.*, 28 Fed.Appx. 560, 562 (7th Cir. 2002).

More recently, some courts have looked at the intent of the insured-versus-insured exclusion, which is to prevent collusive action by insureds, rather than the literal language, and have allowed coverage for non-collusive lawsuits between the directors, officers, and corporation. *MegAvail Inc. v. Illinois Union Insurance Co.*, No. 05-1374-AS, 2006 U.S.Dist. LEXIS 53658 (D.Or. July 19, 2006) (applying Oregon law) (holding primary purpose of insured-versus-insured exclusion is to prevent collusion, and since there was no clear evidence of collusion, summary judgment in favor of insured was not warranted). Other courts have also refused to strictly apply the insured-versus-insured exclusion to bar all recovery. *See, e.g., Level 3 Communications, Inc. v. Federal Insurance Co.*, 168 F.3d 956, 960 – 961 (7th Cir. 1999) (applying Nebraska law) (holding presence of one of insureds did not eliminate coverage for entire claim; rather, it required allocation between covered and noncovered claims).

### 5. [7.32] Personal Profit

When a director or officer has gained a profit or advantage to which he or she is legally not entitled, a claim arising from such conduct will be excluded under a D & O policy.

### 6. [7.33] Regulatory Exclusion

Due to the generally expansive definition of a "claim," if an insurer providing D & O coverage wishes to exclude regulatory or administrative investigations from coverage, it must include a "regulatory exclusion." *Compare Federal Deposit Insurance Corp. v. Zaborac,* 773 F.Supp. 137, 140 (C.D.Ill. 1991) (regulatory exclusion clearly barred coverage for claims related to cause of action brought by FDIC against bank), *with Walsh v. Employers Insurance of Wausau,* No. 85 C 1770, 1985 U.S.Dist. LEXIS 14027 (N.D.Ill. 1985) (lawsuit brought by FDIC was at least potentially covered by D & O policy; therefore, insurer's motion to dismiss was denied).

### 7. [7.34] Tax Liability

Public policy prohibits insurance coverage for a corporation's failure to pay its taxes. *St. Paul Fire & Marine Insurance Co. v. Briggs,* 464 N.W.2d 535, 539 (Minn.App. 1990).

## C. [7.35] Special Issues Under D & O Policies

A special issue arising under D & O policies is the allocation between losses covered by the policy and losses not covered when litigation involves officers and directors and the company itself. In *Caterpillar, Inc. v. Great American Insurance Co.,* 62 F.3d 955, 963 (7th Cir. 1995), the Seventh Circuit concluded that coverage was available for 100 percent of the settlement of the underlying lawsuit brought against the uninsured corporation and the insured officers and directors. *See also Level 3 Communications, Inc. v. Federal Insurance Co.,* No. 96 C 5346, 1999 U.S.Dist. LEXIS 13338 (N.D.Ill. Aug. 17, 1999) (rejecting claim that portion of settlement should be apportioned to uninsured corporation).

When a claim against an insured is settled, special issues may also arise as to whether the insured is legally obligated to pay for a loss under the settlement. In *Genesis Insurance Co. v. FTD.COM, Inc.,* No. 03 C 4444, 2004 U.S.Dist. LEXIS 9854 (N.D.Ill. May 28, 2004), shareholders sued Florists' Transworld Delivery, Inc. (FTDI), which held an 83-percent interest in FTD.COM, in connection with a sale of FTD.COM stock. The shareholders settled for $10.7 million in FTDI stock. As part of the settlement, FTD.COM executed a promissory note under which it promised to reimburse FTDI for the $10.7 million. The note provided that the amount of the indebtedness would be reduced if FTD.COM was unable to recover the full amount from its insurers. 2004 U.S.Dist. LEXIS 9854 at *4. In an unreported decision, the District Court for the Northern District of Illinois held that FTD.COM was not legally obligated to pay based on the language of the settlement agreement; however, the court found that the promissory note did create a legal obligation on the part of FTD.COM and denied the D & O carrier's motion for judgment on the pleadings. 2004 U.S.Dist. LEXIS 9854 at **7 – 11.

## III. [7.36] EMPLOYMENT PRACTICES LIABILITY POLICIES

Employers purchase employment practices liability insurance (EPLI) to protect against employment-related exposures, including discrimination and sexual harassment lawsuits. These policies are designed to protect the employers from vicarious liability for the acts of their employees, not to protect the employees themselves. EPLI may be provided through a separate policy, or an EPLI endorsement can be made a part of an existing CGL policy or D & O policy, providing coverage for employment-related claims. See, *e.g.*, the policy described in *Farmers Automobile Insurance Ass'n v. St. Paul Mercury Insurance Co.*, No. 05-1331, 2006 U.S.Dist. LEXIS 40711 (C.D.Ill. June 19, 2006).

### A. [7.37] Prerequisites for Coverage Under EPLI Policies

Little "standard" policy language has developed for EPLI policies, and to the extent there is standard policy language, it has only rarely been interpreted by the courts. *Krueger International, Inc. v. Royal Indemnity Co.*, 481 F.3d 993, 994 (7th Cir. 2007) (noting dearth of caselaw interpreting provisions of EPLI policies). Different policies may provide significantly different coverage depending on their language.

