THE ILLUSORY COVERAGE DOCTRINE: Going Beyond the "Plain Language" of the Policy

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I. Introduction

Policyholders invoke the "illusory coverage" doctrine to prevent application of policy exclusions or limitations that are themselves worded unambiguously but, if applied literally, would gut the scope of coverage provided in the policy's coverage grant. Regardless that the language of the exclusion may be "unambiguous," the policyholders generally point to a tension – i.e., ambiguity – that arises where the broadly worded exclusion "swallows" a significant portion of the coverage grant. In this sense, the doctrine is similar the "reasonable expectations" doctrine and "*contra proferentem*."

Consistent with the general rule that unambiguous policy language should be applied as written, courts typically have been hostile to the illusory coverage doctrine so long as some remnant of coverage still remains after applying the exclusion or

[1]Marion Adler and Vincent Morgan both regularly represent commercial policyholders in coverage disputes; Michael Hamilton and Monica Sullivan both regularly represent insurers. The views expressed in this paper do not necessarily represent the views of their firms or clients.

coverage limitation. *See, e.g., Bitco Nat'l Ins. Co. v. Old Dominion Ins. Co.* 379 F. Supp. 3d 1230, 1242-43 (ND. Fla. 2019) ("in order for an exclusion to render a policy's coverage illusory, it must "completely contradict the insuring provisions,"… and "eliminate all—or at least virtually all—coverage in a policy"), *quoting Interline Brands, Inc. v. Chartis Specialty Ins. Co.*, 749 F.3d 962, 966 (11th Cir. 2014). *Accord Lend Lease (US) Constr. LMB Inc. v. Zurich Amer. Ins. Co.*, 28 N.Y.3d 675, 684 (2017) ("enforcement of the exclusion" did not render policy "illusory" where the exclusion did not "swallow" the entirety of coverage under the policy).

As addressed below, policyholders typically work within this general black letter law but try to chip away at the courts' skepticism about the "illusory coverage" grant by focusing in a more granular fashion on how a policy exclusion, as applied, has swallowed a grant of coverage. Insurers stress the unambiguity of the exclusion or limitation and the portion of the coverage grant that remains, as well as the insured's sophistication and the underwriting history, when helpful.

II. Illusory Coverage as Applied to Various Types of Policies

The argument that a policy's coverage is illusory or that a broad exclusion or limitation on coverage renders a policy illusory has arisen in a wide variety of both third-party and first-party coverage disputes. The case law discussed below provides a mere sampling of the situations in which the doctrine has been addressed.

A. CGL Policies – Coverage A

Among the most common CGL Coverage A cases in which the illusory coverage doctrine is raised are those arising from exposure to pollutants or other hazardous substances and construction defect disputes but it also arises in a wide variety of other situations.

In re Liquidation of Legion Indem. Co., 2015 IL App (1st) 140452 (Tex. law), is an example where the court relied upon the doctrine to defeat application of a "Health Hazard" exclusion to coverage for bodily injury claims under a CGL policy. The policyholder was a general contractor who was sued by multiple officeworkers for injury arising from their exposure to mold in buildings constructed by the insured. The policy did not contain an exclusion for mold or fungi claims but it did contain a "Health Hazard" exclusion, barring claims "arising wholly or in part, directly or indirectly, … on account of a single, continuous, or intermittent or repeated *exposure to, ingestion of* [,] *inhalation of* [,] *or absorption* of any Health Hazard." *Id.* ¶ 7 (emphasis added). "Health Hazard" was defined to include any "substance [or] product … alleged or determined to be … harmful." *Id.* The Appellate Court rejected the insurer's reliance on the "broad and generic" wording of the exclusion and the definition of Health Hazard; read literally, the exclusion would bar coverage for "*anything*—solid, liquid, gas or substance—that would potentially cause injury to a

person." *Id.* ¶¶ 16, 18.) (emphasis added.) As such, the exclusion would "mak[e] the Policy illusory" and therefore was unenforceable. *Id.* ¶ 18. The insurer easily could have worded the policy to expressly bar claims arising from exposure to mold or fungi but did not. *Id.* ¶ 16.

By contrast, *Colony Ins. Co. v. Total Contracting & Roofing, Inc.*, No. 10-23091-CIV, 2011 U.S. Dist. LEXIS 120269, 2011 WL 496251 (S.D. Fla. Oct. 18, 2011), rejected the argument that the illusory coverage doctrine barred application of a "hazardous materials" exclusion to claims of injury arising from defective Chinese drywall. The court held that, to be "illusory," the exclusion must "completely contradict the insuring provisions of the policy," which was not true of this exclusion. 2011 U.S. Dist. LEXIS 120269 at *17 (distinguishing *Purelli v. State Farm Fire & Cas. Co.*, 698 So. 2d 618, 620 (Fla. Ct. App. 1997), discussed *infra* at 7). Notably, the "Hazardous Material" exclusion in *Total Contracting* was much narrower than the "Health Hazard" exclusion in *Legion Indemnity*. Whereas the exclusion in *Legion Indemnity* essentially negated coverage for all product liability claims because it applied to any alleged injury arising from "exposure" to any "substance," the exclusion in *Total Contracting* was an expanded version of the familiar "Total Pollution Exclusion." It barred coverage for injury arising from "the actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape" of "'pollutants', lead, asbestos, silica, and materials containing them." *See Total Contracting*, 2011 U.S. Dist. LEXIS 120269 at *7.

Courts typically reject the argument that a "Total Pollution Exclusion" renders a CGL policy "illusory." For example, in *Liberty Mut. Ins. Co. v. Linn Energy, LLC*, 574 Fed. Appx. 425 (5th Cir. 2014) (Tex. law), the insured argued that appying the exclusion rendered an policy endorsement for "Underground Resources and Equipment Coverage" meaningless. But the court disagreed, reasoning that, even though the exclusion severely limited the scope of coverage available under the endorsement, it was enforceable – not only becauase Texas traditionally had enforced broadly-worded pollution exclusions, but the language of the exclusion was unambigous and the endorsement "still provide[d] coverage for all non-pollution property damage, such as depletion of a reservoir." *Id. at* 426.

