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NEWSLETTER

Court Holds Return of Two Times Security Deposit Is "Damages"

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The United States District Court for the Northern District of Illinois, applying Illinois law, has held that "damages" in a professional liability policy issued to a company that operated residential apartment buildings includes the amount paid to settle a class action lawsuit allowing the plaintiffs to recover two times their security deposit plus interest. *Nutmeg Ins. Co. v. East Lake Mgmt. & Dev. Corp.*, 2006 WL 3409156 (N.D. Ill. Nov. 22, 2006). The court also rejected the insurer's argument that the payment by the company was uninsurable under Illinois law.

The insurer issued a professional liability policy to a company that owned, operated, and managed residential apartment buildings. The policy covered "Damages" and "Claims Expenses" that the management company became obligated to pay as a result of claims made against it for certain wrongful acts. The policy defined "damages" as "a compensatory monetary amount for which [the management company] may be held legally liable, including judgments (inclusive of any pre- or post-judgment interest), awards, or settlements negotiated with the approval of [the insurer]. Damages do not include... fines, sanctions, taxes, penalties or awards deemed uninsurable pursuant to any applicable law." The policy provided that "[d]amages include punitive and/or exemplary damages or the multiple portion of any multiplied damage award unless such damages are uninsurable pursuant to applicable law." The policy further provided that the term "damages" does not include "any return... of professional fees, profits or other charges."

In the underlying class action suit, a group of tenants alleged that the management company violated the Chicago Residential Landlord and Tenant Ordinance (RLTO) by failing to pay interest on security deposits, failing to provide notice regarding security deposits when the property changed hands, and failing adequately to maintain a residential building. The tenants sought recovery under the RLTO statute providing that the "tenant shall be awarded damages in an amount equal to two times the security deposit plus interest." The settlement of the suit allocated $308,000 for tenants not properly paid interest and not properly notified of the building's transfer of ownership and $100,000 for attorneys' fees and costs. While Nutmeg Ins. Co., the underlying suit, was pending, the insurer filed a declaratory judgment action that sought a declaration that none of the damages sought was covered under the policy. The parties cross-moved for summary judgment on the declaratory judgment claim.

The court first agreed with the policyholder's assertions of ambiguity regarding the portion of the definition of "damages" that carved out "fines, sanctions, taxes, penalties or awards deemed uninsurable pursuant to any applicable law." The court opined that it was questionable whether the phrase "deemed insurable pursuant to any applicable law" modified only "awards" or also modified "fines, sanctions, taxes, [and] penalties." The insurer relied on the "last antecedent rule," providing that "a qualifying phrase is to be confined to the last antecedent phrase," as set forth in *City Trust, Safe Deposit & Surety Co. of Philadelphia v. Lee*, 68 N.E.2d 485 (Ill. 1903), to argue that the phrase modified only "awards." The court disagreed, distinguishing *City Trust* on the basis that the indemnity bond at issue in that case explicitly provided that its terms were to be "most strongly construed" against the party that prepared the indemnity bond. The court then concluded that because the definition of "damages" was ambiguous, it would accept the policyholder's interpretation that the phrase modified both "penalties" and "awards;" it therefore was irrelevant whether the damages awarded under the RLTO statute constituted a "penalty" or an "award" unless the amount was uninsurable under Illinois law.

The management company next argued that the damages, whether a "penalty" or an "award" were uninsurable under Illinois law, relying on *Beaver v. Country Mutual Insurance Co.*, 420 N.E.2d 1058 (Ill. App. Ct. 1981), which held that "public policy should invalidate any contract of insurance against the civil punishment that punitive damages represent." The court rejected the management company's contention that the damages described in Beaver included the type provided by the RLTO statute. The court noted that the statutory damages were not analogous to punitive damages, as it made "no difference whether the landlord's failure to comply with the ordinance was inadvertent or intentional" because the liability under the statute was "absolute." Therefore, the court concluded, damages provided by the RLTO statute were insurable under Illinois law.

The insurer then argued that the part of the settlement allocated to remedy the RLTO claims did not constitute "damages" under the carve out providing that damages do not include "any return... of professional fees, profits or other charges." The court determined that the security deposits and interest did not constitute professional fees or profits under the policy language. Noting that exclusions are narrowly construed, the court suggested that "other charges" "would be amounts that [the management company] demanded for some thing or service" and then concluded that a security deposit and interest did not fall into this category because the money belonged to the tenant, not to the management company.

Relying on *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), the insurer lastly argued that the return of the deposits and interest "constitute[d] the return of funds wrongfully withheld rather than an out-of-pocket loss to [the management company]" and thus did not constitute damages. The court distinguished Level 3, asserting that the issue in that case was whether a settlement in a securities-fraud case constituted a "loss." The court observed that the relevant policy term at issue here was not "loss" but rather "damages," an assuredly broader term. The court further stated that the statutory damages provided under the RLTO were not analogous to those available in certain securities-fraud actions, which are restitutionary in nature, since the purpose in securities actions is to deprive the defendant of the "net benefit of the unlawful act." The court noted that the statutory damages under the RLTO go further, as the landlord is liable for two

times the amount of the security deposit, and therefore provide more than restitution. The court therefore concluded that the $408,000 settlement was covered under the policy.