EPLI policies generally provide coverage for claims against an employer, directors, and officers for specifically enumerated "Wrongful Employment Practices" or "Employment Wrongful Acts," including discrimination, harassment, wrongful termination, retaliation, and other workplace torts (negligent supervision or training, for example) against the employer by potential, current, or past employees. *Farmers Automobile Insurance Ass'n v. St. Paul Mercury Insurance Co.*, 482 F.3d 976, 976 – 977 (7th Cir. 2007). See also the EPLI policy described in *West Bend Mutual Insurance Co. v. Rosemont Exposition Services, Inc.*, 378 Ill.App.3d 478, 880 N.E.2d 640, 643 – 644, 316 Ill.Dec. 904 (1st Dist. 2007). EPLI policies often specifically cover Equal Employment Opportunity Commission proceedings as well as interoffice complaints. EPLI policies provide coverage for a wide range of damages including backpay, front pay, compensatory damages, and attorneys' fees. Where not prohibited by law, some also provide coverage for punitive damages.

#### 1. [7.38] Deductibles and Self-Insured Retentions

As is the case with many other "specialty" insurance policies, EPLI policies usually have deductibles or self-insured retention amounts that must be satisfied by payments by the insured before any coverage is available. See, *e.g.*, the employment practices liability policy described in *West Bend Mutual Insurance Co. v. Rosemont Exposition Services, Inc.*, 378 Ill.App.3d 478, 880 N.E.2d 640, 645, 316 Ill.Dec. 904 (1st Dist. 2007).

#### 2. [7.39] Claims-Made

EPLI policies are usually provided on a claims-made-and-reported basis. See, *e.g.*, the EPLI policy described in *West Bend Mutual Insurance Co. v. Rosemont Exposition Services, Inc.*, 378 Ill.App.3d 478, 880 N.E.2d 640, 643, 316 Ill.Dec. 904 (1st Dist. 2007), covering claims made and

reported to the insurer during a single policy period. Some provide the insured with a certain period of time thereafter (a runout period) to report claims. Other EPLI policies are pure claims-made policies, covering claims made during the policy period and reported "as soon as practicable."

### 3. [7.40] Duty To Defend

Most EPLI policies contain a duty to defend on behalf of the insurer. Some allow the employer to select its own counsel, and some do not. Many EPLI policies are "burning limits" policies, in which any amount paid for defense erodes the amounts available for indemnity. See, *e.g.*, the EPLI policy described in *West Bend Mutual Insurance Co. v. Rosemont Exposition Services, Inc.*, 378 Ill.App.3d 478, 880 N.E.2d 640, 642, 316 Ill.Dec. 904 (1st Dist. 2007).

## B. Common EPLI Policy Exclusions

### 1. [7.41] Coverage Provided by Other Policies

Like other non-CGL insurance policies, EPLI policies exclude coverage for bodily injury, property damage, or personal and advertising injury. They also exclude coverage for independent contractors; there are separate policies designed to provide the same coverage for only independent contractors.

### 2. [7.42] Particular Wrongful Acts

EPLI policies typically exclude claims arising out of particular state and federal statutes, including ERISA and the Fair Labor Standards Act, and similar claims for violation of state minimum wage laws. *Farmers Automobile Insurance Ass'n v. St. Paul Mercury Insurance Co.*, 482 F.3d 976 (7th Cir. 2007). They also typically exclude workers' compensation claims since there is other insurance available to expressly cover workers' compensation claims.

EPLI policies also generally exclude any claims for breach of an employment contract and do not provide coverage for claims for exclusively nonmonetary relief. They also do not cover fines or penalties imposed by the government. EPLI policies do not cover fraudulent, dishonest, or criminal conduct or any claim the insured had reason to know of prior to the inception of the policy.

### 3. [7.43] Claims Arising out of Written Employment Agreements

EPLI policies generally do not provide coverage for claims rooted in breach of a written employment agreement, on the apparent rationale that those claims can be prevented with careful drafting of written employment agreements. *Krueger International, Inc. v. Royal Indemnity Co.*, 481 F.3d 993, 995 (7th Cir. 2007).

## C. [7.44] Special Issues Under EPLI Policies

EPLI policies are relatively new, so there is a dearth of caselaw interpreting the policy provisions.

Where not prohibited by law, some EPLI policies provide coverage for punitive damages.

Some EPLI policies provide coverage when employees are leased to another employer, but some do not; whether there is coverage depends on the language employed.

Although there is no standard policy language for EPLI policies, most are offered only on a claims-made-and-reported basis. See, *e.g.*, the policy described in *Executive Risk Indemnity, Inc. v. Chartered Benefit Services, Inc.*, No. 03 C 3224, 2005 U.S.Dist. LEXIS 15411 (N.D.Ill. July 29, 2005). Depending on the wording of the policy, the claims-made-and-reported requirement may be an absolute prerequisite to coverage, or it might allow the insured to report the claim within a "reasonable time."

Most EPLI policies include "administrative proceedings" within their definition of a "claim," and courts have, consistent with that definition, found that EEOC hearings are potentially covered "claims" that must be disclosed during the notice period. *American Center for International Labor Solidarity v. Federal Insurance Co.*, 518 F.Supp.2d 163 (D.D.C. 2007) (EEOC hearings are "claims" that must be reported); *Williams v. Synergy Care, Inc.*, No. 07-0137, 2008 U.S.Dist. LEXIS 57242 (W.D.La. July 29, 2008) (finding definition of "claim" is broad enough to encompass EEOC hearings); *National Waste Associates, LLC v. Travelers Casualty & Surety of America*, No. CV 07-5013789-S, 2008 WL 2746021 (Conn.Super. June 20, 2008) (EEOC hearings are potential claims under EPLI policy).