U.S. Gypsum Co. v. Admiral Ins. Co., 268 Ill. App. 3d 598, 633-34 (1994), illustrates application of the doctrine to a manuscript "repair and replacement exclusion" that "would [have] basically eliminate[d] any property damage claim from coverage under the 'comprehensive' liability policy." The case involved asbestos-containing products in buildings. Unlike typical business risk exclusions that bar coverage for repair or replacement of the insured's own product or work, but not damage to other property, the manuscript exclusion prohibited coverage for "the cost of repairing or replacing *any* goods, products or completed work," which the insurer argued also barred coverage for damage to "other" property. *Id.* at 633 (emphasis added.). Although unreported, during oral argument, the insurer's attorney argued

that the exclusion did not render the policy's "property damage" coverage illusory because it would still be available to cover claims arising from "property" not subsumed by the terms "goods, products, or completed work" such as to the ground below or adjoining a building; a member of the appellate panel was incredulous, commenting to the effect that it seemed improbable that a policyholder would procure coverage for "a hole in the ground" but not damage to the actual structure.[2]

On the other hand, courts have readily rejected "illusory coverage" arguments directed at claims arising from alleged construction defects when the exclusions are narrower in scope. For example, in *Bitco*, 379 F. Supp. 3d at 1242-43, the insurer for a general contractor argued that an "EIFS Exclusion" in a subcontractor's policy (pursuant to which the general contractor was an "additional insured") rendered the policy "illusory" because it precluded coverage for the EIFS-related work performed by the subcontractor on the subject project. The court disagreed:

> … [T]he EIFS Exclusion does not 'swallow up' the insuring provisions of the Crum CGL policies …. To the contrary, the insuring provisions of the Crum CGL policies expressly provide a wide range of coverage for bodily injury and property damage claims arising from West Coast Metal's faulty or defective work .... The EIFS Exclusion only precludes coverage for a small subset of claims—those arising from West Coast Metal's work on the exterior of a building on which there is EIFS.

Id. at 1243. *See also Southern-Owners Ins. Co. v Sanborn Bldrs., Inc.*, No. 3:18cv145, 2019 U.S. Dist Lexis 40940 at *6 (N.D. Fla. Feb. 6, 2019) (modified "your work" exclusion that eliminated the subcontractor's exception did not render Products/ Completed Operations Endorsement illusory where approximately one-half of the coverage under that endorsement remained).

Other cases applying the doctrine to CGL Coverage A include:

- *Cincinnati Speciality Underwriters Ins. Co. v. Larschied*, 2014-Ohio-4137 ¶¶ 32-35, which rejected the argument of a restaurant owner that an assault-and-battery exclusion in its CGL policy rendered the bodily injury coverage illusory. "So long as an exclusion does not eliminate all coverage under a policy, it will not render the policy illusory." *Id.* ¶ 33. Coverage for other types of bodily injury claims remained intact despite the exclusion. *Id.* ¶ 34.

- To the opposite effect, see *Monticello Ins. Co. v. Mike's Speedway Lounge, Inc.*, 949 F. Supp. 694, 700-702 (S.D. Ind. 1996), which applied the illusory coverage doctrine to an "absolute" liquor exclusion in a CGL policy issued to a tavern. Unlike the typical liquor exclusion, which only applies to situations in which

[2] Co-author Marion Adler was one of the attorneys for U.S. Gypsum.

the bar owner violated the law, the subject exclusion applied to all claims "in connection" with "selling, distributing, manufacturing, or furnishing of alcoholic beverages." *Id.* at 700. The court held that it was immaterial that the exclusion left a remnant of coverage for bodily injury arising from, for example, a slip-and-fall claim resulting from a wet floor. *Id.* at 701. "[A]n insurer cannot avoid an illusory coverage problem by simply conceiving of a single hypothetical situation to which coverage would apply." *Id*. By issuing "a commercial general liability policy to a tavern and incorporat[ing] an exclusion from coverage that would apply to virtually any claim the insured might reasonably be expected to file …. the prospects for coverage [we]re sufficiently remote that the liability coverage must be deemed illusory." *Id.* at 702 (internal quote marks omitted).

- *St. Paul Fire & Marine Ins. Co. v. Antel Corp.*, 387 Ill. App. 3d 158, 166-67 (2008), in which the court declined to give effect to an exclusion barring coverage for claims arising from any "part or ingredient of anything else" because it would have completely negated the coverage available to a component part supplier as an additional insured under a vendor's endorsement. "[N]o purpose is served by providing full coverage for a product whose only use is as part of another product and then removing all coverage in another clause when the product is so used." *Id.* at 167, following *Murray Ohio Mfg. Co. v. Continental Ins. Co.*, 705 F. Supp. 442, 445 (N.D. Ill.1989).

B. CGL Policies – Coverage B

There are a wide range of situations in which insureds have argued, sometimes with success, that policy exclusions and limitations render provisions of Coverage B illusory. Often these disputes entail relatively recent exclusions for intellectual property, employment-related, and TCPA claims that historically were deemed within the scope of Coverage B until more explicit exclusions were added.

For example, *Secard Pools, Inc. v. Kinsale Ins. Co.*, 318 F. Supp. 3d 1147 (C.D. Cal. 2017), *aff'd*, 732 Fed. Appx. 616 (9th Cir. 2018), concerned the application of a broadly-worded Intellectual Property Exclusion that was endorsed onto the policy, in substitution for standard "Exclusion i." Whereas Exclusion i included an exception that retained coverage for claims "of infringement, in your advertisement, of copyright, trade dress, or slogan," the endorsement negated coverage for all intellectual property claims, without exception. *See* 318 F. Supp. 3d at 1150-52 & n.1. The court rejected the argument that this endorsement rendered Coverage B "illusory." *Id.* at 1153-54. The coverage would be "illusory" only if the exclusion "result[ed] in a complete lack of policy coverage" but the endorsement did not impair coverage for other Coverage B offenses, like defamation, that are unrelated to intellectual property rights. *Id.*

Princeton Express & Surplus Lines Ins. v. DM Ventures USA LLC, 209 F. Supp. 3d 1252, 1257-58, 1260 (S.D. Fla. 2016), took the opposite tack as to an endorsed "Field of Entertainment" exclusion. The endorsement wiped out all coverage for the personal and advertising injury offenses available under subparts d through g, although not impairing the coverages in subparts a through c for false arrest, malicious prosecution, or wrongful eviction. The coverage dispute arose from a lawsuit brought by eight models for the unauthorized use of their images in advertisements to promote the insured's bar. *Id.* at 1254. The models claimed, not only that the use of their images was unauthorized, but that it was defamatory and invaded their privacy. *Id.* The endorsement unambiguously barred coverage for any "actual or alleged" offenses involving infringement of intellectual property rights, defamation, invasion of privacy, or unauthorized use of any material, but the court refused to enforce the exclusion. "Giving effect to the Exclusion would make the advertising injury coverage illusory, which is prohibited by Florida law." *Id.* at 1260.

