

No. 03-3010

IN THE APPELLATE COURT OF ILLINOIS
FIRST DISTRICT

AMERICAN MOTORISTS INSURANCE)
COMPANY,)

Plaintiff-Appellant,)

v.)

MILGRAY ELECTRONICS, INC., n/k/a)
BELL INDUSTRIES, INC.,)

Defendant-Appellee.)

Case No. 98 CH 08305

Judge Deborah M. Dooling

BRIEF OF DEFENDANT-APPELLEE MILGRAY ELECTRONICS, INC.,
N/K/A BELL INDUSTRIES, INC.

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INTRODUCTION

This is a case that never should have been brought. Rather than simply acknowledging its duty to defend under the broad provisions of its comprehensive general liability insurance policy and the generous coverage standards of Illinois law, American Motorists Insurance Company (“AMICO”) initiated this preemptive declaratory judgment action in the hope that it might be absolved of its obligations under the policy. Despite having conceded that the underlying federal complaint alleges “property damage,” AMICO continues to insist that the allegation is not clear enough, and further argues that any such damage must have been “expected or intended” based on the now vacated verdict and judgment in the federal trial.

The circuit court squarely rejected AMICO’s arguments no fewer than *eight* times – denying five separate motions for summary judgment and two motions for reconsideration brought by AMICO, and granting the summary judgment motion here on appeal – and it was right in so doing. As we explain below, the federal complaint plainly alleges a “loss of use” of tangible property, which does not even require “physical injury” under the terms of the policy. Moreover, since AMICO filed its brief in this Court, the Seventh Circuit has vacated the very finding of fact that forms the basis for AMICO’s contention that the property damage that occurred here falls within the policy’s “expected or intended” exception. AMICO has nothing left to stand on.

It is time to put this wasteful, six-year-old litigation to rest. We therefore respectfully request that this Court affirm the circuit court’s disposition of the motion and cross-motion for summary judgment in its entirety.

ISSUE PRESENTED

Whether an insurer may claim to have no duty to defend its insured under a comprehensive general liability insurance policy even when the complaint in the underlying litigation alleges a potentially covered claim.

JURISDICTION

This appeal arises from the trial court's order granting defendant's motion for summary judgment and denying plaintiff's cross-motion for summary judgment, expressly made final and appealable pursuant to Illinois Supreme Court Rule 304(a). That order did not dispose of the entire proceeding, insofar as it did not address plaintiff's claims against a second defendant in this case, Williams Electronic Games, Inc. ("Williams"). It also did not revisit the court's previous orders denying four separate motions for summary judgment submitted by plaintiff. Consequently neither the claims against Williams, nor the prior summary judgment orders, are at issue here.

STATEMENT OF FACTS

A. Introduction

Bell Industries, Inc. ("Bell") is a small California corporation that acquired Milgray Electronics, Inc. ("Milgray") in January 1997. C1987. Following the acquisition, Bell discovered that for many years Milgray employees Larry Gnat ("Gnat") and Richard Slupik ("Slupik") had secretly operated a competing business called Microcomp, Inc. ("Microcomp"). C2002, C2004-C2006, C2014-C2015. Slupik and Gnat made millions selling electronic components to Milgray's customer, Williams, which used the components to make video games. *Ibid.* Williams' senior buyer, Greg Barry, facilitated the Microcomp sales by taking kickbacks from Gnat and Slupik and agreeing to keep their scheme secret. *Ibid.*

One year after Bell's acquisition of Milgray, Williams filed a federal complaint against Milgray, Arrow Electronics and other companies alleging that the companies' salesmen (including Slupik and Gnat) had paid kickbacks to Barry. *Williams Electronic Games, Inc. v. Garrity, et al.*, No. 97 C 3743 (N.D. Ill.). Milgray raised a number of affirmative defenses based on Williams' participation (through its agent Barry) in Gnat and Slupik's fraud on Milgray.

Determining that the complaint filed against it was potentially within the scope of its liability insurance policy with AMICO, Milgray requested defense and indemnity for the Williams litigation. Rather than acknowledging its duty to defend and proceeding pursuant to a reservation of rights, AMICO filed this action for a declaratory judgment, seeking to avoid both the duty to defend and the duty to indemnify. AMICO filed two motions for summary judgment early in the proceedings, arguing as a matter of law that (a) the federal complaint alleged a deprivation of Williams' property that was insufficient to trigger the duty to defend, and (b) the "property damage" and "expected or intended" exclusions of the subject policy barred any duty to defend. Both motions were denied.

B. The Federal Trial

The Williams litigation then went to trial, resulting in a jury verdict on March 14, 2002.¹ The evidence at trial supported Milgray's allegations against Williams and established that Milgray was not liable for any of Williams' claims. In particular, the evidence showed that from 1991 to 1996 Gnat and Slupik made millions of dollars by using their secret company (Microcomp) to sell components to Williams that Milgray also sold to Williams. C2003-C2004, C2010-C2012, C2014-C2015. In furtherance of the scheme, Gnat and Slupik paid Barry more

¹ Although Williams originally asserted a host of claims against Milgray, it proceeded to trial on only two claims – fraud and inducement of breach of fiduciary duty.

than \$625,000 in kickbacks to purchase electronic components from Microcomp. C2002. Neither Barry nor Gnat nor Slupik ever disclosed to Milgray the payment of the kickbacks or the diversion of sales from Milgray to Microcomp. C2005-C2006, C2015-C2017.

