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Leaking Windows Trigger CGL Insurer's Duty to Defend

The court in *Milwaukee Mutual Insurance Co. v. J.P. Larsen, Inc.*, No. 1-10-1316, 2011 Ill. App. LEXIS 872 (1st Dist. August 15, 2011), held that a CGL insurer was required to defend J.P. Larsen, Inc. ("Larsen"), a window caulking subcontractor, in a lawsuit alleging that Larsen's negligent window sealing work contributed to water damage. That water damage was caused by leaking windows in a condominium building. The court found that that underlying pleadings alleged damage to property other than Larsen's own defective work.

The underlying action in *Milwaukee Mutual* was brought by Weather-Tite, Inc. ("Weather-Tite"), a window installation subcontractor that had hired Larsen to apply window sealant to windows installed by Weather-Tite in the Prairie District Homes condominium building (the "PDH"). The windows subsequently leaked and caused water damage. The PDH homeowners' association (the "PDH Association") sued Weather-Tite for breach of express and implied warranties due to the faulty installation of the windows. Weather-Tite, in turn, filed a third-party complaint for contribution against Larsen, alleging that if the PDH Association prevailed on its breach of warranty claims against Weather-Tite, Larsen would be liable for contribution as a joint tortfeasor because Larsen had committed "negligent acts and/or omissions" in performing window sealing work for Weather-Tite. *See Milwaukee Mut. Ins.,* 2011 Ill. App. LEXIS 872, at *10.

Larsen tendered Weather-Tite's third-party complaint to Milwaukee Mutual Insurance Co. ("Milwaukee Mutual"), its CGL insurer. Milwaukee Mutual denied Larsen's tender and filed a declaratory judgment action, contending that the claim against Larsen was not covered because it did not seek damages because of "property damage" caused by an "occurrence." *See id*. at *2. Milwaukee Mutual and Larsen filed cross motions for summary judgment on the duty to defend. The trial court ruled in favor of Larsen, and Milwaukee Mutual appealed.

The *Milwaukee Mutual* appellate court affirmed, finding that the insurer was obligated to defend Larsen because the PDH Association's complaint against Weather-Tite, the allegations of which the court found to be "imputed against Larsen *vis-à-vis* the third-party complaint in which Larsen was alleged to be a joint tortfeasor based on negligence," established "property damage" resulting from an "occurrence" within, or potentially within, the terms of the Milwaukee Mutual policy. *Id.* at *14.

The *Milwaukee Mutual* appellate court first found that the underlying pleadings (the PDH Association's complaint and the third-party complaint) alleged "property damage." The Milwaukee Mutual policy defined "property damage" to mean, in relevant part, "physical injury to tangible property, including all resulting loss of use of that property . . . ." *See id*. at *11. In so ruling, the court rejected Milwaukee Mutual's arguments that: (1) economic losses caused by construction defects do not

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constitute "property damage;" and (2) the claims against Larsen were rooted in contract and, therefore, cannot involve covered "property damage." *See id*. at *11.

In determining whether the underlying pleadings alleged "physical injury to tangible property," the *Milwaukee Mutual* appellate court relied upon "the policy considerations behind CGL insurance." *See id*. at *12. The court stated that CGL policies are "intended to protect the insured from liability for injury or damage to the persons or property of others[,]" but are "not intended to pay the costs associated with repairing or replacing the insured's defective work and products, which are purely economic losses." *Id*. at *12 (quoting *Travelers Insurance Co. v. Eljer Manufacturing, Inc.*, 197 Ill. 2d 278, 314, 757 N.E.2d 481 (2001)).