In *Standard Mut. Ins. Co. v. Lay*, 2014 IL App (4th) 110527-B ¶ 28, the court applied the doctrine to negate a professional services exclusion that the insurer argued barred advertising injury coverage for alleged violations of the TCPA. The insured was a real estate agency; the TCPA violations stemmed from unsolicited fax advertisements of real estate listings. The insurer contended that the "professional services" exclusion barred coverage because the advertising "related" to the insured's professional activities as a real estate broker. The court disagreed because the policy specifically included coverage for "advertising injury" and the insured's profession was not advertising: "Following Standard's argument [that] an insured advertising its business is an excluded professional service would read the coverage of advertising injuries entirely out of the policies despite the fact such coverage is specifically available under the policies." *Id.* ¶ 28.

By contrast, the court in *Interline Brands*, 749 F.3d at 966-67 (Fla. law), rejected the argument that the illusory coverage doctrine prevented application of an exclusion for claims arising from violations of any statute prohibiting the transmission or distribution of any material or information to a claim for TCPA violations. The insured contended that the exclusion reduced the policy's coverage for advertising injury to a "façade," but the court disagreed:

> The Exclusion only applies to the personal and advertising injury coverage …. [and] only excludes from coverage violations of a statute, ordinance, or regulation (i.e.[,] not common law) and only in relation to "sending, transmitting or communicating of any material or information." … [I]t does not render the policy absurd or completely contradict the insuring provisions.

Id.

Jostens, Inc. v. Northfield Ins. Co., 527 N.W.2d 116 (Minn. Ct. App. 1995), concerned the limited scope of coverage afforded for claims of "discrimination" under the personal injury provisions of an umbrella policy. Although not directly quoted, the policy evidently included coverage for many of the ususal personal injury offenses but contained an exception for "discrimination" as to claims:

> (1) arising out of the violation of a statute;
> (2) committed by or with your knowledge or consent;
> (3) discrimination towards an employment applicant, employee or wrongful termination of any employment; or
> (4) committed on the basis of race, creed, color, sex, age or national origin.

Id. at 117. The insured argued that this rendered the coverage for discrimination illusory "because the four limitations effectively swallow[ed] the general grant of discrimination coverage." *Id*. at 118. Similar to the approach in *Secard* (see *supra* at 5), *Jostens* rejected this argument because the excess policy still covered "a wide variety of damages other than those arising from discrimination," which were not impaired by the exceptions to the "discrimination" coverage. *Id.* Further, based upon other Minnesota case law, the court concluded that the illusory coverage doctrine is "best applied" to situations "where part of the premium is specifically allocated to a particular type or period of coverage and that coverage turns out to be functionally nonexistent." *Id.* at 119. The insured had not presented any evidence of an intent to allocate any part of the premium specifically to the discrimination coverage. *Id.*

Another line of cases involves the tension created by the intentional nature of the "offenses" for which Coverage B expressly extends coverage compared to policy language barring coverage for "expected or intended" injuries. For example, in *Purelli v. State Farm Fire & Cas. Co.*, 698 So. 2d 618, 620-21 (Fla. Ct. App. 1997), the insurer argued that the policy's requirement that claims arise from an "accident" and that the damage not be "expected or intended" negated any coverage available for claims of invasion of privacy, which is necessarily an intentional tort. The court rejected the argument that the illusory coverage doctrine was inapplicable because a policy that "provides coverage for specifically enumerated intentional torts, but only if they are committed unintentionally is "'complete nonsense.'" *Id.* at 620, *quoting*, *Lincoln Nat'l Health & Cas. Ins. Co. v. Brown,* 782 F. Supp. 110, 112-13 (M.D. Ga. 1992) (rejecting argument that "expected and intended" exclusion barred coverage under law enforcement liability policy for claims of false arrest, malicious prosecution and assault and battery, which were explicitly listed as covered by the policy).[3]

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[3] The "accident" and "expected and intended" language at issue in *Purelli* is more commonly found in Coverage A, not B. From the description of the policy in the opinion, however, these terms evidently were present in *Purelli*'s Coverage B.

More recent forms of Coverage B contain narrower exclusions, couched in terms of

Downey Venture v. LMI Ins. Co., 66 Cal. App. 4th 478 (1998) (Croskey, J.), presented a related illusory coverage argument, except that insurer's grounds for refusal to indemnify a claim for malicious prosecution was, not a policy exclusion, but Section 533 of the California Insurance Code, which prohibits an insurer's indemnification of loss caused by the insured's "wilful acts."[4] The court held as a preliminary matter that, because the tort of malicious prosecution under California law requires proof of "actual malice" – meaning "either actual hostility or ill will" or "a subjective intent to deliberately misuse the legal system for personal gain" – a claim against an insured under California law for its own commission of the tort of malicious prosecution necessarily involves a "wilful act" within the scope of Section 533. *Id.* at 499-500. As a fallback, the insured argued that the insurer should be held liable under a "promissory fraud" theory for misleadingly selling a policy that purported to cover claims of malicious prosecution but which was voided by Section 533. *Id.* at 512. The court rejected this argument too because the policy's coverage for malicious prosecution still conferred "substantial coverage benefits" in three forms. Section 533 did not prevent the insurer from funding: (a) the defense of malicious prosecution claims;[5] (b) indemnity for claims of malicious prosecution based on the insured's vicarious liability for the wilful acts of another; and (c) indemnity for claims of malicious prosecution arising under the law of another state that permits imposing liability even when the defendant's mental state did not rise to the "actual malice" standard required by California law. *Id.* at 512-16. "For all these reasons, we conclude that LMI's policy provisions describing coverage for 'malicious prosecution' was hardly an empty or illusory promise." *Id.* at 516