The evidence thus established that Barry helped Gnat and Slupik defraud Milgray of their faithful and loyal services (and millions of dollars in lost sales) by taking kickbacks and by concealing the fraud from Milgray executives. C2002, C2005-C2006; SA2.² This fact clearly emerged from the testimony of Williams' star witness at trial – Barry himself:

Q. And you knew, Mr. Barry, that by taking \$625,000 in kickbacks from Gnat and Slupik to buy parts from Microcomp, you were helping Gnat and Slupik cheat Milgray; isn't that true?

A. Yes.

SA2. Finally, the evidence showed that Williams paid a competitive rate for the components it purchased from *Milgray* and that Williams did not suffer any harm as a result of any kickbacks that Gnat and Slupik allegedly paid to Barry on behalf of *Milgray*. C1990.

At the close of the evidence, the jury returned a verdict in Williams' favor only on its fraud claim against one defendant (an Arrow salesman named James Garrity) and awarded Williams \$78,000 in damages only against *Garrity*. With respect to *Milgray*, the jury entered a verdict of no liability for *Milgray* based on its affirmative defenses, even though the jury found that Williams had proved common law fraud. C2019-C2021.

Following the jury verdict, Williams moved for judgment on its remaining equitable claims against *Milgray*. The district court denied the claims. C1996. In so doing, the district court stressed that Williams had “established no damages, and no loss resulting from the payments to its buyer.” *Ibid.* In particular, the district court found that “(1) [Williams] paid a

² References to “A__” are to appellant's appendix; references to “SA__” are to appellee's supplemental appendix, which is attached hereto.

competitive rate for the components purchased from Arrow and Milgray; (2) [Williams] would have purchased from Arrow and Milgray even in the absence of the kickbacks.” C1990. Accordingly, based on the jury’s verdict and its own findings, the district court entered judgment against Williams and for Milgray on all of Williams’ claims. C1997.

C. Additional Proceedings in the Instant Litigation

Following the trial in the *Williams* case, AMICO once again moved for summary judgment in the instant action, this time arguing that the federal verdict showed that the litigation did not involve “property damage” within the meaning of the subject CGL policy. This motion was denied – as was yet *another* AMICO summary judgment motion, submitted subsequently and advancing the theory that Milgray should be “estopped” from denying that the “expected or intended” exclusion of the policy applied in light of the *Williams* jury’s finding that the elements of fraud had been established against Milgray.

Milgray then filed its own motion for summary judgment, relying in part on conclusions previously reached by the circuit court in denying AMICO’s summary judgment motions. AMICO filed a cross-motion for summary judgment. Following argument, the circuit court granted Milgray’s motion and denied AMICO’s cross-motion in an oral ruling and judgment entered on September 22, 2003.³ A6, A78, A82. This appeal followed.

D. The Seventh Circuit Decision

On April 29, 2004, the United States Court of Appeals for the Seventh Circuit ruled in the *Williams* litigation, vacating the jury’s fraud finding against Milgray and reversing all aspects of the trial court’s judgment relevant to the instant appeal. *Williams Electronics Games, Inc. v.*

³ In addition to ruling on AMICO’s four unsuccessful motions for summary judgment (and its final cross-motion), the circuit court denied AMICO’s motions to reconsider on Oct. 13, 1999, and Feb. 1, 2002. C507, C1444. Thus, together with the ruling on appeal granting Milgray’s motion for summary judgment, the circuit court has rejected AMICO’s arguments on the merits no fewer than *eight times*.

Garrity, 366 F.3d 569, 580 (7th Cir. Apr. 29, 2004). In an opinion by Judge Posner, the court of appeals concluded that the jury instructions on affirmative defenses were flawed in such a way as to undermine the jury’s determination that the elements of fraud had been established. *Id.* at 573-575. Indeed, according to the court, the erroneous affirmative-defense instructions “made a confusing mish-mash with the instruction on prima facie fraud.” *Id.* at 574. The court thus remanded the case for a new trial on fraud, expressly rejecting Williams’ argument that it should be entitled to judgment based on the fraud finding. *Id.* at 574-575. The verdict and judgment having been rendered of no effect by the court of appeals, the case is once again proceeding before the federal district court.

STANDARD OF REVIEW

Illinois courts have long recognized that summary judgment is an “important tool in the administration of justice,” and its use in appropriate cases “is to be encouraged.” *Allen v. Meyer*, 14 Ill. 2d 284, 292, 152 N.E.2d 576, 580 (1958). The standard of review in cases involving summary judgment is *de novo*, *Ragan v. Columbia Mut. Ins. Co.*, 183 Ill. 2d 342, 349, 701 N.E.2d 493, 496 (1998), keeping in mind that where the duty to defend is at issue, “[t]he underlying complaints and the insurance policies must be liberally construed in favor of the insured,” and “[a]ll doubts and ambiguities must be resolved in favor of the insured.” *United States Fidelity & Guaranty Co. v. Wilkin Insulation Co.*, 144 Ill. 2d 64, 74, 578 N.E.2d 926, 930 (1991).

ARGUMENT

I. THE CIRCUIT COURT APPLIED THE CORRECT LEGAL STANDARDS IN DETERMINING THAT AMICO HAS A DUTY TO DEFEND MILGRAY

In its decisions, the Supreme Court has identified four major principles governing an insurer’s duty to defend – a duty much broader than the duty to indemnify. *First*, the Court has

held that the duty to defend must be determined “*solely* from the allegations of the complaint in the underlying suit.” *National Union Fire Ins. Co. v. Glenview Park Dist.*, 158 Ill. 2d 116, 124, 632 N.E.2d 1039, 1042 (1994) (emphasis added).⁴ Under this rule, a trial court “must look *only* to the complaint to see if the allegations show that the insured’s conduct is potentially within coverage.” *United States Fidelity & Guaranty Co. v. Wilkin Insulation Co.*, 193 Ill. App. 3d 1087, 1092, 550 N.E.2d 1032, 1035 (1st Dist. 1989) (emphasis added), *aff’d*, 144 Ill. 2d 64, 578 N.E.2d 926 (1991).