The key to the *Milwaukee Mutual* court's conclusion that Larsen was entitled to a defense is that the PDH Association sought damages for property damage suffered by individual unit owners *in addition to* the repair or replacement of Larsen's faulty work. *See Milwaukee Mut. Ins.,* 2011 Ill. App. LEXIS 872, at *13. Specifically, the PDH Association's complaint alleged that "due to faulty construction, the condominium common elements, individual units and unit owners' personal property were damaged . . . ." *Id*. at *13. As the *Milwaukee Mutual* court explained, the "damages alleged are not merely construction defects, which would constitute economic losses not covered under the CGL policy . . . [t]he costs associated with the 'property damage' suffered by individual unit owners . . . are not intangible or merely associated with the repair or replacement of the faulty window caulking and sealant." *Id*. at *14. Concluding that the underlying pleadings adequately alleged the potential for covered "property damage,"' the *Milwaukee Mutual* court stated that, "[a]lthough the damages to the common elements, individual units and personal property were not expressly described, we must construe the pleadings liberally to allow for coverage, or, at least, the potential for coverage." *Id*. at *14.

The key to the *Milwaukee Mutual* court's conclusion that Larsen was entitled to a defense is that the PDH Association sought damages for property damage suffered by individual unit owners *in addition to* the repair or replacement of Larsen's faulty work.

The *Milwaukee Mutual* court also held that a contract-based claim can be covered under a CGL policy because "allegations based in contract have resulted in duties to defend as long as the damage is not to the actual property the insured was working on but, rather, is to other property caused by the insured's work product." *See id*. at *15. "[A]llegations of the pleading control over its form" including "the allegations in the third-party complaint [that] repeatedly state[d] that Larsen negligently completed the job for which it was hired." *See id.*

After finding that the underlying "pleadings alleged 'property damage' within, or at least potentially within, the definition of the CGL policy[,]" the *Milwaukee Mutual* court held that the "property damage" had been caused by an "occurrence" because as "damage to something other than the project itself *does* constitute an 'occurrence' under a CGL policy . . . . [D]efective workmanship could be covered if it damaged something other than the project itself." *Id*. at *17 (emphasis in original). Accordingly, the *Milwaukee Mutual* court found that the underlying pleadings alleged an "occurrence" because the "'property damage' that was, at least possibly, imputed to Larsen through his negligent workmanship" included damage to personal property and water damage to portions of the building other than Larsen's window sealing and caulking work. *Id*. at *19. ■

Bankruptcy and Insured versus Insured Exclusions Did Not Apply To Claims by Trustee against Company Directors

In *Yessenow v. Executive Risk Indemnity, Inc.*, No. 1-10-2920, 2011 WL 2623307 (June 30, 2011), the Illinois Appellate Court addressed the applicability of bankruptcy and "insured versus insured" exclusions within a D&O policy to a lawsuit filed by a trustee-in-bankruptcy against a healthcare company's former directors. In *Yessenow*, two former directors of iHealthcare were insureds under a D&O policy issued by Executive Risk Indemnity, Inc. (Executive). The policy contained an "insured versus insured" exclusion, stating:

> This policy does not apply to: (E) any Claim by or on behalf of, or in the name or right of, the Company or any Insured Person . . . .

Yessenow, 2011 WL 2623307 at *2. It also included this bankruptcy exclusion:

> (1) In the event that a bankruptcy . . . is commenced by or against the Company, no coverage will be available under the Policy for any Claim brought by or on behalf of:
>
> (a) The bankruptcy estate or the Company in its capacity as a Debtor in Possession; or
>
> (b) any trustee . . . appointed to take control of, supervise, manage or liquidate the Company . . . .

Id. at *2. iHealthcare was an insured under the policy.

After iHealthcare filed for Chapter 11 bankruptcy and one of its subsidiaries was forced into involuntary bankruptcy, a court-appointed trustee-in-bankruptcy filed suit against iHealthcare's former directors. *Yessenow*, 2011 WL 2623307 at *1. The former directors tendered the lawsuit to Executive under the D&O policy. Executive denied the tender raising the policy's "insured versus insured" and bankruptcy exclusions. In the ensuing declaratory judgment action, the trial court ruled in favor of the directors, finding that the "insured versus insured" exclusion was ambiguous and that the Bankruptcy Code precluded the use of the bankruptcy exclusion. *Id.* at *3. Applying Indiana law, the Illinois Appellate Court affirmed.