## IV. [7.45] ENVIRONMENTAL IMPAIRMENT LIABILITY POLICIES

Environmental impairment liability insurance (EIL) policies are specialized insurance policies designed to cover liability and cleanup costs associated with pollution and hazardous waste removal. They are often sold as endorsements to commercial general liability policies or first-party property policies. In the 1970s, insurers began to offer EIL policies to fill the gap left by the pollution exclusions in CGL policies and to specifically cover environmental remediation required by the Comprehensive Environmental Response, Compensation and Liability Act. *Doerr v. Mobil Oil Corp.*, 774 So.2d 119, 126 (La. 2000). EIL policies have been widely available in the United States since the 1980s. *Olin Corp. v. Insurance Company of North America*, 221 F.3d 307 (2d Cir. 2000).

### A. [7.46] Prerequisites for Coverage Under EIL Policies

EIL policies are generally provided on a "claims-made" basis. Like other specialty policies, the insuring language of EIL policies varies. There is relatively little judicial precedent interpreting the language of EIL policies. *Masonite Corp. v. Great American Surplus Lines Insurance Co.*, 224 Cal.App.3d 912, 274 Cal.Rptr. 206 (1990) (noting dearth of caselaw interpreting EIL policies). Most EIL policies provide for indemnification for the insured for damages incurred by reason of liability imposed on the insured by law due to (1) personal injury, (2) property damage, or (3) impairment with an environmental right protected by law, presuming such costs and expenses are incurred with the prior written consent of the insurer. However, depending on the insuring agreement, an EIL policy may or may not cover on- or off-site pollution and may cover claims for property damage but not for bodily injury or economic loss.

The EIL insurer generally agrees to reimburse the insured for costs and expenses of operations outside the insured's premises to remove, neutralize, or clean up any substance released or escaped that has caused "environmental impairment" or that could cause "environmental impairment" if not removed, neutralized, or cleaned up. Reimbursement is typically limited to the extent that such costs and expenses have been incurred or have become payable by the insured as a result of a legal obligation or in the endeavor to avert a loss covered by the policy.

### 1. [7.47] Environmental Impairment

EIL policies provide coverage for claims for "environmental impairment." *Central Illinois Public Service Co. v. Allianz Underwriters Insurance Co.*, 158 Ill.2d 218, 633 N.E.2d 675, 198 Ill.Dec. 834 (1994). Environmental impairment generally includes a wide range of pollutants to cover the gap left by the "absolute pollution exclusions" found in most present-day CGL policies. EIL policies provide coverage for "environmental impairment," sometimes defined as

> **damage to the environment caused by:**
>
> **(1) the emission, discharge, dispersal, release, seepage, or escape of smoke, vapors, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants, into or upon land, the atmosphere or any watercourse or body of water, or**
>
> **(2) the generation of odor, noises, vibrations, light, electricity, radiation, changes in temperature, or any other sensory phenomena arising out of or in the course of the INSURED'S operations** [that is] **neither expected nor intended.** *Masonite Corp. v. Great American Surplus Lines Insurance Co.*, 224 Cal.App.3d 912, 274 Cal.Rptr. 206, 209 (1990).

### 2. [7.48] Claims-Made

Most EIL policies are claims-made policies, often with substantial policy limits to compensate for extraordinarily high environmental remediation costs. See, *e.g.*, the policies at issue in *Central Illinois Public Service Co. v. American Empire Surplus Lines Insurance Co.*, 267 Ill.App.3d 1043, 642 N.E.2d 723, 204 Ill.Dec. 822 (1st Dist. 1994) ($15 million), and *Rhone-Poulenc Inc. v. International Insurance Co.*, 71 F.3d 1299 (7th Cir. 1995) ($20 million per claim and $40 million per occurrence). A typical definition of "claim" in EIL policies is "any single claim or series of claims from one or multiple claimants resulting from the same isolated, repeated or continuing environmental impairment." See the EIL policy language quoted in *Insurance Company of North America v. Kayser-Roth Corp.*, No. PC 92-5248, 1999 WL 813661 at *9 (R.I.Super. July 29, 1999). Some policies specifically provide coverage for third-party claims for property damage and bodily injury as well as governmental action. See, *e.g.*, the policy at issue in *Alan Corp. v. International Surplus Lines Insurance Co.*, 823 F.Supp. 33 (D.Mass. 1993) (strictly construing claims-made requirements of policy to preclude coverage for cleanup required by EPA after expiration of policy period even though notice of contamination was made during policy period).

Where the term "claim" is not defined by a policy, the Illinois courts will require a formal demand by a third party to establish a "claim" under a claims-made EIL policy. *Central Illinois Public Service, supra.* In Illinois, the insurer is not liable until such a formal claim is made during the policy period, even if it is apparent the insured will be liable for the cleanup. *Id.* Although Illinois has strictly construed the term "claim" when determining if coverage is available under an EIL policy, other states and federal courts have found a "claim" even where there has been no formal claim or demand by a third party. 14 COUCH ON INSURANCE 3D §201:13 (2008), citing *International Insurance Co. v. RSR Corp.*, 426 F.3d 281 (5th Cir. 2005) (claim for environmental impairment is not limited to filing of CERCLA action by EPA, but may also include listing location on EPA National Priorities List). Under rulings in some jurisdictions, a "claim" may include a "demand for action" from an environmental authority. *Cargill, Inc. v. Evanston Insurance Co.*, 642 N.W.2d 80, 85 (Minn.App. 2002).

### 3. [7.49] Deductibles, SIRs, and Burning Limits

Most EIL policies provide for indemnification as well as reimbursement of defense costs. See, *e.g.*, the policy at issue in *Waste Management Inc. v. International Surplus Lines Insurance Co.*, 144 Ill.2d 178, 579 N.E.2d 322, 161 Ill.Dec. 774 (1991). In many EIL policies, defense costs are be charged against the limits of liability, commonly known as "burning limits." See, *e.g.*, the policy at issue in *W.R. Grace & Co. v. Maryland Casualty Co.*, 33 Mass.App.Ct. 358, 600 N.E.2d 176 (1992).