Second, the Court has held that the underlying complaint need only allege facts that are *potentially* within the coverage of the policy to establish the duty to defend. *Glenview Park Dist.*, 158 Ill. 2d at 124-25, 632 N.E.2d at 1043. Under this principle, the complaint “need not allege or use language affirmatively bringing the claims within the scope of the policy, as the question of coverage should not hinge exclusively on the draftsmanship skills or whims of the plaintiff in the underlying action.” *Western Cas. & Sur. Co. v. Adams County*, 179 Ill. App. 3d 752, 756, 534 N.E.2d 1066, 1068 (4th Dist. 1989).

Third, the Court has held that the “threshold that a complaint must meet to present a claim for potential coverage is low.” *Wilkin*, 193 Ill. App. 3d at 1092, 550 N.E.2d at 1035. Under this principle, any “[d]oubt as to coverage must be resolved in favor of the insured.” *Id.*

Fourth, the Court has held that “once the duty to defend is found to exist with respect to one or some of the theories of recovery advanced in the underlying litigation, the insurer must defend the insured with regard to the remaining theories of recovery as well.” *Glenview Park Dist.*, 158 Ill. 2d at 124, 632 N.E.2d at 1042-43.

⁴ Remarkably, in its brief, AMICO does not discuss (or even cite) *Glenview Park District*, the leading Illinois Supreme Court decision dealing with an insurer’s duty to defend.

What emerges from these cases, then, is the following rule: If a complaint alleges *any* facts that *potentially* fall within the coverage of the policy, the insurer has a duty to defend the entire case, even if the complaint also alleges other facts that fall outside the policy – and even if the plaintiff’s allegations ultimately prove to be false or groundless. Thus, as the Illinois Supreme Court stated in *Glenview Park District*:

If the underlying complaints allege facts within or *potentially* within policy coverage, the insurer is obliged to defend its insured *even if the allegations are groundless, false, or fraudulent*. An insurer may not justifiably refuse to defend an action against its insured unless it is clear from the face of the underlying complaints that the allegations fail to state facts which bring the case within, or potentially within, the policy’s coverage.

158 Ill. 2d at 124, 632 N.E.2d at 1043 (citation omitted and emphasis added).

These principles properly informed the circuit court’s disposition of the various summary judgment motions in this matter.

II. THE COMPLAINT IN THE UNDERLYING LITIGATION ALLEGES “PROPERTY DAMAGE” WITHIN THE MEANING OF THE POLICY

At bottom, this case is quite simple. It ultimately boils down to the question whether the circuit court correctly applied the above principles when it concluded – as it did first in April 1999 and then on numerous subsequent occasions in response to AMICO’s renewed summary judgment motions – that the federal complaint alleged facts potentially within the AMICO policy’s definition of “property damage.”⁵

⁵ AMICO misstates the record when it asserts (at 11) that the circuit court “did not specifically state, but rather implied,” that the Williams complaint alleged “property damage.” When it initially denied AMICO’s motion for summary judgment in April 1999, the court quoted directly from an earlier (and substantially similar) version of Paragraph 20 of the federal complaint, which specifically alleged a deprivation of “property”:

THE COURT: But what you’re doing is you’re overlooking the statement in that earlier sentence where it says, “Barry’s honest services and its money *and property*,” and he’s talking about the Defendants and [Milgray] is unquestionably one of the Defendants.

...(continued)

The AMICO policy defines “property damage” to consist not only of “physical injury to tangible property,” but also the “loss of use of tangible property that is not physically injured”:

- (a) *Physical Injury to Tangible Property*, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or
- (b) *Loss of Use of Tangible Property* that is not physically injured. All such loss of use shall be deemed to occur at the time of the “occurrence” that caused it.

C1937 (emphasis added). Thus, under the express terms of the policy, “property damage” can occur if a plaintiff is deprived of his use of tangible property even though that property is *not* “physically injured.”

It is the “loss of use” definition that is implicated in the federal complaint.⁶ As the circuit court repeatedly (and correctly) found, the plain language of that complaint refutes AMICO’s claim. For example, in Paragraph 20, the Third Amended Complaint specifically alleges that the defendants (including Milgray) facilitated a scheme to deprive Williams of both money *and* the use of its property by paying kickbacks to Barry and through various other means. C2103-C2104. Similarly, in Paragraph 49, the Third Amended Complaint expressly alleges that the defendants “directly injured” Williams in both its *property* and its business. C2113-C2114. The Complaint thus expressly alleged that the defendants deprived Williams of the use of its money *and* its tangible property, and on this basis, Williams sought to hold Milgray accountable for the conduct of its two former employees.

...(continued)

C2068-C2069 (emphasis added). Based on this analysis, the court held that the federal complaint sufficiently alleged a deprivation of property to trigger AMICO’s duty to defend.

⁶ For this reason, AMICO’s argument that the Williams complaint does not allege “physical injury” to property is a red herring to which no response is required. See Pl. Br. 11-13.

AMICO argues that the federal complaint alleges only “purely economic losses” (such as “lost profits” or “lost financial interests”), which it claims fall outside the definition of “loss of use of tangible property.” Pl. Br. 13. The federal complaint nowhere defines the term “property” in economic terms, however. Indeed, to the extent there is any ambiguity in the federal complaint, Williams has submitted discovery responses in the instant action clarifying that its references to “property” in the underlying suit go beyond a mere “claim [that] money is property,” C828, and asserting damage to certain computer databases and electronic components supposedly resulting from Milgray's alleged conduct. C1129-C1130.