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the insured's acting with "knowledge" that its conduct would injure or infringe the underlying plaintiff's rights or arising out of a "criminal act." (See, e.g., ISO CG 00 01 10 01 at 6 § 2(a) & (b).) Because "reckless disregard" is typically a sufficient degree of *scienter* to give rise to liability under the intentional torts in Coverage B, these narrower exclusions for *knowing* violations do not create the same illusory coverage issue. *See, e.g., St. Paul Ins. Co. v. Landau, Omahana & Kopka, Ltd.*, 246 Ill. App. 3d 852, 858-59 (1993) (because "actual malice" element for claims of defamation is a "term of art" that encompasses statements made with "reckless disregard," exclusion for statements made with "actual knowledge" of statement's falsity did not necessarily bar coverage).

[4] Section 533 reads: "An insurer is not liable for a loss caused by the wilful act of the insured; but he is not exonerated by the negligence of the insured, or of the insured's agents or others." Because Section 533 uses this variant spelling of "wilful," we use the same spelling in our discussion of *Downey Venture*.

[5] Indeed, the insurer in *Downey Venture* had paid the costs of defense of the malicious prosecution claim. *See* 66 Cal. App. 4th at 488-89.

C. Directors and Officers Policies

The typical D&O policy has a very broadly worded insuring agreement that encompasses coverage for virtually any "wrongful act" committed by an insured that results in a claim made and reported during the policy period. However, this coverage grant is pruned away by a host of exclusions. These exclusions have generated a wealth of case law addressing the illusory coverage doctrine.

One of the most common issues in this area involve "professional services exclusions." A typical example bars claims:

> based upon, alleging, arising out of, or in any way relating to, directly or indirectly, any actual or alleged act, error or omission by any insured with respect to the rendering of, or failure to render professional service for any party.

See, e.g., Great American Ins. Co. v. Geostar Corp., No. 09-123888-BC, 2010 WL 845953 at *9 (E.D. Mich. Mar. 5, 2010). Sometimes the policy includes a definition of "professional services" but oftentimes it does not. In the absence of a definition, the term is typically interpreted as meaning services "arising out of a vocation, calling, occupation, or employment involving specialized knowledge, labor or skill, and the labor or skill is predominantly mental or intellectual, rather than physical or manual." *Id.* at *10. Especially where the insured's principal business entails supplying a "specialized labor or skill" that is "predominantly mental or intellectual" – such as accounting, consulting, or management services – virtually any claim against it arises, at least "indirectly," from its "rendering" or "failure to render" such services. This tension has encouraged "illusory coverage" arguments.

For example, in *Geostar*, the insured was an investment advisor that had placed clients in a program leasing thoroughbred mares. Rogue employees committed fraud by leasing the same mare to multiple clients. The court held that a professional services exclusion barred coverage for claims against the defendant investment advisor for "negligent tax or investment advice" but did not extend to the entirety of the fraudulent "mare lease" scheme. *Id.* at *9. The Court reasoned that the entire nature of the coverage afforded under a D&O policy is "designed specifically to protect directors and officers from liability arising from negligence or misconduct in managing a business" – i.e., activity that, by its nature is "predominantly mental or intellectual as opposed to physical or manual." *Id.* at *12. Therefore, a professional services exclusion in a D&O policy "must be interpreted more narrowly to avoid negating the entire coverage scheme through the operation of an overly broad exclusion." *Id.*

The court in *Federal Ins. Co. v. Hawaiian Elec. Indus., Inc.*, No. 94-125 HG, 1997 U.S. Dist. LEXIS 24129 at*33-*34 (D. Haw. Dec. 23, 1997), similarly held that

a broad reading of a "professional services exclusion" in a D&O policy would render the coverage illusory:

> The definition of professional service … as "one calling for specialized skill and knowledge in an occupation or vocation[,]" *Ministers Life, 483 N.W.2d at 91*, is *not readily transferrable from the general liability policy context to the D&O policy context without* modification. Otherwise, claims arising from any services or acts performed by officers or directors calling for specialized skill or knowledge in the performance of their duties as officers or directors, would be excluded from coverage. Such an expansive interpretation is *not reasonable because it would have the effect of vitiating virtually all of the coverage provided by a D&O policy,* the purpose of which is to cover any wrongful act committed by an officer or director in their capacity as an officer or director.

(Emphasis added.) *See also Prosper Marketplace, Inc. v. Greenwich Ins. Co.*, A132967, 2012 WL 2878121 at *7-*8 (Cal. App. July 16, 2012) (unpub'd) ("close connection between the provision of professional services and the underlying claim" is necessary because a broad interpretation of the exclusion "would effectively vitiate the coverage provided by the D&O policy").

Not all courts are receptive to illusory coverage attacks on D&O professional services exclusions. *Benecard Servs., Inc. v. Allied World Specialty Ins. Co.,* Civ A. No. 15-8593, 2020 U.S. Dist. LEXIS 94749 at *40-41 (D.N.J. May 31, 2020), rejected the insured's argument that a "Managed Care" exclusion rendered its D&O coverage illusory. Benecard contracted to provide administrative services relating to insurance plans for drug coverage offered by its client, Smart. *Id.* at *3-*4. Smart sued Benecard for alleged breaches in the performance of its contractual duties, as well as alleged misrepresentations and fraudulent concealment relating to the problems arising from those breaches. *Id.* at *5. The "Managed Care Activities" to which the exclusion applied encompassed the very services that Benecard supplied to Smart. *Id.* at *12-*13. The court held that, even if the term "Managed Care Services" applied to the entirety of Benecard's operations, the exclusion did not render the policy illusory because, "the exclusion bars coverage from claims involving the performance of Benecard's commercial services—not any claim relevant to its business." Coverage was still available under the policy for:

> … wrongdoing in connection with a merger or acquisition, claims involving the offering of an equity or debt, defense coverage for directors or officers indicted for stealing from Benecard or others, and myriad other claims against directors or officers arising from commercial transactions.