Most EIL policies have a self-insured retention (SIR) endorsement or a significant deductible, and some also have an additional percentage of cleanup costs that must be borne by the insured.

## B. Common EIL Policy Exclusions

### 1. [7.50] Intentional Acts

EIL policies generally exclude from the definition of covered "environmental impairment" any intentional acts. *Central Illinois Public Service Co. v. Allianz Underwriters Insurance Co.*, 158 Ill.2d 218, 633 N.E.2d 675, 198 Ill.Dec. 834 (1994); *Masonite Corp. v. Great American Surplus Lines Insurance Co.*, 224 Cal.App.3d 912, 274 Cal.Rptr. 206 (1990) (interpreting exclusion for expected or intended actions to preclude coverage where insured's actions were intentional even if resulting damage was not). *See also McReynolds v. Petroleum Marketers Mutual Insurance Co.*, 1992 WL 178630 (Tenn.App. July 29, 1992) (where dumping itself was not intended by insured, therefore there was potentially covered "environmental impairment").

### 2. [7.51] Own Property

An exclusion for damage to the insured's own property is generally strictly construed to preclude all first-party damages under EIL policies. Lee R. Russ and Thomas F. Segalla, 9 COUCH ON INSURANCE 3D §126:38 (2008), citing *Golden Eagle Refinery Co. v. Associated International Insurance Co.*, 85 Cal.App.4th 1300, 102 Cal.Rptr.2d 834 (2001).

### 3. [7.52] Particular Types of Damages

EIL policies are narrowly designed to cover only damages arising out of the insured's liability for "environmental impairment" and therefore have fewer exclusions than CGL policies, which are designed to provide broad liability coverage. EIL policies generally do not provide coverage for governmental fines and penalties even where they do provide coverage for cleanup required by the government. Modern EIL policies also exclude coverage for damages arising out of asbestos or lead remediation. Punitive damages are also commonly excluded.

### 4. [7.53] Sudden and Accidental Release of Pollutants

EIL policies generally exclude coverage for losses that could be or should be covered by an insured's CGL policy. The exclusion for pollution in many CGL insurance policies makes an exception for "sudden and accidental losses"; therefore, EIL policies may exclude coverage for the sudden and accidental release of pollutants. See, *e.g.,* the policy at issue in *Masonite Corp. v. Great American Surplus Lines Insurance Co.,* 224 Cal.App.3d 912, 274 Cal.Rptr. 206 (1990).

## C. [7.54] Special Issues Under EIL Policies; Allocation Among Insurers

EIL and CGL insurers are often both called on to indemnify an insured facing liability for environmental damage. Therefore, allocation among EIL insurers and among EIL and CGL insurers for environmental damage is commonly addressed by the courts. EIL policies may purportedly be excess to an insured's CGL coverage pursuant to "other insurance" clauses, but courts are unlikely to count CGL policies as primary over EIL policies for environmental impairment liability, absent a clear indication that was the intention of the insurer and insured when entering into the contract. *Rhone-Poulenc Inc. v. International Insurance Co.,* 71 F.3d 1299 (7th Cir. 1995); *Cargill, Inc. v. Evanston Insurance Co.,* 642 N.W.2d 80, 88 – 89 (Minn.App. 2002). Where an insured could have purchased EIL coverage, but chose not to, a court may allocate uninsured policy years to the insured. *Olin Corp. v. Insurance Company of North America,* 221 F.3d 307, 326 – 327 (2d Cir. 2000).

Failure of the insured to present evidence to allocate damages between covered and noncovered damages may be fatal to the insured's case seeking coverage under several policies for environmental damage. *Golden Eagle Refinery Co. v. Associated International Insurance Co.,* 85 Cal.App.4th 1300, 102 Cal.Rptr.2d 834 (2001). However, the principles applicable to allocate the risk among occurrence-based policies may not be applicable to EIL or other claims-made policies. Lee R. Russ and Thomas F. Segalla, 15 COUCH ON INSURANCE 3D §220:25 (2008), citing *Champion Dyeing & Finishing Co. v. Centennial Insurance Co.,* 355 N.J.Super. 262, 810 A.2d 68, 73 (2002) (holding that continuous trigger is not applicable to claims-made coverage; therefore only those policies in place at time injury manifested itself are on risk). EIL policies specifically cover only those claims arising during their policy period. *Id.*

## V. [7.55] FIRST-PARTY POLICIES

Most insurance policies described in this chapter are third-party policies, that is, they provide coverage for claims against the insured made by third parties. Those policies are in contrast to first-party policies, which provide coverage for losses incurred directly by the insured. Two common types of first-party insurance are (1) property insurance and (2) business interruption insurance, which is often provided ancillary to first-party property insurance. Sections 7.46 – 7.59 below provide a brief overview of these two types of insurance.

### A. [7.56] Property Insurance

Property insurance is purchased by businesses and individuals alike to provide coverage for their real or personal, commercial or personal, property. Property insurance generally covers "direct physical loss" to "covered property" resulting from any "covered cause of loss." Direct physical loss is one that occurs as a natural result of the covered cause of loss. A "named-perils" policy is designed to limit the cause of loss to a single specifically enumerated cause of damage, whereas a "multiperil" policy (also referred to as an "all-risk" policy) covers multiple potential causes. An important difference exists between named-perils policies and multiperil policies. With a named-perils policy, for coverage to apply, the insured must prove that the loss was caused by a *covered* cause of loss. With a multiperil policy, if a loss to covered property occurs, it is initially assumed that coverage applies. However, coverage may be denied if the insurer can prove that the loss was caused by an excluded cause of loss. Most all-risk policies contain specific exclusions for losses caused by "contamination," earth movement, water (flood, waves, tides, etc.), and enforcement of laws or ordinances.