AMICO's argument in the end reduces to little more than the contention that Williams was not specific enough in its complaint and failed to use the magic words “loss of use.” But this is not required in order for the underlying complaint to allege facts that are *potentially* within the coverage of the policy. See *Glenview Park Dist.*, 158 Ill. 2d at 124-25, 632 N.E.2d at 1043; *Western Cas. & Sur. Co.*, 179 Ill. App. 3d at 756, 534 N.E.2d at 1068 (noting that “the question of coverage should not hinge exclusively on the draftsmanship skills or whims of the plaintiff in the underlying action”); *Travelers Ins. Cos. v. P.C. Quote, Inc.*, 211 Ill. App. 3d 719, 724, 570 N.E.2d 614, 617 (1st Dist. 1991) (“In order to sustain a claim for potential coverage, the threshold requirements of the allegations of the complaint are minimal.”); *Avemco Ins. Co. v. Acer Enters., Inc.*, 796 F. Supp. 343, 346 (N.D. Ill. 1992) (under Illinois law, the “duty to defend hinges on a liberal reading of the underlying complaint”).

In addition, the cases AMICO cites have no relevance to the facts here. In two of the cases, for example, the underlying complaint did not allege the loss of use of tangible property. *CMO Graphics, Inc. v. CNA Ins.*, 115 Ill. App. 3d 491, 497, 450 N.E.2d 860, 863-64 (1st Dist. 1983) (Plaintiff “did not attempt in the third amended complaint to recover for any damage

caused to its products or for the diminution in market value of its products”); *Bituminous Cas. Corp. v. Gust K. Newberg Constr. Co.*, 218 Ill. App. 3d 956, 965, 578 N.E.2d 1003, 1009 (1st Dist. 1991) (“Moreover, in the State’s answers to interrogatories, it admits that ‘the damages alleged do not specifically refer to or include loss of use and diminution in value’”).

Commercial Union Ins. Co. v. Image Control Property Mgmt., Inc., 918 F. Supp. 1165 (N.D. Ill. 1996), is equally inapposite, in that the supposed claims of “property damage” there amounted to nothing more than allegations of “lost profits,” “lost funds,” and “lost physical, financial and emotional independence due to the defendants’ discrimination.” *Id.* at 1171 & n.10. Similarly, in *Travelers Ins. Cos. v. P.C. Quote, Inc.*, 211 Ill. App. 3d 719, 570 N.E.2d 614 (1st Dist. 1991), the underlying case involved the theft of computers that the insured did not receive but may have been required to pay for. The mere obligation to pay, the Court held, does not implicate property damage. *Id.* at 725-26, 570 N.E.2d at 618.

This case is more like *Gibraltar Cas. Co. v. Sargent & Lundy*, 214 Ill. App. 3d 768, 574 N.E.2d 664 (1st Dist. 1991), also cited by AMICO. Pl. Br. 13. In *Gibraltar Casualty*, the insured was sued for fraud and RICO violations arising out of the plaintiff’s allegedly lost investment in the construction of a nuclear power plant that had been delayed. The insurer balked at defending the insured under a loss of use of property definition identical to AMICO’s policy, arguing that the loss of use alleged resulted in merely economic losses. The appellate court affirmed summary judgment for the insured in a declaratory judgment action, holding that an increase in the cost of the plaintiff’s investment and construction delays were sufficient to allege a loss of use. The court reasoned that there is “loss of use of a new or existing building” where “faulty construction causes construction delay and the temporary inability to use the property, and loss of use damages include the cost of correcting the defect.” 214 Ill. App. 3d at

781-82, 574 N.E.2d at 671-72. The court distinguished between loss of use claims and loss of investment:

Loss of use as distinguished from loss of profits is the loss of the right to use property which is an incident of ownership. Loss of use claims are not the same as claims for anticipated profits or loss of investment, and a party's description of loss of use damages as merely economic does not take them outside the coverage of an insurance policy that defines property damage as including loss of use.

Id. at 780, 574 N.E.2d at 671 (citation omitted). In this same way, Williams alleges that it was deprived of its property. Just as the buildings in the nuclear power plant in *Gibraltar Casualty* remained unused for a period of time, the complaint here (clarified by Williams' discovery responses) alleges that Williams' computer database was rendered useless and its electronic components ultimately were thrown out. Therefore, the underlying litigation plainly involves a claim of "property damage" against Milgray, and AMICO owes a duty to defend pursuant to the terms of its policy.

III. THE CIRCUIT COURT RIGHTLY REJECTED AMICO'S "EXPECTED OR INTENDED" ARGUMENTS

A. The Seventh Circuit's Decision Vacating The Factual Findings And Jury Verdict In The Underlying Litigation Effectively Defeats AMICO's "Expected Or Intended" Arguments.