According to the court, "because a bankruptcy trustee is not asserting claims by or on behalf of the bankrupt entity but, rather, on behalf of the estate and for the benefit of the creditors, the trustee is not a trustee of the entity, but rather, is a trustee of the bankruptcy estate."

The appellate court first found that the "insured versus insured" exclusion did not preclude coverage for the trustee-in-bankruptcy's lawsuit. It rejected Executive's argument that the trustee was prosecuting an action "by or on behalf of or in the name or right of the Company or an Insured Person." According to the court, "because a bankruptcy trustee is not asserting claims by or on behalf of the bankrupt entity but, rather, on behalf of the estate and for the benefit of the creditors, the trustee is not a trustee of the entity, but rather, is a trustee of the

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bankruptcy estate." *Yessenow*, 2011 WL 2623307 at *9. Consequently, "the trustee and the debtor hospital [were] not the same entity for purposes of the insured versus insured exclusion." *Id.*

In reaching its decision, the appellate court distinguished the present case from *Biltmore Associates, LLC v. Twin City Fire Insurance Co.*, 572 F.3d 663 (9th Cir. 2009), which found that an "insured versus insured" exclusion precluded coverage for a bankrupt company's lawsuit against its former directors. First, *Biltmore* involved a debtor-in-possession while the present case involved a court-appointed trustee. According to the Court, "[a] court-appointed trustee, unlike a debtor-in-possession, is acting with the imprimatur of the court, reducing the fear of collusion, which . . . is 'among the kinds of moral hazard that the insured versus insured exclusion is intended to avoid.'" *Yessenow*, 2011 WL 2623307 at *9, *quoting Biltmore*, 572 F.3d at 674. Second, in *Biltmore*, evidence of collusion existed between the debtor-in-possession and the directors whereas no such evidence was present here. *Id.*

The appellate court also agreed that the bankruptcy exclusion was unenforceable under Section 541 of the Bankruptcy Code. After deciding that the former directors had standing to raise Section 541 as a defense, the appellate court found that Section 541 prohibited the application of the policy's bankruptcy exclusion. According to the court,

> [C]overage arises from a policy that has become a property interest of iHealthcare and Heartland, the debtors. That property interest is protected by section 541(c)(1), which invalidates contract provisions "that are conditioned on the insolvency or financial condition of the debtor [or] on the commencement of a bankruptcy case." Here, because the bankruptcy exclusion is conditioned on the commencement of [a] bankruptcy case, the trial court did not err in finding that the bankruptcy exclusion in this D&O policy is unenforceable under section 541(c)(1).

Yessenow, 2011 WL 2623307 at *7. ■

Equitable Subrogation and Reimbursement Did Not Apply To a Self-Insured Municipality

State Farm Mutual Automobile Insurance Company v. DuPage County, No. 02-10-0580, 2011 WL 2471920 (Ill. App. Ct. June 16, 2011) focused on an insurer's ability to seek recovery from a self-insured municipality through claims of equitable contribution and reimbursement. In *DuPage County*, a prosecutor within the DuPage County State's Attorney's office was an insured under a personal liability umbrella policy issued by State Farm Mutual Automobile Insurance Company (State Farm). 2011 WL 2471920 at *2. The umbrella policy had an "other insurance" clause stating that the policy was "excess over all other valid and collectible insurance." DuPage County was a self-insured municipality with a self-insured retention limit of up to $2 million. *Id*. DuPage County had commercial liability insurance policies above its self-insured retention. *Id*.

The prosecutor and her coworkers had been drinking at a restaurant where the prosecutor consumed 6-8 alcoholic drinks. After leaving the restaurant, the prosecutor was involved in a car accident that killed the prosecutor and injured Michele Lubinski (Lubinski), the other driver. At the time of the accident, the prosecutor was driving a 2003 Impala owned by DuPage County. *DuPage County*, 2011 WL 2471920 at *1. Lubinski subsequently sued the prosecutor's estate, DuPage County, and the DuPage County State's Attorney. State Farm defended the prosecutor's estate under the umbrella policy. *Id.* at *2. State Farm settled Lubinski's claim against the prosecu-

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tor's estate for $400,000. *Id*. Prior to settlement, State Farm spent $45,128.56 in defense costs. *Id.* at *3.