#### 1. [7.57] Prerequisites for Coverage Under First-Party Property Policies

Typical language providing coverage in a first-party property insurance policy provides:

**We will pay for direct physical loss of or damage to Covered Property at the premises described in the Declarations caused by or resulting from any Covered Cause of Loss.**

For a detailed description of the insurance available through first-party property and business interruption insurance, see John H. Mathias, Jr., et al., INSURANCE COVERAGE DISPUTES, Ch. 11, p. 11-1 (1996).

The insured bears the initial burden of establishing a direct physical loss to covered property resulting from a covered cause of loss (or peril). *St. Michael's Orthodox Catholic Church v. Preferred Risk Mutual Insurance Co.*, 146 Ill.App.3d 107, 496 N.E.2d 1176, 100 Ill.Dec. 111 (1st Dist. 1986) (policyholder's burden to initially establish coverage under policy); *Reed v. Commercial Insurance Co.*, 248 Or. 152, 432 P.2d 691, 693 (1967) (policyholder's burden to initially establish existence of potentially covered peril). Property insurance policies do not usually define the term "direct physical loss." Courts have interpreted the term to mean a loss that occurs as an immediate or proximate result of a covered peril. *Louisville & Jefferson County Metropolitan Sewer District v. Travelers Insurance Co.*, 753 F.2d 533, 537 (6th Cir. 1985)

(applying Kentucky law; direct physical loss when there was no intervening cause). *See also Marshall Produce Co. v. St. Paul Fire & Marine Insurance Co.*, 256 Minn. 404, 98 N.W.2d 280, 289 (1959). However, there is no real consensus among courts interpreting "direct physical loss" when the cause of the loss is not clearly "direct." *Compare Granchelli v. Travelers Insurance Co.*, 167 A.D.2d 839, 561 N.Y.S.2d 944 (1990) (finding direct physical loss when wind blew door open resulting in water damage from frozen pipes), *with Williams v. Liberty Mutual Fire Insurance Co.*, 334 Mass. 499, 135 N.E.2d 910 (1956) (finding there was no direct physical loss when wind blew shutters open, resulting in water damage when pipes froze). This example is taken from INSURANCE COVERAGE DISPUTES, Ch. 11, p. 11-6.

Even though the declarations page on a property insurance policy generally lists the address of the "covered property," property insurance covers the policyholder's interests in the property and not the property itself. Therefore, two or more policies may cover various interests in the property; for example, a mortgagor and mortgagee may each separately insure their legal interests in a single property. To be entitled to coverage under a property insurance policy, an insured must demonstrate a legal or "insurable" interest in the property. *Whitten v. Cincinnati Insurance Co.*, 189 Ill.App.3d 90, 544 N.E.2d 1169, 136 Ill.Dec. 394 (4th Dist. 1989). A majority of jurisdictions require that the policyholder have an insurable interest at the time of the policy's issuance, and a minority, including Illinois, require only that the policyholder have an insurable interest at the time of the covered loss. *Compare Peninsular Fire Insurance Co. v. Fowler,* 166 So.2d 206 (Fla.App. 1964), *with Hawkeye-Security Insurance Co. v. Reeg,* 128 Ill.App.3d 352, 470 N.E.2d 1103, 83 Ill.Dec. 683 (5th Dist. 1984). See also INSURANCE COVERAGE DISPUTES, Ch. 11, p. 11-7. The legal or insurable interest in the property does not require ownership or title to the property; rather, it requires that the policyholder suffer a loss due to the destruction of the property or a profit due to the continued existence of the property. *Harrison v. Fortlage,* 161 U.S. 57, 40 L.Ed. 616, 16 S.Ct. 488 (1896); *Reznick v. Home Insurance Co.*, 45 Ill.App.3d 1058, 360 N.E.2d 461, 4 Ill.Dec. 525 (1st Dist. 1977). See also INSURANCE COVERAGE DISPUTES, Ch. 11, p. 11-6.

Even a party responsible for the temporary care of the property can have an insurable interest in it. *Traders Insurance Co. v. Pacaud & Co.*, 51 Ill.App. 252 (1st Dist. 1893) (property insurance insures interest in property, not property itself, and can therefore be extended to anyone with interest in property, even when such interest is temporary); *Keystone Fabric Laminates, Inc. v. Federal Insurance Co.*, 407 F.2d 1353 (3d Cir. 1969) (applying Pennsylvania law; bailee may insure its independent interest in property in its care, custody, and control). *See also Lititz Mutual Insurance Co. v. Lengacher,* 248 F.2d 850 (7th Cir. 1957) (building contractor has insurable interest in building); *Big John, B.V. v. Indian Head Grain Co.*, 718 F.2d 143 (5th Cir. 1983) (bailee has insurable interest in property in its temporary custody); *Daeris, Inc. v. Hartford Fire Insurance Co.*, 105 N.H. 117, 193 A.2d 886 (1963) (tenant has insurable interest in improvements made to leased property). For a comprehensive discussion of insurable interests, see INSURANCE COVERAGE DISPUTES, Ch. 11, pp. 11-8 through 11-10.

Property insurance policies provide coverage for a variety of covered perils. Fire insurance is the most common type of property insurance. 1 Lee R. Russ and Thomas F. Segalla, COUCH ON INSURANCE 3D §1:37 (2008). Other common covered perils include burglary or theft, water, weather, and "natural forces," including flood or water damage, hail, lightning, and windstorms. *Id.* When the policy provides for coverage for multiple perils, it can be relatively easy to

determine if the loss results from a covered peril. However, if a policy provides coverage only for losses arising out of defined covered perils, determining whether the damage is proximately caused by a covered peril can be more difficult.