Id. at *41. These latter types of claims are "the very risks for which D&O coverage is generally sought, not the risk of claims by customers." *Id.*

First Bank of Del., Inc. v. Fid. & Deposit Co. of Md., No. N11C- 08-221, 2013 Del. Super. LEXIS 465, 2013 WL 5858794 (Oct. 30, 2013), concerned coverage under the "Electronic Risk Liability" part of a D&O policy for claims brought by Visa and Mastercard against the bank arising from data breaches of customer accounts, resulting in unauthorized withdrawals. Visa and Mastercard restored the unauthorized funds to the customers' accounts but then sought indemnification of those sums from the bank, as provided under the banks' agreements. The policy provided coverage for "any unauthorized use of, or unauthorized access to electronic data ... with a computer system" but contained an "Exclusion M" that barred coverage for claims:

> based upon or attributable to or arising from the actual or purported *fraudulent* use by any person or entity of any data or in any credit, debit, charge, access, convenience, customer identification or other card, including, but not limited to the card number.

2013 Del. Super. LEXIS 465 at *16 (emphasis added). The court agreed that this exclusion rendered the policy's coverage grant for "unauthorized" use or access to electronic data illusory because, although it was "theoretically possible that an example of non-fraudulent unauthorized use of data exists …. in the context of this Policy, all unauthorized use could be, to some extent, fraudulent." *Id* at *25. The illusory coverage doctrine negated the exclusion where "[t]he abstract possibility of some coverage surviving the fraud exclusion is not sufficient to persuade the Court to apply an exclusion that is almost entirely irreconcilable" with the coverage grant. *Id.*

When "illusory coverage" arguments arise in the context of D&O coverage, courts that reject the doctrine often focus as much on the insured's sophistication and its deliberate purchase of a policy with limitations on coverage rather than whether the exclusion swallows a coverage grant. For example:

- In *Zucker v. U.S. Specialty Ins. Co.*, 856 F.3d 1343, 1351-53 (11th Cir. 2017) (Fla. law), a bank purchased a D&O policy that excluded claims arising from any "prior acts" coinciding with the policy's inception date. In the months preceding that date, regulatory authorities had launched an investigation of the bank's risky lending practices, the press had reported on that investigation, and investors had filed a class action suit – all of which led the bank's then-current D&O insurer to decline renewal. *Id.* at 1344-45. When the bank shopped its D&O coverage, U.S. Specialty quoted alternative policies with or without the "prior acts" date, with a significantly higher premium for a policy lacking the exclusion. *Id.* at 1346. The bank elected to purchase the policy

containing the prior acts exclusion. *Id.* Ultimately, the administrator appointed after the bank was declared bankrupt challenged the enforceability of the "prior acts exclusion" based upon the illusory coverage doctrine. The court rejected this argument because the policy did not "eliminate all – or at least virtually all – coverage in the policy," as required by the applicable Florida law, (citing *inter alia Interline* and *Purelli*, discussed *supra* at 6-7). *Id.* at 1352. Rather, coverage still remained for claims stemming from conduct that occurred after the policy's effective date, which sufficed. *Id.* at 1353. Further, the bank was a sophisticated insured that deliberately chose to purchase the policy with the prior acts exclusion, rather than a more expensive policy that lacked the exclusion. *Id.*

- Similarly, in *American Cas. Co. v Baker,* No. SA CV 90-125 1993 U.S. Dist. Lexis 6981 at *17-*18 (C.D. Cal. Apr. 29, 1993), a "regulatory exclusion" in an insolvent bank's policy was challenged as unenforceable. As in *Zucker*, the court's rejection of this argument focused on the underwriting history; there had been extensive negotiations between bank officers and insurers over the course of several years, and, not only did the insureds have clear notice of all of the exclusions before accepting the policies, they were well aware that D&O coverage generally was not available without a regulatory exclusion. *Id.* As such, the insureds could not have had any "reasonable expectation" that claims within the scope of the regulatory exclusion would be covered by the policy, which defeated their argument that the coverage was "illusory." The "purpose of the illusory coverage doctrine is to protect the reasonable expectations of the insured." *Id.* at 17.

D. Errors and Omissions Policies

E&O policies also give rise to illusory coverage disputes. Here are a few examples:

Crum & Forster Specialty Ins. Co. v. DVO, Inc., 939 F.3d 852, 857-58 (7th Cir. 2017) (Wis. law), involved an E&O policy issued to a designer of industrial machinery, facing a design defect claim. The policy contained a "contractual liability exclusion" that barred coverage for any claims, "[b]ased upon or arising out of … breach of contract, whether express or oral, nor any 'claim' for breach of an implied in law or an implied in fact contract[]." The court held that the broad wording of the exclusion gutted the purpose of the E&O policy, which was to protect the insured for claims of professional malpractice; "the overlap between claims of professional malpractice and breach of contract is complete, because the professional malpractice necessarily involves the contractual relationship." *Id.* at 857. The insurer argued that, even with the exclusion, the policy still covered tort claims brought by third-parties, which was the grounds accepted by the District Court in rejecting the insured's illusory coverage argument. *Id.* at 855. The Court of Appeals disagreed. The broad wording of the

exclusion – barring coverage for all claims "based upon or arising out of" a contract breach – went beyond claims sounding in breach of contract to also bar coverage for third-party tort actions; as such, the exclusion rendered the coverage illusory, even as to third-party tort claims. *Id.* at 855-58.