After settling with Lubinski, State Farm sued DuPage County alleging equitable subrogation and reimbursement and sought recoupment of the $445,128.56 expended during Lubinski's lawsuit. *DuPage County*, 2011 WL 2471920 at *3-4. The trial court granted summary judgment in favor of DuPage County, finding that State Farm could not satisfy the elements of equitable subrogation or reimbursement. *Id.* at *3. On appeal, the Illinois Appellate Court affirmed.

The appellate court first found that State Farm could not meet the requirements of equitable subrogation. Under a theory of equitable subrogation, a plaintiff insurance carrier must establish that:

> (1) the defendant carrier is primarily liable to the insured for a loss under a policy of insurance; (2) the plaintiff is secondarily liable to the insured for the same loss under its policy; and (3) the plaintiff carrier discharged its liability to the insured and, at the same time, extinguished the liability of the defendant carrier.

DuPage County, 2011 WL 2471920 at *1. DuPage County was not an insurance carrier as a self-insured municipality, State Farm therefore could not satisfy the first element. In making this determination, the appellate court observed that public policy supported a finding that self-insured municipalities were not insurance carriers because public policy favors the protection of government funds. *Id.* at *6-7.

While refusing to permit State Farm's equitable subrogation claim, the appellate court rejected State Farm's argument that DuPage's purchase of liability insurance for amounts above its self-insuance limit removed the public policy of protecting government funds from the purview of this case. The Court noted that State Farm was seeking amounts less than DuPage County's self-insurance limit and, thus, only seeking governmental funds. The court left open the possibility that the result might be different if DuPage's commercial insurance had been at issue. *DuPage County*, 2011 WL 2471920 at *6.

The appellate court also concluded the principles of horizontal exhaustion did not require DuPage County to contribute to the settlement. "The general principle of horizontal exhaustion requires an insured to exhaust all available primary insurance before any excess insurance may be invoked." *DuPage County*, 2011 WL 2471920 at *7. As a result, "an excess carrier need not contribute to a settlement until the limits of a primary insurance carrier are exhausted." *Id.* The appellate court held that horizontal exhaustion was not implicated in this case because DuPage County was not an insurer. *Id.*

When determining that principles of horizontal exhaustion did not apply to self-insured municipalities, the appellate court distinguished case law cited by State Farm treating self-insurance as primary insurance for purposes of horizontal exhaustion. According to the court, "[t]hese cases are distinguishable because each involves private or commercial entities or pools, not public entities or pools." *DuPage County*, 2011 WL 2471920 at *7. The appellate court found that "[t]his is a distinction of paramount importance for public policy reasons already discussed . . . *i.e.*, the importance of protecting government funds." *Id.*

DuPage is a troubling decision. The court offered no principled reason to distinguish between private and public self-insurance programs. It also raises issues between those public entities which buy traditional insurance versus those who do not. The latter gets a windfall while the former would not, even if the loss history leads to higher premiums. In that scenario, the public would ultimately pay through higher taxes to cover the cost of claims. ■

Sole Negligence Exclusion Does Not Apply Where Additional Insured Not Alleged to be "Exclusively" Liable

The court in *A-1 Roofing Co. v. Navigators Ins. Co.*, No. 1-10-0878, 2011 Ill. App. LEXIS 656 (Ill. Ct. App. June 24, 2011), held that a general contractor was entitled to a defense as an additional insured because the underlying complaint did not allege that the general contractor was solely negligent, even though the named insured subcontractor was not a party in the underlying action. The Additional Insured endorsement at issue provided:

> Neither the coverages provided by this insurance policy nor the provisions of this endorsement shall apply to any claim arising out of the sole negligence of any additional insured or their agents/employees.