Courts have generally used one of two causation approaches to address situations in which covered perils and noncovered perils combine, either an "efficient proximate causation" analysis or a "concurrent causation" analysis. INSURANCE COVERAGE DISPUTES, Ch. 11, p. 11-15. According to the efficient proximate causation analysis, coverage is available if the primary cause of the loss is a covered peril. *See, e.g., Howell v. State Farm Fire & Casualty Co.,* 218 Cal.App.3d 1446, 267 Cal.Rptr. 708 (1990). In contrast, under a concurrent causation analysis, which is used by Illinois courts, coverage is available if any one of the multiple potential causes was a covered peril. *Mattis v. State Farm Fire & Casualty Co.,* 118 Ill.App.3d 612, 454 N.E.2d 1156, 73 Ill.Dec. 907 (5th Dist. 1983); *Henning Nelson Construction Co. v. Fireman's Fund American Life Insurance Co.,* 361 N.W.2d 446 (Minn.App. 1985).

Most property insurance policies have a "sue-and-labor" provision requiring the insured to take necessary steps to minimize continued damage to the property. For example, when a roof is damaged in a windstorm, the insured is required to take necessary steps to ensure the interior of the property is not further damaged.

### 2. [7.58] Common First-Party Property Insurance Exclusions

Property insurance polices have exclusions found in the insuring agreement as well as separate endorsements. It is important to keep in mind that property insurance is generally designed to cover only specific types of risks, including flood, fire, or windstorm damage.

#### *a. [7.59] Increased Risk or Hazard Within the Knowledge of the Insured*

Property insurance policies generally exclude coverage for materially increasing the risk that damage will occur to the property. See John H. Mathias, Jr., et al., INSURANCE COVERAGE DISPUTES, Ch. 11, p. 11-22 (1996). See, *e.g.,* the policy discussed in *Industrial Development Associates v. Commercial Union Surplus Lines Insurance Co.,* 222 N.H.Super. 281, 536 A.2d 787 (1988).

#### *b. [7.60] Policyholder Neglect of the Property*

Similar to the sue and labor provision that requires the insured to take reasonable steps to make reasonable repairs to make sure the property is not further damaged, most property insurance policies exclude coverage for losses resulting from the policyholder's neglect, meaning the policyholder's "failure to use all reasonable means to save and preserve the property at and after the time of a loss, or when property is endangered." *Fetzer v. Safeco Insurance Co.,* No. CV-04-0092567-S, 2007 WL 4634728 at *1 (Conn.Super. Dec. 7, 2007) (failure to fix roof when it had been leaking intermittently for three years warranted denial of coverage when roof collapsed).

*c. [7.61] War Risks, Nuclear Accident, Governmental Action, Operations of Law*

Property insurance generally excludes damages arising out of war or combat, nuclear accidents, or governmental action, including zoning changes or eminent domain.

*d. [7.62] Damage Caused by Animals, Earth Movement, Volcanoes, Flooding, or Other Risks Specific to Certain Regions*

As mentioned in §7.56 above, property insurance is generally meant to cover specific risks. Unless those risks are enumerated in the policy, there is no coverage for earthquakes or volcanoes. However, to ensure those risks are unambiguously excluded, regional risks that might cause large-scale damages are regularly listed in the policy exclusions. In some cases, there may be specific insurance policies available for those risks in exchange for high policy premiums.

*e. [7.63] Pollution or Contamination*

Property insurance policies generally provide broad pollution exclusions, excluding coverage for loss or damage caused by or resulting from "discharge, dispersal, seepage, migration, release or escape of 'pollutants," with "pollutants" broadly defined as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot(,) fumes, acids, alkalis, chemicals and waste." *Ocean Partners, LLC v. North River Insurance Co.*, 546 F.Supp.2d 101, 104 (S.D.N.Y. 2008) (no coverage for particles released from World Trade Center site and landing on neighboring property due to absolute pollution exclusion).

*f. [7.64] Mold and Asbestos*

Due to the enormous verdicts in asbestos class actions in the past two decades, most property insurance policies issued within the past ten years have exclusions for any damages related in any way to the exposure or remediation of asbestos. Additionally, as media coverage of the potential harm due to mold exposure increased in the past two decades, most property insurance policies issued in the past several years have comprehensive mold exclusions precluding coverage for any damages "resulting directly or indirectly from or caused by mold, fungus, or spores, regardless of any other cause or event contributing concurrently to or in any sequence to the loss." *See, e.g., DeVore v. American Family Mutual Insurance Co.*, 383 Ill.App.3d 266, 891 N.E.2d 505, 322 Ill.Dec. 490 (2d Dist. 2008) (mold exclusion unambiguously excluded coverage for any damages relating to mold remediation).

