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Illinois Coverage Basics

Can Insurers Pay Under Reservation of Rights and Later Seek Reimbursement From Their Insureds in Illinois?

Under Illinois' rule of estoppel a liability insurer must either seek a declaratory judgment or defend its insured under reservation of rights in order to preserve coverage defenses. It is up to the insurer to choose which of these methods best fits its needs in a particular case. In some cases it makes most sense to file a declaratory judgment action; in other cases it may be better to defend under reservation of rights; and in yet other cases an insurer may opt to defend under reservation while also pursuing a declaratory judgment. Many practical considerations may guide the insurer's choice, and one of the most important considerations is whether the insurer can seek reimbursement from its insured for monies paid under a reservation of rights.

The answer to whether an insurer can pay and recoup from its insured depends upon the nature of the payment made by the insurer. The law is now clear in Illinois that an insurer may not recover from an insured payments made under reservation of rights for the *defense* of the insured. Whether an insurer may obtain reimbursement from an insured for *indemnity* payments made under reservation of rights has not yet been directly addressed by the Illinois courts. What is clear, however, is that the Illinois courts' refusal to allow insurers to recoup defense expense paid under reservation does not necessarily mean that insurers are barred from recouping indemnity payments from an insured. Based on authority from jurisdictions outside of Illinois, a credible argument can be made that insurers should have a right to seek reimbursement from their insureds for indemnity payments made under reservation of rights.

Insurers Have No Right to Pay and Recoup Defense Expense From Insureds in Illinois

The nearly unanimous view of courts across the country is that an insurer paying defense expense under a reservation of rights is entitled to reimbursement of those payments if it is later determined that the insurer owed no duty to defend. See Westport Insurance Corporation v. Ong, 2008 WL 892941 at *4 (D. Utah 2008) (majority rule cases collected). However, in General Agents Insurance Company v. Midwest Sporting Goods Company, 215 Ill.2d 146, 828 N.E.2d 1092 (2005), the Illinois Supreme Court prohibited liability insurers from recovering defense costs paid pursuant to a reservation of rights, unless the insurance policy expressly authorizes such a recovery. The Illinois Supreme Court acknowledged that its holding was contrary to the majority rule followed in most other jurisdictions, which generally follow the California Supreme Court's opinion in Buss v. Superior Court, 16 Cal.4th 35, 939 P.2d 766 (1997).

The Illinois Supreme Court's rationale for departing from the majority view is important to understand, because it impacts how the Court may rule on the issue of whether insurers may obtain reimbursement from insureds for indemnity paid under reservation of rights. The Illinois

Supreme Court expressed its reasons for denying recoupment of defense expenses from an insured as follows:

“As a matter of public policy, we cannot condone an arrangement where an insurer can unilaterally modify its contract, through a reservation of rights, to allow for reimbursement of defense costs in the event a court later finds that the insurer owes no duty to defend . . . recognizing such an implied agreement effectively places the insured in the position of making a Hobson’s choice between accepting the insurer’s additional conditions on its defense or losing its right to a defense from the insurer.”

The General Agents Ruling Does Not Control the Recoverability of Indemnity Payments

The General Agents ruling was founded on the principle that an insurer must defend if a complaint filed against an insured raises any *potential* for coverage. In contrast, an insurer has no duty to indemnify unless a claim is *actually* (not merely potentially) covered. Thus, the General Agents ruling does not control whether an insurer can recover reimbursement from an insured for indemnity payments made under reservation of rights. The recoverability of indemnity payments remains an open question in Illinois.

There is disagreement among other states as to whether an insurer may seek reimbursement from an insured for indemnity paid under a reservation of rights. The Texas courts have struggled with this question for a number of years, but the most recent opinion of the Texas Supreme Court held that insurers shall have no right to such recoveries under Texas law. See Excess Insurers at Lloyds v. Frank’s Casing Crew & Rental Tools, 246 S.W.3d 42 (2008).

In contrast, California law permits insurers to recover indemnity payments made under reservation of rights, even if the insured specifically objects to the insurer’s reservation of the right to seek reimbursement. See Blue Ridge Insurance Company v. Jacobsen, 25 Cal.4th 489 (2001). Under the California rule, three conditions must be met in order for an insurer to seek reimbursement from an insured for indemnity payments: (1) a timely and express reservation of rights; (2) an express notification to the insured of the insurer’s intent to accept a proposed settlement offer; and (3) an express offer to the insureds that they may assume their own defense if the insurer and insureds disagree whether to accept the proposed settlement.

One reason why Illinois courts might favor the California approach over the Texas rule is that Illinois has a strong public policy favoring the peaceful settlement of claims. See Dubina v. Mesirow Realty Development, Inc., 197 Ill.2d 185, 191, 756 N.E.2d 836, 840 (2001). Denying insurers a right to seek reimbursement from their insureds when they pay claims despite the existence of coverage questions would discourage insurers from settling claims and thereby frustrate the public policy of encouraging settlements. At present, insurers’ right of recovery with respect to indemnity payments remains an unresolved issue in Illinois.

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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.