A-1 Roofing Co., 2011 Ill. App. LEXIS 656, at *1.

A-1 Roofing Company ("A-1") was the general contractor for a roof-resurfacing project at a high school. Jack Frost Iron Works Inc. ("Frost") was one of A-1's subcontractors. Frost subcontracted with Midwest Sheet Metal, Inc. ("Midwest"). William McKoin, one of Midwest's employees, was killed when a boom-lift he was operating on the project flipped. The boom-lift had been leased by Bakes Steel Erectors, Inc. ("BSE"), another Frost subcontractor. *See id*. at *1-*2. McKoin's estate brought a wrongful death and construction negligence lawsuit against A-1, BSE, and two other defendants, but did not sue Frost nor mention Frost in the complaint. *See id*.

Frost was a named insured on a CGL policy issued by Navigators Insurance Company, and A-1 was an additional insured on that policy. A-1 tendered the McKoin suit to Navigators, which denied the claim. A-1 then filed a declaratory judgment action against Navigators, seeking a judgment that Navigators had a duty to defend and indemnify A-1.

Frost was a named insured on a CGL policy issued by Navigators Insurance Company ("Navigators"), and A-1 was an additional insured on that policy. *See id*. at *1. A-1 tendered the McKoin suit to Navigators, which denied the claim. A-1 then filed a declaratory judgment action against Navigators, seeking a judgment that Navigators had a duty to defend and indemnify A-1. The trial court found Navigators had no duty to defend or indemnify A-1 pursuant to the above-referenced "sole negligence" exclusion because the underlying complaint did not state a cause of action against Frost, the named insured. *Id*. at *5. A-1 appealed, and the appellate court reversed, holding that the "sole negligence" exclusion did not extinguish Navigators' duty to defend. In so ruling, the court held that Navigators had breached its duty to defend A-1 in the McKoin lawsuit and, accordingly, was estopped from raising any coverage defenses.

The first issue addressed by the appellate court was whether the claim against A-1 fell within the scope of the additional insured endorsement on the Navigators policy, which extended coverage to an additional insured "with respect to liability arising out of 'your [the named insured's] work' for that [additional] insured by or for you

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[the named insured]." *See id*. at *3-*4. A-1 contended that its liability "arose" out of Frost's work for A-1 because "but for" Frost's retention of BSE, McKoin would not have been killed and A-1 would not have been sued. *Id*. at *3. The Navigators policy defined "[y]our work" to include "[w]ork or operations performed . . . *on your behalf*." *Id*. at *3 (emphasis in original).

The *A-1 Roofing Co.* court agreed, holding that A-1's liability arose out of Frost's work for purposes of coverage under the additional insured endorsement because "the underlying complaint alleges McKoin's death occurred while BSE was performing this work on Frost's behalf, in furtherance of the work Frost was contractually obligated to perform for A-1 . . . ." *See id*. at *3-*4.

The second issue addressed by the appellate court was whether the "sole negligence" exclusion extinguished Navigators' duty to defend. A-1 argued that the clause did not eliminate coverage because "McKoin's underlying lawsuit did not *solely* allege negligence on behalf of A-1 but also alleged negligence on behalf of BSE and two other parties[, and that] the exclusion would only apply if the underlying allegations were exclusively directed toward A-1." *Id*. at *5 (emphasis in original). Navigators argued that the sole negligence exclusion applied because McKoin did not allege that Frost was negligent, but did allege that A-1 was negligent. *See id*.