AMICO devotes much of its brief to the argument that the circuit court erred in "ignoring" the outcome of the federal trial, which AMICO characterizes as conclusively defeating coverage here. Pl. Br. 17-21. Variations of this argument featured prominently in several of AMICO's unsuccessful motions for summary judgment, which (as shown below) the circuit court was right to reject even before the recent Seventh Circuit decision in the underlying litigation. Now that the fact findings and jury verdict that form the basis for AMICO's collateral estoppel and "extrinsic evidence" arguments have been vacated on appeal, however, AMICO's arguments based on the outcome of the federal trial should be rejected out of hand. See, e.g.,

Meeker v. Payne, 101 Ill. App. 3d 723, 726, 428 N.E.2d 614, 615-16 (5th Dist. 1981) (judgment of trial court that has been reversed is a “nullity”); *United States v. Williams*, 904 F.2d 7, 8 (7th Cir. 1990) (“[W]hen a conviction is vacated, the effect is to nullify the judgment entirely and place the parties in the position of no trial having taken place at all.”); *State v. Cribbs*, 967 S.W.2d 773, 788 (Tenn. 1998) (declining to reinstate jury verdicts because, “once vacated, the jury’s findings with respect to those two counts were rendered void”) (citing Black’s Law Dictionary 1548 (6th ed. 1990) (defining “vacate” as “[t]o annul; to set aside; to cancel or rescind. To render an act void; as to vacate an entry of record, or a judgment”)).⁷

This is particularly the case insofar as AMICO asserts that collateral estoppel principles should prevent Milgray from arguing that the “expected or intended” exclusion does not bar a duty to defend. “A vacated judgment has no collateral estoppel or res judicata effect under Illinois law.” *Pontarelli Limousine, Inc. v. Chicago*, 929 F.2d 339, 340 (7th Cir. 1991); *Jackson v. Coalter*, 337 F.3d 74, 85 (1st Cir. 2003) (“After all, it is hornbook law that a vacated judgment has no preclusive force either as a matter of collateral or direct estoppel”); *Meeker*, 101 Ill. App. 3d at 726, 428 N.E.2d at 615 (cited by *Northern Ind. Commuter Transp. Dist. v. Chicago Southshore & South Bend R.R.*, 685 N.E.2d 680, 689 (Ind. 1997) (under Illinois law, a “judgment in a civil case that is reversed on appeal is not entitled to preclusive effect”); 18A Charles Alan Wright et al., *Federal Practice and Procedure* § 4432, at 61 (2002) (“Once . . . the judgment is vacated, preclusion is of course defeated as to any matter that is left open for further proceedings.”); 23A Illinois Law and Practice *Judgments* § 300, at 94 (1979) (“Generally, a

⁷ Indeed, AMICO’s entire second Question Presented (concerning intentional acts) is predicated upon the finding of fraud by the jury in the underlying litigation. Pl. Br. 4. Consequently, AMICO’s appeal is properly limited to arguments concerning the definition of “property damage.”

judgment which has been reversed on appeal . . . is deprived of its conclusive character and thereafter no longer stands as a bar to a further action on the same cause of action.”⁸

AMICO argues that consideration of extrinsic evidence “is not prohibited of a trial court” in determining a duty to defend. Pl. Br. 18. This contention, however – in addition to colliding with *Glenview Park District’s* insistence that the duty to defend be determined “solely from the allegations of the complaint in the underlying suit,” 158 Ill. 2d at 124, 632 N.E.2d at 1042 – fails to acknowledge Illinois courts’ reluctance to rely on extrinsic evidence to determine the duty to defend except in narrow circumstances involving “ancillary matters.” *State Farm Fire & Cas. Co. v. Shelton*, 176 Ill. App. 3d 858, 867, 531 N.E.2d 913, 919 (1st Dist. 1988). Moreover, the two cases AMICO relies on in an effort to show the importance of extrinsic evidence in fact involved the duty to *indemnify* following a finding of liability on the part of the insured. See *State Farm Fire & Cas. Co. v. Martin*, 186 Ill. 2d 367, 377, 710 N.E.2d 1228, 1234 (1999) (“Accordingly, State Farm is not required to indemnify Martin for the civil liability resulting from his actions.”); *J. Roth Builders, Inc. v. Aetna Life & Cas. Co.*, 151 Ill. App. 3d 572, 572, 503 N.E.2d 782, 783 (1st Dist. 1987) (plaintiff insured brought “garnishment action” against insurer in light of \$103,000 judgment previously entered against insured). Therefore, this case should be decided based on the allegations in the underlying complaint.⁹

⁸ *Illinois Founders Ins. Co. v. Guidish*, 248 Ill. App. 3d 116, 618 N.E.2d 436 (1st Dist. 1993), cited by AMICO (at 18-19), is not to the contrary. It is not inconsistent to recognize that, although a judgment may enjoy preclusive effect while an appeal is pending, it is *deprived* of such effect if subsequently vacated. See *U.S. Philips Corp. v. Sears Roebuck & Co.*, 1992 WL 296361, *4 n.3 (N.D. Ill. Oct. 14, 1992) (“A judgment that has been vacated, reversed, or set aside on appeal is thereby deprived of all conclusive effect, both as res judicata and as collateral estoppel”) (citing Moore’s Federal Practice), *aff’d*, 55 F.3d 592 (Fed. Cir. 1995); Restatement (Second) of Judgments § 16 (1982) (same).

⁹ AMICO does not contend that the duty to indemnify is at issue, and Milgray agrees that it would be premature to argue over the duty to indemnify given the current posture of the underlying litigation. *Maryland Cas. Co. v. Chicago & N.W. Transp. Co.*, 126 Ill. App. 3d 150, 156, 466 N.E.2d 1091, 1095-96 (1st Dist. 1984) (“A declaratory judgment action to determine an insurer’s duty to indemnify its insured, ... (continued)

B. The “Expected Or Intended” Exclusion Would Not Apply In Any Event.

AMICO next claims that, apart from any collateral estoppel effects, Milgray is not entitled to coverage under the “expected or intended” exclusion because (1) the relevant provisions of the policy exclude coverage for any property damage caused by “intentional conduct”; and (2) the federal complaint alleges only that Milgray intended to defraud Williams of its money and property. Pl. Br. 15-24. As shown below, AMICO is wrong on both counts.