### 3. [7.65] Special Issues Arising Under First-Party Property Insurance

The trigger of coverage for an occurrence spanning multiple policy periods arises as a potential issue in cases in which the covered peril causes damage slowly, such as water seepage, rather than a single dramatic occurrence, such as a windstorm. Courts use several different approaches to determine when a property insurance policy is triggered, including exposure (determining when the property was first exposed to the peril) (*Insurance Company of North America v. Forty-Eight Insulations, Inc.*, 633 F.2d 1212 (6th Cir. 1980)); manifestation (determining when the damage to the property first manifested itself) (*Reed v. Commercial*

*Insurance Co.*, 248 Or. 152, 432 P.2d 691 (1967); *Prudential-LMI Commercial Insurance v. Superior Court of San Diego County*, 51 Cal.3d 674, 798 P.2d 1230, 274 Cal.Rptr. 387 (1990); *Jackson v. State Farm Fire & Casualty Co.*, 108 Nev. 504, 835 P.2d 786 (1992)); and the most prevalent method, continuous trigger (coverage is available for any policies providing coverage during the time after exposure while the damage manifests itself) (*St. Michael's Orthodox Catholic Church v. Preferred Risk Mutual Insurance Co.*, 146 Ill.App.3d 107, 496 N.E.2d 1176, 100 Ill.Dec. 111 (1st Dist. 1986)). Just as the insured bears the initial burden of establishing the potential for coverage, the insured also bears the burden of establishing the trigger of coverage for each policy.

Usually, a property insurance policy contains an appraisal clause and a method for determining the value of a loss if the policyholder and insurer cannot agree on an appraiser. See discussion in John H. Mathias, Jr., et al., INSURANCE COVERAGE DISPUTES, Ch. 11, p. 11-22.4 (1996).

## B. [7.66] Business-Interruption Insurance

Business-interruption insurance is purchased by businesses to provide insurance against a loss of business income due to a particular risk beyond the control of the business owners. 1 Lee R. Russ and Thomas F. Segalla, COUCH ON INSURANCE 3D §1:61 (2008). It is generally purchased as a complement to commercial property insurance.

### 1. [7.67] Prerequisites for Coverage Under Business-Interruption Policies

There are several types of business-interruption coverage.

"Business-income coverage" reimburses the insured for the lost profits and the fixed costs of operating the business if the insured is forced to stop its operations due to damage to the business property. Typical policy language provides:

**We will pay for the actual loss of Business Income you sustain during the necessary suspension of your "operations" during the "period of restoration." The suspension must be caused by direct physical loss of or damage to a property at premises described in the Declarations and for which a Business Income Limit of Insurance is shown in the declarations.**

"Extra-expense coverage" provides supplemental coverage for the extra expenses incurred because of a covered business interruption such as moving fees, costs to set up a temporary location, and cleanup costs.

"Contingent business-interruption coverage" provides supplemental coverage (in addition to traditional business-income and extra-expense coverage) for losses "resulting from direct physical loss or damage insured . . . occurring at each supplier and customer location(s)." See, *e.g.*, the policy at issue in *Penton Media, Inc. v. Affiliated FM Insurance Co.*, 245 Fed.Appx. 495, 497 (6th Cir. 2007).

"Ingress/egress coverage" provides coverage for the loss sustained when the access to the business is prevented due to a direct result of an insured peril. See, *e.g.*, the policy at issue in *City of Chicago v. Factory Mutual Insurance Co.*, No. 02 C 7023, 2004 U.S.Dist. LEXIS 4266 (N.D.Ill. Mar. 11, 2004).

"Civil-authority coverage" reimburses the insured for lost profits when the insured is prevented from accessing or continuing the operations of the business because governmental authority prevents access to the property, usually due to severe weather, disturbances of the peace, or, more recently, the September 11 terrorist attacks. See, *e.g.*, *Southern Hospitality, Inc. v. Zurich American Insurance Co.*, 393 F.3d 1137 (10th Cir. 2004) (September 11 attacks). It is relatively rare, and therefore only a handful of reported cases exist interpreting its provisions. See, *e.g.*, the policies at issue in *United Airlines, Inc. v. Insurance Company of State of Pennsylvania*, 385 F.Supp.2d 343 (S.D.N.Y. 2005), and *South Texas Medical Clinics, P.A. v. CNA Financial Corp.*, No. H-06-4041, 2008 U.S.Dist. LEXIS 11460 (S.D.Tex. Feb. 15, 2008). Typical policy language provides:

**We will pay for the actual loss of Business Income you sustain and necessary Extra Expense caused by action of civil authority that prohibits access to the described premises due to direct physical loss of or damage to property other than the described premises caused by or resulting from any Covered Cause of Loss.**

### 2. [7.68] Common Business-Interruption Exclusions

Business-interruption coverage often is provided ancillary to first-party property insurance coverage; therefore, the policy exclusions common to first-party property insurance are often also common to business-interruption insurance. Furthermore, because business-interruption insurance is designed to provide narrowly defined coverage in the first place, there are few exclusions necessary to limit its coverage.

### 3. [7.69] Special Issues Under Business-Interruption Policies

Business-interruption coverage generally provides reimbursement for a direct loss or damage to the property. It covers only losses due to the complete interruption (not the slowing) of a business caused by a covered peril. *Broad Street, LLC v. Gulf Insurance Co.*, 832 N.Y.S.2d 1, 37 A.D.3d 126 (2006) (emphasizing total cessation of insured's business required for coverage under business-interruption policies, but finding "necessary suspension" after September 11 attacks qualified as total business interruption for coverage under business-interruption policy); *GTE Corp. v. Allendale Mutual Insurance Co.*, 372 F.3d 598 (3d Cir. 2004) (applying New Jersey law; no business-interruption coverage for Y2K remediation efforts because potential business interruption was not caused by covered peril).

