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Illinois Coverage Basics

Federal Interpleader Actions Filed in Indiana Allow Insurers to Deposit Limits with Court and Terminate Defense Obligation

In Illinois the law is well established that a primary insurer may not escape its duty to defend by simply tendering its indemnity limits. Illinois courts hold that a tender of limits by an insurer terminates its duty to defend *only* if the payment of limits is made pursuant to a settlement or judgment resulting in a *full release* of the insured. However, the law is to the contrary in at least two of Illinois' neighboring states (Indiana and Wisconsin), which creates a possibility for insurers to expand their options by litigating this issue outside of Illinois.

In particular, federal interpleader actions filed in Indiana now allow an insurer to terminate its defense obligation by depositing its indemnity limits with the court, even in cases governed by Illinois law. This opportunity has arisen because the United States District Courts in Indiana have adopted an interpretation of Illinois law on this issue that differs from the way that the Illinois courts themselves interpret the Illinois law. Consequently, in a case governed by Illinois law, an insurer seeking to terminate its defense obligation by tendering its full indemnity limits may be able to accomplish that goal by filing an interpleader action in one of the federal courts in Indiana, even though an Illinois state court would probably reject such an effort by an insurer.

The governing case in Illinois is the Illinois Supreme Court's 1982 opinion in Conway v. Country Casualty Insurance Company, 92 Ill.2d 388. In Conway, a liability insurer tendered its full indemnity limits to an injured plaintiff in an effort to terminate both its defense and indemnity obligations. Although the plaintiff accepted the payment from the insurer, she did not release the insurer or the insured in return. Instead, she continued to prosecute her damages action against the insured. When the insured requested the insurer to defend him, the insurer refused, arguing that its tender of limits to the plaintiff should terminate its defense and indemnity obligations. The Illinois Supreme Court held that the insurer could not discharge its duty to defend simply by tendering its indemnity limits, because the insurer's duty to defend and its duty to indemnify were separate and distinct. The Conway court found that the insurer had a continuing duty to defend because the payment of its limits did not release the insured from the underlying plaintiff's claim.

The Illinois Supreme Court's analysis in Conway has been expanded by the Illinois Appellate Court to apply to cases in which an insurer seeks to terminate its duty to defend and its duty to indemnify by tendering its limits to a court. In Douglas v. Allied American Insurance, 312 Ill.App.3d 535 (5th Dist. 2000), the Appellate Court held that the insurer's voluntary payment of its indemnity limits to the court did not constitute a payment for which the insured was *legally*

obligated to pay within the meaning of the insuring agreement of the liability policy. The Douglas Court concluded that, regardless of the particular language of the insurance contract, the public policy of the State of Illinois prohibits a liability insurer from escaping its duty to defend by simply tendering its limits to a court.

Similarly, in American Standard Insurance Co. v. Basbagill, 333 Ill.App.3d 11 (2nd Dist. 2002), although the insurer paid its entire indemnity limit to the court via interpleader, the Appellate Court found that the payment did not terminate the insurer's duty to defend.

In contrast, a pair of statutory interpleader cases filed in the United States District Courts in Indiana has interpreted Illinois law to mean that an insurer can terminate its defense obligation by tendering its limits into the court. See Carolina Casualty Insurance Co. v. Estate of Studer, 555 F.Supp. 2d 972 (N.D. Ind. 2008) and Carolina Casualty Insurance Co. v. Estate of Zinmaster, 2007 WL 3232461 (S.D. Ind. 2007). Although the Studer and Zinmaster actions were filed in Indiana, both applied Illinois law on this issue. Studer and Zinmaster held that under Illinois law, an insurer can terminate its duty to defend by tendering its indemnity limits to the court, so long as the tender is unconditional and the insurer retains no expectation that it will later recoup any of that money. They reasoned that if an insurer unconditionally commits its indemnity limits, it cannot have any further indemnity obligation; consequently an unconditional tender of the full indemnity limits necessarily terminates the insurer's duty to defend.

Studer or Zinmaster ignored the Illinois Supreme Court's Conway opinion, so it is unlikely that Illinois state courts will follow their holdings. Nevertheless, Studer and Zinmaster indicate how the federal courts in Indiana will probably decide this question in future cases. Although the Illinois courts hold otherwise, the federal courts in Indiana will hold that an insurer can terminate its duty to defend under Illinois law by tendering its indemnity limits to a court, so long as the tender is unconditional. Since Illinois state courts will decide the issue differently than federal courts in Indiana, selection of venue may be critical to the outcome on this question.

Studer and Zinmaster reflect that courts outside Illinois may interpret Illinois law differently than courts inside Illinois. A more basic question is whether Illinois law should apply at all, as Illinois' position on this issue is quite different than that of its neighboring states. Under Indiana law and Wisconsin law, an insurer's payment of its full limits to a court can terminate its duty to defend. See, e.g., Abstract & Title Guaranty Co. v. Chicago Insurance Co., 489 F.3d 808 (7th Cir. 2007) (Indiana law); Gross v. Lloyds of London Insurance Co., 121 Wis.2d 78, 81 (1984).

Accordingly, an insurer that wants to terminate its duty to defend by tendering its indemnity limits should (a) determine whether the law of a state other than Illinois may apply, and (2) if Illinois law must apply, consider filing a statutory interpleader action in one of the United States District Courts in Indiana, invoking the rationale of Studer and Zinmaster.

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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.