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Supreme Court of Pennsylvania Holds That Homeowners Insurer Had No Duty to Defend Overdose Suit

Decedent's mother brought a wrongful death suit against her son's friend and his parents. The son overdosed on drugs allegedly given to him by his friend. The decedent's mother alleged that the friend's parents were negligent because they knew or should have known that their son was involved in narcotics and breached their duty of care to the decedent as an invitee in their home.

The parents' homeowners insurer, Nationwide Property and Casualty Insurance Company, denied coverage for the claim. Nationwide denied coverage based on an exclusion in the policy for personal liability for bodily injury related to the use or delivery of controlled substances. The parents sued Nationwide in Pennsylvania state court.

The trial court granted summary judgment for the parents. The trial court ruled that the controlled substances exclusion was inapplicable because the liability theory in the underlying suit sounded in the parents' negligence, not the use or delivery of controlled substances. Nationwide appealed.

The Superior Court affirmed on alternative grounds. It found that the controlled substances exclusion applied to "bodily injury" (defined as "bodily harm, including resulting care, sickness or disease, loss of service or death" but not including "emotional distress, mental anguish, humiliation, mental distress or injury, or any similar injury unless the direct result of bodily harm"). But the court found that the suit was not limited to "bodily injury." It potentially asserted emotional distress and mental injury not directly connected to bodily injury. Because the underlying suit potentially included emotional and mental distress, it found the controlled substances exclusion did not bar a claim seeking those damages and that Nationwide had a duty to defend. Nationwide appealed again.

The Supreme Court of Pennsylvania reversed the judgment of the Superior Court. The court noted that the policy requires an Occurrence, which in turn, must cause "bodily injury." As "bodily injury" under the policy included emotional distress only if the direct result of bodily harm, the Superior Court's determination that the mother did not suffer "bodily injury" under the policy should have resulted in no coverage. The court thus reversed the judgment of the Superior Court that affirmed the trial court's order granting the parent's motion for summary judgment.

The case is *Kramer v. Nationwide Prop. & Cas. Ins.,* No. 103 MAP 2022 (Pa. Apr. 25, 2024).

The Case of the Missing Diamond: Illinois Appellate Court Finds Innocent Insured Doctrine Trumps Misappropriation Exclusion

We've seen plenty of insurance cases that distinguish between "an" insured and "the" insured. But this case takes that to another level.

The case arises from a spat between a husband and wife, both insured under a policy on a 3.57 carat diamond engagement ring valued at nearly $140,000. After an argument, the husband ran off with the ring, proclaiming that his wife would never see it again. But she got an emergency protective order, and as part of that order, her husband had to return the ring. He returned the ring. The only problem was that he swapped the real diamond for a synthetic one.

The wife filed a claim under the policy. The insurer investigated. A few competing stories emerged. The wife suspected her husband replaced the stone because he threatened to take the ring many times before. But the husband said that he pawned the ring to support his wife's gambling habit and that the pawn shop must have substituted the fake diamond for a real one. The husband also suggested that he might have been framed by his wife's father.

Whatever the case, the insurer denied coverage under the misappropriation exclusion. That exclusion read: "We do not cover any loss caused by the taking or other misappropriation by or directed by

a person named in the Coverage Summary, that person's spouse, a family member, or a person who lives with you."

The insurer concluded that it did not matter which spouse was responsible for the loss; neither were entitled to recover because both were insured under the policy. The trial and appellate courts both agreed that the misappropriation exclusion applied. As the trial court noted, it "excludes coverage where *one of the insureds* took the ring and replaced the real diamond with an imitation diamond." And the appellate court affirmed that the phrase "loss caused by the taking or other misappropriation" was clear and unambiguous. Since one of the insureds took the ring or otherwise wrongly made use of the diamond, the court found the misappropriation exclusion applied.

End of story, right? Wrong.

Despite the misappropriation exclusion, the court found the wife could recover because she was an innocent insured.

The innocent insured doctrine allows an insured who is innocent of wrongdoing to recover despite the wrongdoing of other insureds. Illinois courts have typically applied the doctrine to avoid enforcement of the intentional act exclusion, such as where a child sets fire to or vandalizes his or her parent's home. These courts often justify the result by suggesting that the policy did not clearly state that it would be void as to all insureds because of the improper behavior of any insured.