The purpose of business-interruption coverage is to "protect the earnings which the insured would have enjoyed had no interruption occurred." *A. Miller & Co. v. Cincinnati Insurance Co.*, 217 Ill.App.3d 572, 577 N.E.2d 885, 887, 160 Ill.Dec. 560 (3d Dist. 1991). The main dispute arising regarding business-interruption coverage involves precisely which amounts should be included in determining the earnings the insured would have enjoyed in the absence of the

interruption. *See, e.g., Green v. International Insurance Co.*, 238 Ill.App.3d 929, 605 N.E.2d 1125, 179 Ill.Dec. 111 (2d Dist. 1992) (dispute involved determining whether monthly payments to owner-insured were lost income, and therefore covered, or noncontinuing business expense, and therefore not covered); *A. Miller & Co., supra* (court held costs to replace inventory that was used during interruption were not recoverable expenses); *DiLeo v. United States Fidelity & Guaranty Co.*, 109 Ill.App.2d 28, 248 N.E.2d 669 (1st Dist. 1969) (court held that payroll expenses less amount to retain key personnel should be deducted from expenses if business resumed, but if business did not resume, amount deducted would be payroll expenses less amount insureds would have had to pay to resume their business).

## C. Employee-Dishonesty/Fidelity Coverage

### 1. [7.70] Prerequisites for Coverage Under Employee-Dishonesty Policies

"Employee-dishonesty" or "fidelity" policies are designed to cover only direct, intentional losses caused by employee theft. Employee-dishonesty policies typically provide coverage for:

> **(A) Loss resulting directly from dishonest or fraudulent acts committed by an [e]mployee acting alone or in collusion with others.**
>
> **Such dishonest conduct or fraudulent acts must be committed . . . with manifest intent:**
>
> **(a) to cause the Insured to sustain a loss; and**
>
> **(b) to obtain financial benefit for the [e]mployee or another person or entity.**
>
> *RBC Mortgage Co. v. National Union Fire Insurance Company of Pittsburgh*, 349 Ill.App.3d 706, 812 N.E.2d 728, 730 – 731, 285 Ill.Dec. 908 (1st Dist. 2004).

"Loss" is generally defined to include "the unlawful taking of Money, Securities, or other property [from] the insured," but does not include other compensation such as ill-gotten bonuses. *Bradner Central Co. v. Federal Insurance Co.*, 257 Ill.App.3d 466, 628 N.E.2d 1129, 1130, 195 Ill.Dec. 665 (1st Dist. 1993); *Philips Electronics, N.V. v. New Hampshire Insurance Co.*, 312 Ill.App.3d 1070, 728 N.E.2d 656, 245 Ill.Dec. 574 (1st Dist. 2000).

### 2. [7.71] Common Employee-Dishonesty Exclusions

The coverage of employee-dishonesty policies is narrowly tailored to cover only an employer's direct loss due to employee theft; therefore, they do not contain many exclusions. They generally exclude losses arising from accounting errors, vandalism, and governmental seizure or destruction of the property. Employee-dishonesty policies also exclude damages for "inventory shortages"; however, where direct employee theft causes an inventory shortage, coverage may still be available under the policy. *Blitz Corp. v. Hanover Insurance Co.*, No. 95 C 2725, 1996 U.S.Dist. LEXIS 7761 (N.D.Ill. June 5, 1996).

### 3. [7.72] Special Issues Arising Under Employee-Dishonesty Policies

Employee-dishonesty policies provide coverage only for losses resulting *directly* from the dishonest or fraudulent acts committed by employees. Where an employee's dishonesty results in liability of the employer to a third party, a question may arise as to whether such a loss is a "direct" loss. Most courts, including courts in Illinois, find that such a loss is not a "direct" loss and is therefore not covered by employee-dishonesty policies. *RBC Mortgage Co. v. National Union Fire Insurance Company of Pittsburgh,* 349 Ill.App.3d 706, 812 N.E.2d 728, 285 Ill.Dec. 908 (1st Dist. 2004) (monetary settlement entered into by broker-employer with buyer of mortgage loans could not be direct loss under policy); *175 E. 74th Corp. v. Hartford Accident & Indemnity Co.,* 51 N.Y.2d 585, 416 N.E.2d 584, 435 N.Y.S.2d 584 (1980). However, in other jurisdictions, such losses may be covered, effectively transforming a first-party employee-dishonesty policy into a third-party liability policy. *Auto Lenders Acceptance Corp. v. Gentilini Ford, Inc.,* 181 N.J. 245, 854 A.2d 378 (2004). Third-party coverage may also be added by an endorsement to standard employee-dishonesty policies.

Employee-dishonesty policies provide coverage only where the dishonest employee intends to cause losses to the insured, sometimes requiring "manifest intent." Lee R. Russ and Thomas F. Segalla, 11 COUCH ON INSURANCE §161:3 3D (2008). Where an employee embezzles funds, such intent can be presumed since embezzlement is a zero-sum game; however, where the employee solicits funds from customers, however wrongly, manifest intent may not be present. *Compare Phillip R. Seaver Title Co. v. Great American Insurance Co.,* No. 08-CV-11004, 2008 U.S.Dist. LEXIS 95267 at *13 (E.D.Mich. Sept. 30, 2008) (embezzlement is zero-sum game; therefore, intent of employee to harm employer may be presumed and coverage was available under employee-dishonesty policy), *with Fireman's Fund Insurance Co. v. Special Olympics International, Inc.,* 346 F.3d 259 (1st Cir. 2003) (employee's intent in raising funds in insured's name from outside sources was to benefit himself but was not clearly intended to harm employer; therefore, there was no coverage under employee-dishonesty policy).

## VI. [7.73] CONCLUSION

Some of the issues arising with CGL and excess insurance policies are also relevant to claims-made and first-party insurance policies. Taken as a whole, each type of policy provides coverage for the gaps in coverage created by the insuring agreements and exclusions in the typical CGL and excess policies. This chapter is meant as an introduction to the issues and coverages available under several types of claims-made and first-party policies. Each insurance practitioner and insured must carefully review each policy provision and exclusion to apply them to the facts of each particular case.