1. The Insurance Policy Excludes Only Acts that the Insured “Intended or Expected” to Cause Property Damage

AMICO’s entire argument rests on the claim that the insurance policy in this case specifically excludes “intentional acts.” Pl. Br. 15-16. *This claim is simply not true.* In point of fact, the policy contains no provision excluding coverage for “intentional acts.” Instead, the policy excludes coverage *only* for acts in which the insured “expected or intended” the resulting property damage. C1924.

This distinction is important because the Illinois Supreme Court has squarely held that the exclusion of coverage for property damage that is “expected or intended” by the insured does not apply to all forms of “intentional conduct.” Rather, the exclusion applies only to acts in which the insured specifically “expected or intended” the property damage alleged in the complaint. *Wilkin Insulation*, 144 Ill. 2d at 77-78, 578 N.E.2d at 932.

For example, *Wilkin Insulation* dealt with an “expected or intended” provision identical to the provision here. In that case, the insurer argued that it had no duty to defend suits for asbestos contamination because the insured knowingly installed the asbestos-containing products

...(continued)

brought prior to a determination of the insured’s liability, is premature since the question to be determined is not then ripe for adjudication.”). Milgray expressly reserves its right to argue the duty to indemnify at a later time.

in the buildings – and therefore the insured “expected or intended” the resulting contamination. In rejecting the argument, the Supreme Court held that the key issue is whether the insured *specifically* expected or intended the alleged *property damage*, rather than whether the insured intended the acts giving rise to the property damage:

Under this definition, it is the “property damage” which must be “neither expected nor intended from the standpoint of the insured.” Therefore, it is the contamination of the buildings and their contents that must be neither expected nor intended by Wilkin.

Ibid.

Thus, under *Wilkin Insulation*, it is not enough to simply show that the insured engaged in “intentional conduct.” Rather, an insurer must also show that the insured “expected or intended” the specific damage that resulted from that conduct. *Ibid.*

2. The Complaint Does Not Allege that Milgray “Intended or Expected” the Property Damage

When the above principles are combined with the general rules governing an insurer’s duty to defend as established by the Illinois Supreme Court, the sole issue becomes whether Williams based its theory of recovery *entirely* on the allegation that Milgray “expected or intended” to injure Williams’ property or business. This is because, as shown earlier, if Williams relied on any alternative theory of recovery, the “insurer must defend the insured with regard to the remaining theories of recovery as well.” *Glenview Park District*, 158 Ill. 2d at 124, 632 N.E.2d at 1042-43.

On this score, AMICO argues it is “clear” that the federal complaint, when read “as a whole,” alleges *only* that Milgray intended to defraud Williams of its money and property. Pl. Br. 22. This argument, however, fails to take into account all of the theories of recovery that Williams has advanced in the underlying litigation. In at least two of the theories, Williams

sought to impose liability on Milgray without a showing that Milgray “expected or intended” to injure Williams’ property.

First, as an alternative theory of liability, Williams alleged that Milgray was liable to Williams based on Milgray’s conduct *after* the alleged fraud had occurred. In particular, in its Third Amended Complaint, Williams charged that Milgray was liable to Williams because Milgray purportedly “ratified” the alleged fraud *when Milgray filed its counterclaims in the same lawsuit*:

Milgray subsequently ratified both the Milgray and Microcomp frauds perpetrated by its agents on Williams *by filing a pleading in this Court* which characterized Microcomp’s profits on tainted sales to Williams as “corporate opportunities” of Milgray. At the time the pleading was filed, Milgray’s management had actual and constructive knowledge that both Milgray’s and Microcomp’s profits from sales to Williams were derived from the mail frauds perpetrated on Williams by Milgray’s own general manager.

C2111. Consistent with this allegation, Williams persuaded the district court to instruct the jury that Milgray could be liable for “ratif[ying]” the fraud if, after learning that it had been “unjustly benefited by the wrongful acts of its agent,” Milgray then “endorse[d] the conduct of its agent.” C2375.

Williams relies on “ratification” as an alternative theory of liability to avoid a finding that Gnat and Slupik were acting outside the “scope of [their] employment” by virtue of their Microcomp activities. C2375. For present purposes, however, the point is that this theory plainly did not require proof that Milgray “expected or intended” the property damage described in the complaint. On the contrary, under this theory, Milgray’s liability did not arise until *after* the fraud had transpired – and *after* the property damage had occurred – when Milgray

purportedly “ratified” the fraud by filing its counterclaims in the federal litigation or otherwise engaging in activity that “endorsed the conduct of its agents.”¹⁰

Nor is this Williams’ only theory of recovery triggering a duty to defend. Williams has also claimed that Milgray is liable to Williams because Milgray placed Gnat and Slupik in positions that enabled them to defraud Williams. C2375. Indeed, Williams persuaded the district court to give a jury instruction that specifically embodied this theory of liability:

A defendant employer also is liable for its employee’s conduct when it puts him in a position that enables him, while apparently acting within his authority, to commit fraud upon others. Apparent authority arises when a principal, through words or conduct, creates a reasonable impression that an agent has authority to perform a certain act.

C2375-C2376.

This theory plainly does not allege that Milgray “expected or intended” to cause damage to Williams’ property or business. On the contrary, under this theory, Milgray is supposedly liable to Williams even if Milgray had no knowledge of the alleged fraud, simply because Milgray placed Gnat or Slupik in positions of “apparent authority.”

