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Illinois Coverage Basics

Appellate Court Adopts New Rule To Expand Insurers' Duty To Defend Under Additional Insured Endorsements

The Illinois Appellate Court has adopted a new rule that may vastly expand insurers' duty to defend under additional insured endorsements. In American Economy Insurance Company v. Holabird and Root (First District No. 1-05-0403, filed March 31, 2008), the Appellate Court held that an insurer's defense obligation under an additional insured endorsement should not be determined solely by the allegations of the plaintiff's complaint. Under the Appellate Court's new rule, an insurer's duty to defend under an additional insured endorsement may be triggered by the allegations of the plaintiff's complaint and/or the allegations of any third-party complaint. This is a radical departure from Illinois' traditional duty to defend rule.

Illinois' Duty to Defend Standard Before the American Economy Decision

Illinois has traditionally followed the majority rule that an insurer's duty to defend must be determined by comparing the allegations of the plaintiff's complaint to the language of the insurance policy. U.S. Fidelity & Guaranty Co. v. Wilkin Insulation Co., 144 Ill.2d 64, 73 (1991). This has been called the "four corners" rule. Under the "four corners" rule, an insurer is required to defend if the allegations of the plaintiff's complaint bring the case within the potential coverage of the policy, even if the allegations of the complaint are groundless. Id.

Before the American Economy ruling, Illinois courts recognized only one exception to the "four corners" rule, and that exception allowed a court to consider "true but unpleaded facts" outside the allegations of the plaintiff's complaint when analyzing an insurer's duty to defend. Associated Indemnity Co. v. Insurance Company of North America, 68 Ill.App.3d 807 (1st Dist. 1979). However, courts specifically ruled that allegations of a third-party complaint should not be used to trigger a duty to defend under the "true but unpleaded facts" exception. L.J. Dodd Construction Company v. Federated Mutual Insurance Company, 365 Ill.App.3d 260 (2nd Dist. 2006); National Union Fire Insurance Company v. R. Olsen Construction Contractors, Inc., 329 Ill.App.3d 228 (1st Dist. 2002).

American Economy Decision Changes the Duty to Defend Standard

In American Economy, the plaintiff sued a building owner, architect/general contractor and electrical contractor for damages allegedly caused by her exposure to ultraviolet rays emitted by fluorescent lighting. She did not sue the lighting contractor that installed the fluorescent lighting, and her complaint made no mention of the lighting subcontractor. Later, the building owner filed a third-party complaint against that lighting subcontractor and specifically alleged that the lighting subcontractor installed the lighting that was responsible for the alleged damages.

After the building owner filed its third-party complaint, the architect/general contractor tendered its defense to the lighting subcontractor's liability insurer. The lighting subcontractor's policy contained an additional insured endorsement that listed the architect/general contractor as an additional insured, but only for liability arising out of the lighting subcontractor's work. The lighting subcontractor's insurer denied the tender based on the "four corners rule," reasoning that the plaintiff's complaint failed to allege liability against the architect/general contractor arising out of the lighting subcontractor's work.

Although the plaintiff's complaint was completely silent about the involvement of the lighting subcontractor, the third-party complaint filed by the architect/general contractor fully implicated the lighting subcontractor. The Appellate Court in American Economy held that the allegations of the third-party complaint established a duty to defend under the additional insured endorsement. The Appellate Court recognized that prior opinions had prohibited consideration of third-party complaints when evaluating an insurer's defense obligation.

Practical Consequences of the American Economy Ruling

The Appellate Court's ruling will have significant consequences for insurers, unless the Illinois Supreme Court accepts review and reverses American Economy. The American Economy opinion means - in every case - that the allegations of the plaintiff's complaint *and* the allegations of any third-party complaints must be considered when evaluating an insurer's defense obligation. Thus, a greater number of allegations will be available to trigger a duty to defend. In cases where a plaintiff's complaint has not initially raised a duty to defend, a duty to defend may arise later if a third-party complaint is filed that alleges a potentially covered loss.

The American Economy ruling may have its most profound effects in cases involving job-related injuries. Injured employees cannot sue their own employers because of the exclusive remedy provision of the Workers Compensation Act. The complaints filed by plaintiffs who are injured on the job often do not even refer to their own employers, because they have no reason to allege fault of the employer. In contrast, a third-party complaint filed against a plaintiff's employer will without exception allege involvement and culpability on the part of the employer. Under the American Economy ruling, an additional insured endorsement on an employers' liability policy that is not triggered by the allegations of a plaintiff's complaint (because it does not allege that the injury arose from the employer's work or negligence) will often be triggered by the allegations of a third-party complaint filed against the employer (precisely because it will allege that the injury arose from the employer's work or negligence).

In practical effect, the American Economy ruling will require insurers to reevaluate their potential duty to defend on an ongoing basis if and when third-party complaints are filed. Even if a plaintiff's complaint does not trigger a duty to defend, a third-party complaint or an amended third-party complaint may invoke a defense obligation long after the initial complaint filing date.

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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.