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NEWSLETTER

Policyholder Has Viable Fraud Claim After Insurer Relies on Illinois Law to Deny Coverage for Punitive Damages

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The United States District Court for the Northern District of Illinois, applying Illinois law, has held that a policyholder law firm has a viable claim for fraud against a professional liability insurer where the insurer allegedly misrepresented that there would be coverage for punitive damages by failing to disclose that it planned to assert that Illinois law, which bars coverage for punitive damages, governed the contract interpretation. *Old Republic Ins. Co. v. Ness, Motley, Loadholt, Richardson & Poole, P.A.*, 2005 WL 991909 (N.D. Ill., Apr. 12, 2005). Although the court found the law firm's fraud claims to be viable as a matter of law, it also concluded that they were not pled with the specificity required by Federal Rule of Civil Procedure 9(b) and accordingly dismissed the fraud claims with leave to replead. The court also dismissed the law firm's allegations of breach of good faith and fair dealing because there existed "a bona fide dispute regarding coverage" and therefore the insurer could not be found to have entered into "vexatious and unreasonable conduct" as would be required under the law.

The plaintiff insurer issued several $10 million excess professional liability policies to a law firm. In the underlying action, a $36 million judgment was entered against the law firm. The amount of the award included punitive damages. The insurer filed this action seeking a declaration that it owed no duty to indemnify the law firm for any portion of the judgment. In its counterclaim, the law firm alleged breach of contract, fraud and breach of the duty of good faith and fair dealing against the insurer. With respect to the fraud counts, the law firm alleged that the language of the policies covered punitive damages but that the insurer "never intended to provide the punitive damage coverage" because it always planned to assert that the policies were governed by Illinois law, which forbids insurance coverage for punitive damages as contrary to public policy. The insurer moved to dismiss the law firm's counterclaims with respect to fraud and breach of the duty of good faith and fair dealing.

The district court first rejected the insurer's argument that the law firm failed to state a claim for fraud since it alleged a misrepresentation as to the legal effect of the insurance contract (*i.e.*, the scope of coverage) and not a misrepresentation of fact. While the court noted that the insurer's argument was "well-taken and certainly appealing at first glance," the court was swayed by the law firm's citation to *Glazewski v. Coronet Ins. Co.,* 483 N.E.2d 1263 (Ill. 1985), for the proposition that "Illinois permits a claim for fraud based on alleged

misrepresentations regarding the extent or validity of insurance coverage." According to the court, in *Glazewski*, the Illinois Supreme Court held that the plaintiffs had adequately pled a claim for fraud against an insurer where they asserted that the underinsured motorist coverage they purchased "had no value" because of how Illinois statutes defined "underinsured." Accordingly, the district court concluded that the law firm's claim was permitted as a matter of law.

The court then rejected the insurer's assertion that the law firm's claims amounted to "promissory fraud," a cause of action not recognized in Illinois. While the court agreed that promissory fraud claims are "disfavored" by Illinois courts in breach of contract actions, the court nonetheless found that "promissory fraud" is "a recognized basis for a fraud claim" under Illinois law and therefore the law firm's claim could not be dismissed.

Next, the court rejected the insurer's contention that the law firm had failed to allege that the insurer undertook a scheme to defraud as is required for promissory fraud. The court determined that such a scheme had been adequately pled, focusing on the allegations in the law firm's complaint of "repeated promises" by the insurer and an "undisclosed scheme." Moreover, the court noted that the law firm had cited to deposition testimony of the insurer's underwriter who had testified that members of the insurer's claim department "regularly discussed . . . [the insurer's] non-obligations to pay a punitive damage award and how [the insurer] could invoke choice-of-law principles to insulate itself from liability for punitive damages under Illinois law." In the court's view, these allegations rose above the factual situations in the cases relied on by the insurer which included: (1) alleged misrepresentations that were implied "and not, as here, express," (2) instances where the plaintiff had failed to "point to any evidence of the defendant's intent" or (3) citations to an alleged scheme that was "not in and of itself fraudulent."

The court next considered the insurer's contention that the law firm had not met the heightened pleading requirements for fraud under Federal Rule of Civil Procedure 9(b). The court agreed with the insurer, determining that the law firm had not alleged the time and place of the misrepresentations with requisite specificity. Accordingly, the court dismissed the fraud claims, but granted leave to the law firm to replead its allegations "with particularity," including the place and time of the misrepresentations, as well as the parties who were present when the specific misrepresentations were made.

Finally, the court granted the insurer's motion to dismiss the breach of good faith and fair dealing count with prejudice. According to the court, Illinois law does not recognize a "stand-alone claim" for breach of good faith and, as the law firm had conceded, Section 155 of the Illinois Insurance Code regarding "vexatious and unreasonable conduct" preempts claims for bad faith in breach of contract actions. Since this action involved "a bona fide dispute regarding coverage," the court held that the law firm would not be able to establish "vexatious and unreasonable conduct" on the part of the insurer as a matter of law.

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