The *A-1 Roofing Co.* court agreed with A-1, finding significant that the underlying McKoin complaint alleged that BSE and two other parties also were negligent in addition to A-1. Noting that "[w]e believe the plain, unambiguous meaning of 'the sole negligence of any additional insured' implies 'exclusively or entirely' or 'single handedly' . . . ," the court held that the "sole negligence" exclusion did not apply because the negligence allegations in the underlying McKoin complaint were not "'exclusively' or 'entirely' or 'single handedly' directed at A-1." *Id*. at *9-*10. ■

Amount of Coverage for Series of Related Legal Malpractice Claims Limited to "Each Claim" Limit of Liability

In *Continental Casualty Company v. Howard Hoffman & Associates,* No. 1-10-0957, 1-10-1080, 2011 WL 3612291 (Ill. App. Ct. August 15, 2011), the Illinois Appellate Court decided whether a law firm employee's malfeasances against different clients constituted "related acts or omissions" as defined by a professional liability policy for purposes of applying the policy's per claim limit or aggregate limit of liability. In *Howard Hoffman & Associates,* a law firm was insured under a professional liability policy issued by Continental Casualty Company (Continental) with a $100,000 per claim limit and a $300,000 aggregate limit of liability. 2011 WL 3612291 at *7. The policy contained the following language about related claims:

> If **related claims** are subsequently made against the **Insured** and reported to the **Company**, all such **related claims**, whenever made, shall be considered a single **claim** first made and reported to the **Company** within the **policy period** in which the earliest of the **related claims** was first made and reported to the **Company.**

Id. at *8. It defined "related claims" as "all **claims** arising out of a single act or omission or arising out of **related acts or omissions** in the rendering of **legal** services." *Id.* The policy defined **"**Related acts or omissions" as "all acts or omissions in the rendering of **legal services** that are temporally, logically, or causally connected by any common fact, circumstance, situation, transaction, event, advice, or decision." *Id.*

The law firm employed a paralegal who embezzled funds from probate estates handled by the firm. *Howard Hoffman & Associates*, 2011 WL 3612291 at *4. The paralegal used the same system of forgery and concealment to steal from each probate estate. *Id.* at * 9-10.

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Twelve of the estates brought claims against the firm alleging that the law firm's failure to supervise the paralegal lead to the embezzlement. *Howard Hoffman & Associates*, 2011 WL 3612291 at * 11-12. The law firm submitted these claims to Continental, who asserted that the $100,000 limit of liability applied because all twelve claims only constituted a "single" claim under the policy. In Continental's ensuing declaratory judgment action, the trial court ruled in Continental's favor. On appeal, the Illinois Appellate Court affirmed. *Id.* at *79.

The appellate court first addressed whether the policy's definition of "related claims" was ambiguous. After analyzing the entire policy, the court rejected the insured's claim of ambiguity, stating:

> When combined together, the plain language of these various policy provisions . . . specifies that "all claims" arising out of "all acts or omissions in the rendering of **legal services** that are temporally, logically, or casually connected by any common fact, circumstance, situation, transaction, event, advice or decision" shall be considered a single, related "demand received by the **Insured** for money or services arising out of an act or omission, including **personal injury**, in the rendering of or failing to render **legal services**." As such, each such related claim is subject to the $100,000 "Each Claim" limit of **liability** contained in the policy's declarations page. . . .

Howard Hoffman & Associates, 2011 WL 3612291 at *31.

In finding a lack of ambiguity, the appellate court rejected the insured's contention that the policy's inclusion of "logically . . . connected" within the definition of "related acts or omissions" rendered the policy ambiguous as a matter of law. The court stated, "[S]imply because '[a]t some point, of course, a logical connection may be too tenuous reasonably to be called a relationship' does not mandate that the concept of a logical connection cannot be applied to determine relatedness under a policy of insurance." *Howard Hoffman & Associates*, 2011 WL 3612291 at *38.

The court went on to hold that the $100,000 per claim limit would apply to the claims if (1) "all of the alleged acts and omissions of the [law firm] defendants [were] temporally, logically, or casually connected by [the paralegal's] embezzlement of estate funds" and (2) the "embezzlement of estate funds [was] a common fact, circumstance, situation, transaction, event, advice or decision under the policy." *Howard Hoffman & Associates*, 2011 WL 3612291 at *46. Applying the plain language meaning of these terms, the court found that these conditions were met. The Court noted that the paralegal's "actions in carrying out her embezzlement plan had 'common ties' and involved the same 'modus operandi.'" *Id.* at *56. ■

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