Cray • Huber

Illinois Coverage Basics

How to Write a Bullet-Proof Reservation of Rights Letter for Claims in Illinois

Under Illinois law an insurer with a potential duty to defend can generally avoid estoppel by filing a declaratory judgment action or defending its insured under a reservation of rights. (See Employers of Wausau v. Ehlco Liquidating Trust (1999), 186 Ill.2d 127, 708 N.E.2d 1122.) However, even if an insurer agrees to provide a defense under reservation of rights, it may still face estoppel problems if its reservation of rights letter is improper or incomplete. Careful draftsmanship is crucial when preparing a reservation of rights letter.

When an insurer reserves its rights, the reservation often creates a conflict between the interests of the insurer and the interests of the insured. A conflict of interest exists if the interests of the insurer would be furthered by providing a less than vigorous defense to certain allegations against the insured. (Mobil Oil Corporation v. Maryland Casualty Company, 288 Ill.App.3d 743, 681 N.E.2d 552, 561 (1st Dist. 1997).) If a conflict of interest exists, a defense attorney chosen by the insurance company cannot properly represent the insured, unless and until the insured has been fully informed of the conflict and knowingly consents to representation by the attorney. (Maryland Casualty Company v. Peppers (1976), 64 Ill.2d 355 N.E.2d 24, 30-31.) This requires "full and frank disclosure" on the part of the insurer. (Preferred America Insurance v. Dulceak, 302 Ill.App.3d 990, 706 N.E.2d 529 (2nd Dist. 1999).) Absent proper explanations of the conflict by the insurer and informed consent given by the insured, the insurer must pay the fees of the defense attorney selected by the insured. (Id.)

A proper reservation of rights letter is one that adequately informs the insured of the insurer's coverage defenses and allows the insured to intelligently decide whether to hire independent counsel. (Mobil Oil, supra.) The case law requires that a reservation of rights letter must satisfy three necessary elements, each of which must be set forth with clarity. The reservation of rights letter should (a) explain the insurer's coverage defenses; (b) describe the conflict of interest created by the insurer's assertion of the particular coverage defense; and (c) advise the insured of its right to independent counsel.

(a) Explanation of the coverage defenses. "Bare notice of a reservation of rights is insufficient." (Royal Insurance Company v. Process Design Associates, 221 Ill.App.3d 966, 582 N.E.2d 1234, 1239 (1st Dist. 1991).) The reservation of rights letter must adequately inform the insured of the rights that the insurer intends to reserve, including specific reference to the policy defenses which the insurer asserts. (Mobil Oil, supra; Royal, supra.) Ambiguities in a reservation of rights letter will inevitably be construed against the insurer. Therefore, quoting

the policy language that forms the basis for the reservation of rights is the best practice, and it is also the simplest way to express the reservation with clarity and completeness. Where the applicability of the policy's limiting language may not be obvious to an ordinary policyholder, an explanation of how the policy language applies to the particular allegations of the complaint may also be required. Inadvertent waiver of defenses may be avoided by adding a general caveat to the reservation of rights letter stating "there may be other reasons why coverage does not apply." (Universal Fire& Casualty Insurance Co. v. Jabin, 16 F.3d 1465, 1471 (7th Cir. 1994).)

(b) Description of the conflict of interest. It is not adequate to simply state that a conflict of interest exists. The reservation of rights letter must explain why there is a conflict of interest. The foundational Illinois case on reservation of rights letters (Peppers, supra) illustrates how this should be done. In Peppers, the court found that there was conflict of interest because the complaint filed against the insured contained one count alleging negligence and one count alleging intentional conduct. The Illinois Supreme Court explained the conflict as follows:

> "In the personal injury action if [the insured] is held responsible, it would be to his interest to be found negligent, which, under the policy of insurance, would place the financial loss on [the insurer]. On the other hand it would be to [the insurer's] interest to have a determination that [the insured] intentionally injured [the claimant], which, by terms of the policy, would relieve [the insurer] of the obligation to pay the judgment." (Peppers, supra, 355 N.E.2d at 30.)

Although this kind of explanation does not address all of the ramifications of the conflict, it is deemed sufficient to place the insured on notice that advice of independent counsel should be sought. A proper reservation of rights letter should explain the nature of the conflict in terms of the specific coverage defenses at issue, not in generic terms. Further, in an instance where the insurer has an established close relationship with the assigned defense attorney, the insurer may also need to advise the insured of that relationship in the reservation of rights letter. See Allstate Insurance Co. v. Carioto, 194 Ill.App.3d 767, 551 N.E.2d 382 (1st Dist. 1990).

(c) Advising the insured of its right to independent counsel. Unless the insured accepts the representation of an attorney appointed by the insurance company following full disclosure of a conflict, an insurer with a conflict of interest is obligated to reimburse the insured for the reasonable cost of retaining a defense attorney of the insured's choosing. A proper reservation of rights letter is one that specifically advises the insured of that right. (Insurance Company of Illinois v. Federal Kemper Insurance Company, 291 Ill. App. 3d 384, 683 N.E.2d 947, 950 (1st Dist. 1997).) Failure to include this notification in a reservation of rights letter may invalidate the reservation. (Id.) Simply stating that the insured has a right to retain its own counsel is not sufficient, absent an acknowledgement that the insurer will pay.

A bullet-proof reservation of rights letter is one that includes each of the three necessary elements with clarity and completeness. A reservation of rights letter that omits any one of those elements has the same practical value and effect as no reservation of rights at all.

*   *   *

If you have questions or would like to discuss the implications of this report further, please feel free to contact James K. Horstman at Cray Huber Horstman Heil & VanAusdal LLC, 303 West Madison, Suite 2200, Chicago IL 60606; 312-332-8494; jkh@crayhuber.com.