Either of these theories is alone sufficient to establish AMICO’s “duty to defend,” particularly since the “threshold that a complaint must meet to present a claim for potential coverage is low,” and any “[d]oubt as to coverage must be resolved in favor of the insured.” *Wilkin Insulation*, 193 Ill. App. 3d at 1092, 550 N.E.2d at 1035.

None of the cases cited by AMICO commands a different result. To begin with, in several of the cases, the relevant insurance policy did not contain the same limited exclusion at issue here – *i.e.*, an exclusion only for property damage that is “expected or intended” by the

¹⁰ Indeed, under this theory, Milgray’s liability did not arise until after (1) the federal litigation had commenced; and (2) the lawsuit in this case had been filed. Milgray filed its counterclaims in the federal litigation on January 31, 2000, while AMICO filed its complaint in this case on June 24, 1998.

insured. For example, in *Twin City Fire Ins. Co. v. Somer*, 342 Ill. App. 3d 424, 427, 794 N.E.2d 958, 961 (1st Dist. 2003), the relevant policy provision specifically excluded various forms of intentional conduct, as well as “any insured’s activities in a fiduciary capacity or as a trustee or in any similar activity.”

More importantly, in none of the cases cited by AMICO did the underlying litigation involve theories of liability predicated on either (1) a theory of “ratification” after the alleged fraud had occurred; or (2) a claim that an employer is liable because it vested specific employees with “apparent authority.” On the contrary, in each of the cases cited by AMICO, the underlying litigation involved only claims that the insured had “expected or intended” the resulting harm to the plaintiff. For example, in *Mutual Serv. Cas. Ins. Co. v. Country Life Ins. Co.*, 859 F.2d 548, 552 (7th Cir. 1988), the plaintiff alleged that the insured “knowingly” engaged in a scheme to deprive the plaintiffs of their deserved compensation. By contrast, in this case, Williams has also relied on theories of liability that do not require a showing that Milgray “expected or intended” the property damage alleged in the complaint.

In addition, many of the cases cited by AMICO involved findings that the insured was liable in the underlying litigation. Indeed, in several of AMICO’s cases, the insured had admitted to – or been convicted of – a crime. *See, e.g., State Farm Fire & Cas. Co. v. Martin*, 186 Ill. 2d 367, 376, 710 N.E.2d 1228, 1233 (1999) (criminal conviction); *Illinois Founders Ins. Co. v. Guidish*, 248 Ill. App. 3d 116, 618 N.E.2d 436 (1st Dist. 1993) (criminal conviction). For example, in *American Family Mut. Ins. Co. v. Savickas*, 193 Ill. 2d 378, 381-82, 739 N.E.2d 445, 448 (2000), *the insured admitted in the underlying trial that he intended to commit homicide*. By contrast, in this case, Milgray has consistently maintained (and indeed the jury and the district court both found) that it was not liable and did not cause any harm to Williams.

Consequently, the “expected or intended” exclusion does not apply to defeat AMICO’s duty to defend Milgray in this case.

3. The Policy’s Inclusion of Milgray Employees As Additional Insureds Does Not Change The Analysis

AMICO argues that the circuit court erred in drawing a distinction between Milgray and its employees for purposes of determining whether the “expected or intended” exclusion applies. Pl. Br. 23-24. In advancing this argument, AMICO explains that the policy’s inclusion of Milgray’s employees as additional insureds is part of the “bargained-for exchange” between the parties, and points out that some insurance contracts include such provisions while others do not. Pl. Br. 21, 23. While Milgray has no quarrel with these unremarkable points, AMICO’s attempt to use the policy’s definition of additional insureds to bring this case within the “expected or intended” exclusion is fundamentally mistaken.

For one thing, Milgray’s employees are covered under the AMICO policy only insofar as they act within the scope of their employment. C1929. That was not the case here, of course, since Gnat and Slupik were secretly operating a business (Microcomp) that directly competed against Milgray, and that was directly facilitated by the fraudulent kickbacks alleged by Williams in the underlying litigation.¹¹ AMICO argues (unpersuasively) that Gnat and Slupik acted within the scope of their employment, Pl. Br. 24, but the case law forecloses this conclusion. For example, *Wright v. City of Danville*, 174 Ill. 2d 391, 675 N.E.2d 110 (1996), cited by plaintiff (at 24), involved city commissioners indicted for official misconduct based on various self-interested transactions they had conducted in connection with their work as public servants. *Id.*

¹¹ AMICO tries to minimize the scope of the fraud against Milgray, stating that Gnat and Slupik only “occasionally” acted outside the scope of their employment through their operation of Microcomp. Pl. Br. 23. In point of fact, they made *millions of dollars* at Milgray’s expense by operating this illicit side business. C2355.

at 395-96, 675 N.E.2d at 113. The Illinois Supreme Court found their conduct to be outside the scope of their employment “[a]s a matter of law,” concluding that, while their public employment “provided the opportunity for their misconduct, by no stretch of the imagination could their actions be deemed an extension of their legitimate functions as elected officials.” *Id.* at 407-08, 675 N.E.2d at 119. Similarly here: while Gnat’s and Slupik’s employment by Milgray allegedly “provided the opportunity” for their bribery and pilfering, it is beyond question that they were not hired to engage in such activities.¹² See also *Davila v. Yellow Cab Co.*, 333 Ill. App. 3d 592, 600, 776 N.E.2d 720, 727 (1st Dist. 2002) (“Conduct of a servant is not within the scope of employment if it is different in kind from that authorized . . . or too little actuated by a purpose to serve the master.”) (quoting Restatement (Second) of Agency § 228 (1958)). Thus, as a threshold matter, the conduct of these former Milgray employees is outside the policy’s coverage and has no bearing on whether the primary insured (Milgray) “expected or intended” any particular harm to Williams.