MHM Correctional Svcs, Inc. v. Evanston Ins. Co., 2021 IL App (1st) 200522-U ¶ 58, likewise held that a contractual liability exclusion was unenforceable because it would have rendered coverage under an E&O policy illusory.[6] MHM furnished on-site medical services to various prison systems. The contracts with the prisons included indemnification provisions and required MHM to arrange that the prison systems be named as additional insureds under its liability policies. Evanston issued professional liability policies to MHM containing omnibus additional insured endorsements as to "[a]ny person or organization to whom or to which [MHM] is obligated by virtue of a valid written contract to provide insurance or indemnity such as is afforded by the policy." *Id.* The specific agreements between MHM and the prison systems were provided to Evanston before the policies issued. *Id.* When multiple class action lawsuits were filed alleging constitutional violations by the prisons in the provision of medical services (some of which also named MHM), the prisons and MHM tendered the suits to Evanston for defense. Evanston objected to coverage pursuant to a contractual liability exclusion. *Id.* ¶ 50. The court rejected this argument because "the coverage afforded by the additional insured endorsements would be rendered illusory" under Evanston's interpretation. *Id.* ¶ 58.

The E&O policy in *Hrobachak v. Federal Ins. Co.*, No. 3:10-cv-481, 2010 U.S. Dist. LEXIS 112189, 2010 WL 4237435 (M.D. Pa. Oct. 21, 2010), was issued to a debt collector, who had been sued previously for wrongful debt collection practices. An endorsement to the policy barred coverage by name for each of the prior lawsuits, as well as any future claims that "related" to the listed lawsuits. When the insured was sued again for alleged improper debt collection practices, the insurer invoked the exclusion on the ground that the new suit and the prior suits all "related" to improper debt collection practices. The court rejected this broad reading of the exclusion because it would gut the E&O coverage, given that the policyholder's sole business was debt collection. 2010 U.S. Dist. LEXIS 112189 at *10-*12.

Cushman & Wakefield, Inc. v. Illinois Nat'l Ins. Co., No. 14-8725, 2018 U.S. Dist. LEXIS 67523 at *32 n.25, 2018 WL 1898339 (N.D. Ill. Apr. 20, 2018) (N.Y. law), is another E&O coverage dispute in which the policyholder's illusory coverage argument prevailed. The insured was a real estate business that offered a variety of services, including appraisals. It was sued by a commercial lender who alleged systematic over-valations by the insured in appraisals that it had performed. The policy contained an exclusion barring coverage for "any Claim alleging, arising out of,

[6] As of January 1, 2021, Illinois permits citation to unreported appellate decisions for their persuasive value, but not as "precedent." *See* Ill. Sup. Ct. R. 23(e)(1).

based upon, resulting from, directly or indirectly, or in any way involving . . . the failure of any investment to perform as expected or desired" – which the insured contended only applied to services rendered in its role as an investment advisor, not as an appraiser. 2018 U.S. Dist. LEXIS 67523 at at *13-*14 & n.14. The court rejected the insurer's reliance on this exclusion:

> Such a reading creates ambiguity as it would essentially eliminate coverage for all Claims brought in connection with Cushman's appraisal business, including Claims brought by plaintiffs who objected to how Cushman appraised the value of commercial property, regardless of the appraisal method used. *The court cannot accept an interpretation that would render superfluous the provision of coverage.*

Id. at *32 n.25 (emphasis added).

Hantz Fin. Servs. v. Am. Int'l Specialty Lines Ins. Co., 664 Fed. Appx. 452 (6th Cir. 2016) (Mich. law), entailed coverage under an E&O policy for claims asserted by customers of the insured securities broker-dealer arising from embezzlement of their accounts by a rogue employee of the firm. The firm's E&O insurer denied coverage on the basis of an exclusion for claims arising out of "any actual or alleged Wrongful Act *committed with knowledge* that it was a Wrongful Act." *Id.* at 461 (emphasis added by court).[7] The insured argued that applying the exclusion would render the policy's endorsement for claims of "negligent supervision" illusory as it would block coverage for claims of negligent supervision of an employee who engaged in knowingly wrongful conduct, like the embezzler in this case. *Id.* at 462. Regardless, the court observed, the exclusion would not impair coverage for claims of negligent supervision of "employees who did not knowingly commit a wrongful act." *Id.* Because Michigan resists application of the illusory coverage doctrine, "if there is any manner in which the policy could be interpreted to provide coverage," the exclusion did not render the negligent supervision endorsement illusory. *Id.*

E. First Party Policies

The illusory coverage argument also arises in claims under first-party policies.

Most recently, the doctrine has been rejected in multiple COVID-19 cases. For example, in *Mashallah, Inc. v West Bend Ins. Co.*, No. 24 C 5472, 2021 U.S. Dist. LEXIS 31816 at *11 (N.D. Ill. Feb. 22, 2021), the court rejected "[t]he argument that business income coverage is now illusory" under the insured's policy if coverage were denied for COVID-19 losses. Echoing the rationale of other cases in which the doctrine

[7] The court confusingly refers to this exclusion as the "Wrongful Act Exclusion." The focus of the exclusion is *not* the commission of a Wrongful Act, but committing it "with knowledge" of wrongfulness.

was rejected, the court held that a "policy need not provide coverage against all possible liabilities; if it provides coverage against some, the policy is not illusory." *Id.*

Similarly, *French Laundry Partners, LP v. Hartford Fire Ins. Co.*, Case No. 20-cv-04540-JSC, 2021 U.S. Dist. LEXIS 80726 at *8-*9, *11-*13 (N.D. Cal. Apr. 27, 2021), rejected the illusory coverage doctrine as applied to coverage provided by a "Deluxe Form" endorsed on the policy as to virus-caused property damage if it arose from a "specified cause of loss." The term "specified cause of loss" encompassed:

> windstorm or hail; smoke; aircraft or vehicles; riot or civil commotion; vandalism; "Sinkhole Collapse"; "Volcanic Action"; falling objects; weight of snow, ice or sleet; water damage, "Sprinkler Leakage"; "Theft"; or "Building Glass breakage".

Id. at *12.[8] The insured argued that it was impossible for any of these events to give rise to a viral contamination and hence the restriction of coverage to the "specified cause[s] of loss" rendered the coverage extension illusory but the court disagreed. The court cited to a Nebraska case in which coverage under the same policy language was found as to a viral infection of the insured's pigs when the virus was disseminated during a tornado – i.e., a windstorm, which was among the "specified cause[s] of loss" for which coverage was available. *Id.* at *13. As such, the coverage was not "illusory" because the restrictive language did not result in a "complete lack of any policy coverage." *Id.* "'[T]he mere possibility of some coverage is enough' to defeat Plaintiffs' argument that coverage under the Deluxe Form Limited Virus Coverage is illusory." *Id.* at *14 (quoting *Secard*, discussed *supra* at 5).