The appellate court found that the misappropriation exclusion did not contain a clear statement that the policy was void as to all insureds in the event of wrongdoing. But how could the court say this when it just concluded that the misappropriation exclusion unambiguously applied when *one* of the insureds took the ring?

The insurer argued that applying the innocent insured exception would effectively write the misappropriation exclusion out of the policy. The court disagreed, saying that the exclusion could apply in situations where none of the covered individuals are innocent. But that's not what the exclusion says – all insureds need not be complicit, only one needs to misappropriate. And by tossing aside the plain language

of the exclusion, which the court itself said was unambiguous, the court is violating a canon of policy construction. It's not supposed to rewrite the policy to give the insured a better contract than it bought.

The court justified its decision based on the insured's reasonable expectations; it was reasonable for the wife to expect coverage when she was deprived of the use of her diamond through no fault of her own. But can she reasonably have that expectation when the policy unambiguously says there is no coverage if *any* insured commits a wrongful taking?

The problem with the court's ruling is that it encourages precisely what this exclusion was meant to avoid: deliberate and collusive loss. Under the court's logic, what's to stop an unscrupulous couple from making a nice profit at the expense of the insurer? The husband keeps the cash from the sale of the diamond. The wife professes innocence and is paid the value of the diamond ring. And together they have twice as much. That's not how insurance is supposed to work.

The case is *Dana v. Great N. Ins. Co.,* No. 1-23-0224 (Ill. App. Ct. Apr. 22, 2024).

5th Circuit Finds Endorsement for Motorized Vehicle-Related Deaths Excludes Coverage for Race Wars 2 Spectator Deaths

A car careened off the raceway and collided with spectators at Race Wars 2, a one-day amateur "no prep" drag racing event. Injured spectators, on their own behalf and on behalf of the estates of their deceased family members, sued Flyin' Diesel Performance & Offroad, LLC, the event's sponsor and organizer – which turned to its insurer, Kinsale Insurance Company, for legal defense. The Kinsale policy was a commercial general liability policy with an endorsement that covered injury arising out of certain designated events ("CDE"), including Race Wars 2. The policy also contained a Motorized Vehicle endorsement which excluded coverage for "any claim or 'suit' . . . arising directly or indirectly out of . . . the operation . . . of any motorized vehicle of any type."

The district court, after finding the CGL policy ambiguous, declared that Kinsale owed Flyin' Diesel a duty to defend. Kinsale appealed.

The Fifth Circuit, applying Texas law, reversed. The court rejected Flyin' Diesel's argument that the policy was ambiguous because each endorsement had a footer saying, "All other terms and conditions of the policy remain unchanged." Flyin' Diesel had argued that multiple endorsements with this language couldn't co-exist because they both couldn't change the policy but keep all other terms of the policy the same. But the court said that Flyin' Diesel misunderstood what the "policy" was. The "policy" was the CGL form, declarations, and all the endorsements together. In a literal sense, none of the endorsements modified the policy's terms because they already comprised the policy. Both the CDE endorsement and MV endorsement only modified express "subsets" of the CGL form, not the entire policy. The footer language, the court observed, was merely an express statement of what is usually implied: each endorsement did only what it says, nothing more.

Because the facts in the underlying litigation clearly fell within the motorized vehicle endorsement, the CGL policy did not cover the underlying lawsuit and Kinsale had no duty to defend.

The case is *Kinsale Ins. Co. v. Flyin' Diesel Performance*, No. 23-50336 (5th Cir. 2024).

Sixth Circuit Affirms Order Directing Policyholder to Reimburse Insurer for Defense Costs

Stout Risius Ross, LLC was a financial advisor to a paper manufacturing company's Employee Stock Ownership Plan. Stock prices collapsed, and the plan's investors lost hundreds of millions of dollars. The plan's investors accused Stout of overvaluing stock and inducing employees to invest their retirement savings in the stock ownership plan. They filed two lawsuits against Stout alleging ERISA and securities violations. The suits also alleged common law fraud and negligent misrepresentation.

Stout sought a defense from its professional liability insurer. The policy had an exclusion for claims "based on or arising out of actual or alleged violation of: (1) The Employee Retirement Income Security Act of 1974; (2) The Securities Act of 1933; (3) The Securities Act of 1934; (4) Any state Blue Sky or Securities law."