AMICO also contends that one “reasonable implication” of the Williams complaint is that Milgray’s alleged liability arises only from purported acts of its agents performed within the scope of their employment. Pl. Br. 23. As a basis for this statement, AMICO points to the fact that Williams separately sought relief from Microcomp as well as from Gnat and Slupik individually – the suggestion being that, to whatever extent the alleged fraud was not attributable to Milgray employees acting within the course of their employment, those aspects of the fraud must already be captured in allegations against the other parties. Pl. Br. 22-23.

¹² AMICO’s suggestion that this issue should be submitted to a jury is therefore without basis. The suggestion would also appear inconsistent with AMICO’s request that the denial of its cross-motion for summary judgment be reversed.

This argument, of course, overlooks the “ratification” and “apparent authority” theories presented by Williams in the underlying litigation, which are described above. See *supra* at 17-19. It is also logically flawed: the mere existence of claims against other parties is not determinative of the nature of the claims against Milgray, which must be evaluated on their own terms and could still fail to allege only acts by Milgray employees within the scope of their official duties. See *American Country Ins. Co. v. Williams*, 339 Ill. App. 3d 835, 845, 791 N.E.2d 1268, 1276 (1st Dist. 2003) (recognizing question whether alleged intentional acts were performed in course of employment in insurance coverage case involving allegations against both employer and employee). Indeed, as shown above, that is precisely the case here.

Finally, it is more than a little ironic that AMICO would attempt to use what was meant to be an expansive coverage provision to the detriment of its policyholder. Clauses in insurance contracts extending coverage to employees as additional or secondary insureds

are, of course, subject to the ordinary rules of construction that *inclusionary provisions are liberally construed in favor of the insured and of coverage*, while exclusionary clauses are strictly construed against the insurer, with the general result that *coverage will be found if at all reasonable* under the particular language of the policy.

8 Couch on Insurance 3d § 115:1 (1997) (emphasis added). When Milgray entered into its policy with AMICO, it certainly did not expect that an apparently favorable clause extending protection to Milgray’s employees could someday become a basis for denying a duty to defend Milgray in underlying litigation that would otherwise have been covered.

4. To The Extent The Outcome Of The Federal Trial Remains Relevant, It Confirms AMICO’s Duty To Defend.

For the reasons explained above, this insurance coverage dispute should be resolved based solely on the allegations of the complaint in the underlying suit, rather than on the outcome of the federal trial. However, in the event this Court decides to take the results of the

trial into account notwithstanding the Seventh Circuit decision vacating the jury verdict, the outcome of the trial actually confirms the validity of the circuit court's ruling that the "expected or intended" exclusion does not bar coverage for a duty to defend.

First, as noted earlier, the district court instructed the jury on several theories of potential liability, including the "ratification" theory and the theory that Milgray was liable simply because it placed Gnat and Slupik in positions of "apparent authority." C2375-C2376. As a result, the mere fact that the jury made a finding of fraud does not show that Milgray "expected or intended" to damage Williams' property or business.

Second, contrary to the characterizations in AMICO's brief, the judge and the jury both returned judgments in *Milgray's* favor, finding that Milgray did not have any liability to Williams. Milgray presented evidence showing that its former employees Gnat and Slupik made millions of dollars by paying Williams' employee Barry more than \$625,000 in kickbacks to purchase electronic components from Microcomp, rather than purchasing the same components from Milgray. C2355, C2357-C2359. All of this occurred while Gnat and Slupik were fiduciaries of Milgray who were actually using Milgray's time, resources and offices to divert to Microcomp more than \$10 million in sales of the same type of components that Milgray also sold to Williams. C2009, C2012-C2013. The evidence further showed that Barry helped Gnat and Slupik defraud Milgray of their faithful and loyal services (and millions of dollars in lost sales) by taking kickbacks and by concealing the fraud from Milgray executives. C2002, C2005-C2006.

Milgray also presented evidence showing that in 1997 Milgray was acquired by Bell Industries, which had no involvement in the conduct alleged in the complaint. C2360-C2361. As a result, Bell was a factually innocent party that found itself embroiled in the federal litigation

only because it had the great misfortune to buy Milgray's stock before Williams commenced the underlying litigation. Finally, the evidence showed that, at the time of trial, Bell was a financially struggling company, with total losses of more than \$1 million in 2001 and a loss of more than \$500,000 in the first two months of 2002. *Ibid.*

Based on this evidence, the district court and the jury both found that (1) Milgray was not liable to Williams on any of Williams' claims; and (2) Milgray caused no damages of any kind to Williams. C1810, C1812, C1816. These findings established that Milgray did not "expect or intend" any damages to Williams because Milgray did not damage Williams in any way. Thus, to the extent it is at all relevant here, the outcome of the federal trial only confirms that the "expected or intended" exclusion does not bar coverage for a duty to defend.

CONCLUSION

The judgment of the circuit court granting Milgray's motion for summary judgment and denying AMICO's cross-motion for summary judgment should be affirmed.

Respectfully submitted,

Dated: August 11, 2004

MILGRAY ELECTRONICS, INC., N/K/A
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CERTIFICATE OF SERVICE

The undersigned, an attorney, hereby certify a true and correct copy of the foregoing **Brief of Defendant-Appellee Milgray Electronics, Inc., N/K/A Bell Industries, Inc.**, was served upon the following counsel on this 11th day of August, 2004, by dispatching them for delivery addressed as follows:

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* Page SA2 was inadvertently omitted from the record at page C2007 (accidentally left blank).