Conversely, another Covid-related case, *Henderson Rd. Restaurant Systs., Inc v. Zurich Amer. Ins. Co.*, No. 1:20-cv-1239, 2021 U.S. Dist. LEXIS 9521 (N.D. Oh. Jan. 19, 2021), embraced the illusory coverage doctrine in ruling for an insured restaurant chain. The main holding was that ambiguity in the phrase "direct physical loss of or damage to property" must be construed in the insured's favor based on *contra proferentem*. *Id.* at *33. The illusory coverage doctrine was invoked in response to the insurer's argument that a "Loss of Market or Delay Exclusion" negated the insured's claimed damages. *Id.* at *44-*45. The exclusion barred recovery of "loss or damage caused by or resulting from loss of market, loss of use, or delay," which – as the insured argued and the court agreed – would "vitiate" the policy's grant of coverage for "loss of business income … due to the necessary suspension of operations caused by direct physical loss of or damage to property." *Id.*

[8] "Specified cause of loss" also extended to fires and explosions, but those risks were excluded from the Deluxe Form's grant of coverage for virus-related losses. *See* 2021 U.S. Dist. LEXIS 80726 at *9

Outside the Covid context, *rePlanet Holdings, Inc. v. Federal Ins. Co.*, No. 1:19-cv-00133, 2019 U.S. Dist. LEXIS 124450, 2019 WL 3337907 (E.D. Cal. July 25, 2019), involved coverage under a crime policy for forged vouchers that the insured-recycler issued to consumers in exchange for recyclables. The consumers redeemed the vouchers at grocery stores, which then presented the vouchers to the insured for payment at face value. When rogue employees forged vouchers, the insured sustained millions of dollars in damages and tendered a claim for coverage under the "employee theft" and "forgery of financial instruments" provisions of the policy. The insurer denied the claim because the insured ostensibly "did not suffer a '*direct* loss'" as the loss only arose when the grocers cashed the vouchers. 2019 U.S. Dist. LEXIS 124450 at *6 (emphasis added). The insured countered that, if the insurer's interpretation of the policy was correct, the insurer had engaged in "fraud" by marketing a policy that only provided "illusory coverage":

> By issuing the crime insurance policy that purportedly covered the loss of "Securities" and money due to the "Forgery" of "Financial Instruments," Defendant allegedly made a tacit representation that the policy provided some value in those areas. But Plaintiff alleges that this tacit representation was false.

Id. at *22-*23. The court agreed with the insured and allowed it to amend its pleadings to add a claim of "fraud" against the insurer.

Lend Lease, 28 N.Y.3d 675, held that a "contractor's tools exclusion" in a builder's risk policy did not render the policy's coverage for "temporary works" illusory. The dispute arose from damage to a crane sustained during Superstorm Sandy. The crane fit within the definition of "contractor's tools" under that exclusion. *Id.* at 683-84. The policyholder argued that the exclusion should not be enforced because it rendered coverage granted for "temporary works" illusory. *Id.* at 684. The court disagreed because the exclusion did not "defeat all of the coverage afforded under the policy," and, in particular, under the coverage for "temporary works":

> Th[e] exclusion would not defeat coverage initially granted for such things as the cost of erecting scaffolding, for "temporary buildings," and for such other things as "formwork, falsework, shoring, [and] fences," which are not "tools" within the meaning of the exclusion.

Id.

F. Other Coverages

Here are a few additional examples from other coverages.

1. Title Insurance

Dudek v. Commonwealth Land Title Ins. Co., 466 F. Supp. 3d 610 (D.S.C. 2020), concerned a title insurance policy that granted coverage for easement disputes, but also contained an "exception" for coverage of losses resulting from "[e]asements or claims of easements not shown by the public records" and "easements ... appearing in the public record." *Id*. at 620. The policyholders argued that, if the exception was enforced, the policy coverage was illusory, to which the court agreed, as the exception "exclude[d] from coverage 'the very risk contemplated by the parties,' rendering [the] policy provision 'virtually meaningless.'" *Id*. at 620.[9] The court emphasized this point with a colorful analogy:

> The court can think of no policy provisions better suited for application of the illusory coverage doctrine. The Policy extends coverage for adverse easement claims and simultaneously, by way of two exclusions, completely eliminates the very coverage it purports to extend. *An insurance policy that insures coin flips but excludes coverage in the event that the coin lands on heads and in the event the coin lands on tails provides no insurance coverage at all.*

Id. at 620-21 (emphasis added). Unfortunately for the policyholders, this victory was pyrrhic, as the court then held that coverage was barred by an exclusion for risks known or created by the insured. *Id.* at 621-24.

2. Auto Insurance

Hernandez v. Liberty Mut. Ins. Co., 2014 WI App 36, entailed interpretation of the interplay of the "permissive driver" and "other insurance" provisions of an excess auto liability policy issued to the car-sharing service Zipcar as applied to claims against a Zipcar customer arising from a collision while driving a Zipcar vehicle. Although a primary policy issued to Zipcar insured the customer as a "permissive driver" up to Wisconsin's statutory minimum of $300,000, the definition of an "insured" in the excess policy's jacket only insured Zipcar itself, but not permissive drivers. *Id.* ¶¶ 3, 8. However, a "Wisconsin endorsement" amended the "insured" definition to include permissive drivers, but the endorsement also contained language in the "other insurance" clause excluding coverage as to any permissive drivers:

> when there is other valid and collectible insurance … with at least the limits required by the Wisconsin Financial Responsibility Law, whether the other insurance is *primary*, excess or contingent.

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[9] Quoting *Isle of Palms Pest Control Co. v. Monticello Ins. Co.*, 459 S.E.2d 318, 321 (S.C. App. 1994), *aff'd*, 468 S.E.2d 304 (S.C. 1996).