The insurer defended Stout under a reservation of rights that included the right to seek reimbursement of defense costs if it had no duty to defend. Stout then filed a declaratory judgment action in federal court in Michigan and made a motion seeking to get clear of any duty to defend. The district court denied its motion, finding that the exclusion did not bar the common-law claims.

The investors later amended their complaints by dropping the common-law claims and asserting claims based only on federal securities laws. The insurer again moved for summary judgment, and the court agreed that the insurer no longer had a duty to defend.

The insurer then sought to recoup the defense costs it paid both before and after the amendment. It asserted implied-in-fact contract theory and unjust enrichment. The district court denied the motion for reimbursement of costs before the amended complaint was filed but allowed the insurer to recover the amount paid afterward under the implied-in-fact contract theory. Both parties appealed.

The Sixth Circuit agreed with the district court that the common-law claims were not excluded, and that the insurer could not recoup defense costs paid before the amendment because it was under a duty to defend the allegations in the original complaint. But when the amended complaint was filed, the claim was now confined to one outside of coverage.

Stout argued that Michigan law did not permit reimbursement. The Sixth Circuit disagreed, finding that Michigan law was silent on the issue, such that the court had to make an "*Erie* guess." The Sixth Circuit acknowledged that the policy did not expressly authorize reimbursement, but that did not matter. The district court's ruling that the insurer was entitled to post-amendment reimbursement was based on an implied-in-fact contract. The Sixth Circuit found nothing to suggest that the Michigan Supreme Court would decline to recognize implied-in-fact contracts in the insurance context.

The Sixth Circuit thus concluded that reimbursement under Michigan law is permitted when the insurer issues a timely reservation of rights letter providing notice of the specific possibility of reimbursement and defends an insured after the policy no longer obligated it to do so.

The court rejected Stout's argument that there was no consideration to support a contract because the insurer was under a preexisting duty to defend. The court said that premise failed because the insurer no longer had such a duty after the amended complaint was filed. The court also rejected Stout's contention that mutual assent was lacking. The court found that Stout manifested assent when it accepted the insurer's defense after the insurer timely notified Stout that it might seek reimbursement.

The court concluded that the Michigan Supreme Court would recognize an implied-in-fact contract in this context and thus affirmed the district court's ruling directing the policyholder to pay back the post-amendment defense costs.

The case is *Great Am. Fid. Ins. Co. v. Stout Risius Ross, Inc.,* Nos. 23-1167/1195 (6th Cir. Apr. 8, 2024).

Ninth Circuit Upholds Dismissal of Treasure Hunter's Insurance Claim

We've reported previously on a treasure hunter's quest for insurance coverage in a dispute with his former business partners. The saga continues in the Ninth Circuit, but with the same result. No recovery.

A salvage company sought to recover lost treasure from a ship that sank off the coast of Alaska in 1901. The ship had a sizeable amount of gold bullion. But the expedition did not succeed, and the salvage company later dissolved. During the dissolution, one of the salvage company's partners agreed to convey to Rodger May certain intellectual property that would allow him to conduct future salvage operations. When the intellectual property was not turned over, May sued.

May alleged that the salvage company's failure to relinquish the intellectual property prevented him from moving forward with the salvage operations and jeopardized his recovery of gold bullion valued in the millions of dollars.

May and his former business partners eventually settled the dispute for $7.5 million. As part of the settlement, the salvage company assigned its insurance rights to May.

The insurer denied May's claim for coverage because any harm from the refusal to turn over intellectual property was not caused by an "occurrence," defined in the policy as an "accident." Nor did the claim allege any damage to tangible property.

The insurer sought a declaration that it owed no coverage. May argued that the wrongful deprivation of his intellectual property rights constituted an "accident."

The Ninth Circuit disagreed with May. Applying Washington law, the court observed that an event is an "accident" only if both "the means as well as the result were unforeseen, involuntary, unexpected and unusual." There is no accident when a deliberate act is performed unless some additional unexpected, independent, and unforeseen happening occurs to bring about damage or injury.

Applying that principle here, the court found there was no genuine dispute that the salvage company acted deliberately in withholding the intellectual property and it was foreseeable that its refusal to deliver the intellectual property to May would result in a claim for damages. The court thus ruled that the complaint's allegations did not raise any conceivable possibility of an accident and that the salvage company's actual liabilities under the settlement were not caused by an "occurrence."

The case is *Great Am. Ins. Co. v. May*, No. 23-35024 (9th Cir. Apr. 26, 2024).

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