Id. ¶ 9-10 (emphasis added). The excess insurer declined to cover the claim against the driver because she was covered up to Wisconsin's statutory minimum limits by the primary policy but the court rejected this denial of coverage. *Id.* ¶¶ 13, 21. The Wisconsin Endorsement's coverage for permissive drivers was "illusory" where it simultaneously extended excess coverage to permissive drivers but then excluded those same permissive drivers based on the coverage of the primary policy. *Id.* ¶ 27. Under Wisconsin law, a policy is illusory when "an insured cannot foresee any circumstances under which he or she would collect under a particular policy provision." *Id.* ¶ 25. A dissenting opinion forcefully disagreed with the majority's finding of illusory coverage for two reasons. *Id.* at ¶¶ 29-32. First, Wisconsin Stat. 632.32(3) & (5)(c) specifically permits commercial automobile liability policies that restrict the available coverage for permissive drivers to the statutory minimum; therefore, elimination of excess coverage above that statutory minimum conformed with Wisconsin law. *Id.* ¶¶ 31-32. Second, the excess policy, even as amended by the Wisconsin Endorsement, was not illusory because it still provided coverage to Zipcar and its affiliate; a "policy is 'illusory' when 'the insurer would never have to pay.'" *Id.* ¶ 32 (quoting *Brunson v. Ward*, 2001 WI 89 ¶ 5).

In *Great West Cas. Co. v. XTO Energy, Inc.*, Case No. 1:16-cv-387, 2019 U.S. Dist. LEXIS 797 (D.N.D. Jan. 3, 2019) (Mont. Law), a trucking contractor that hauled water to oilfield operators invoked the illusory coverage doctrine in an effort to avoid application of a commercial auto policy's hydrofracking exclusion. The underlying claim involved bodily injuries sustained in a flash fire during fracking operations. Under Montana law, insurance coverage "is illusory if it provides effectively non-existent coverage for the premium paid." *Id.* at *24 (citing *Monroe v. Cogswell Agency*, 2010 MT 134). However, the coverage was not "non-existent" because, the insured conducted a variety of other operations, unrelated to fracking, that were covered. *Id.* at *25.

III. Related Doctrines – *Contra Proferentem* and "Reasonable Expectations"

The illusory coverage doctrine shares commonalities with the pro-policyholder doctrines of *contra proferentem* and "reasonable expectations." All are rules of construction that entail giving the policyholder the benefit of any doubts when the policy language itself or the policyholder's circumstances create ambiguity as to the scope of policy coverage, especially as to exclusions.

Typically, policyholders also raise *contra proferentem* when they assert illusory coverage. *See, e.g., XTO*, 2019 U.S. Dist. LEXIS 797 at *17-*26. *First Bank of Del.*, 2013 Del. Super. LEXIS 465 at *19. The difference between the two doctrines is that *contra proferentem* focuses on ambiguity in the phrasing of a particular policy

provision whereas illusory coverage focuses on the tension between a broad grant of coverage within the policy that is then "swallowed" by an exclusion or limitation.

Despite the distinct rationales, the two doctrines are sufficiently interrelated that some cases blend the discussion of both. *See, e.g., Cushman & Wakefield*, 2018 U.S. Dist. LEXIS 67523 at *32 n.25 (rejecting insurer's reading of the word "investment" in policy exclusion because "it could render the provision *illusory*" and "creates *ambiguity* as it would essentially *eliminate coverage* for all Claims brought in connection with Cushman's appraisal business") (emphasis added).

The "reasonable expectations" doctrine was first articulated, under that name, by Professor Robert Keeton in a seminal 1970 article:

> The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.

R. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 Harv. L. Rev. 961, 967 (1970). The doctrine is most often applied to coverage disputes where the policyholder is an individual or small business rather than a substantial commercial entity. *See* M. Pentz & J. Evans, *How to Avoid Getting Whacked by the Doctrine of Reasonable Expectations*, 2008 ABA ICLCE Seminar, at 2 (Feb. 27 – Mar. 1, 2008).[10]

The commercial coverage cases that address the illusory coverage doctrine often include discussion of the policyholder's "reasonable expectations" in evaluating the argument. Thus, *Baker*, 1993 U.S. Dist. LEXIS 6981 at * 17, observed that, pursuant to the applicable California law, "[t]he purpose of the illusory coverage doctrine is to protect the reasonable expectations of the insured." *Mike's Speedway Lounge*, 949 F. Supp. at 699-702 – in which the insured bar-owner prevailed in voiding an absolute liquor exclusion under the illusory coverage doctrine – intertwines the discussion of "reasonable expectations" and "illusory coverage," based on Indiana law that "policies providing *illusory coverage* should be interpreted to give effect to the *reasonable expectation* of the insured." *Id.* at 699 (emphasis added).[11] *Jostens*, 527 N.W.2d at 118-19, treated the two doctrines as distinct under Minnesota

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[10] *See* https://foleyhoag.com/-/media/files/foley%20hoag/publications/articles/2008/pentz_reasonable_expectations_2008.ashx?la=en.

[11] The Seventh Circuit opined in *Fidelity & Guar. Ins. Underwriters v. Everett I. Brown Co.*, 25 F.3d 484, 490 n.6 (7th Cir. 1994), that the "reasonable expectations" doctrine to which the parties referred in their briefs does not exist under Indiana law and should have been labeled "illusory coverage."

law, with sequential sections that rejected the policyholder's efforts under both doctrines to void the exceptions to the "discrimination" coverage in its policy.

IV. Conclusion

Coverage lawyers will enjoy reading the cases discussed above because they are a great way to think about coverage arguments on a fundamental level. Our survey of cases is by no means exhaustive. It is interesting to note, however, that across one kind of coverage after another, the insureds won slightly more than half of them, which shows that courts will apply the illusory coverage doctrine where they think it is satisfied.

Insureds and insurers must be both thorough and precise in making these arguments. Courts focus, not only on what is or might be covered, but also on what would not be covered. Other factors, such as underwriting history and statutory intent, may play a role as well. It is also important for carriers to take note that sometimes the effort to completely preclude coverage can be so broad that it ends up being unenforceable.