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Illinois Coverage Basics

What Liability Insurers Need to Know about Excess Exposure Claims Following the R.G. Wegman Decision

Last month's *Illinois Coverage Basics* reported the Seventh Circuit Court of Appeals' landmark opinion in R.G. Wegman Construction Company v. Admiral Insurance Company. In R.G. Wegman, the Court of Appeals ruled that a conflict of interest is created in any case when a liability insurer learns that "a nontrivial probability" of an excess verdict exists. R.G. Wegman also held that when such a conflict arises, the insurer is required to offer the insured the right to select independent defense counsel at the insurer's expense. We now address some of the practical implications and realities of the Seventh Circuit's R.G. Wegman opinion.

The first thing to know about R.G. Wegman is that it is an irreversably final ruling. The only higher court in the federal court system is the United States Supreme Court, and there is no basis for invoking the jurisdiction of the Supreme Court, because this ruling concerns a question of state insurance law. Also, the time for seeking *en banc* rehearing by the Seventh Circuit Court of Appeals has now expired. Further, because the opinion was joined by two of the Court's intellectual heavyweights, Judges Richard Posner and Frank Easterbrook, it is unlikely that any subsequent decision of the Seventh Circuit will change the substance of R.G. Wegman.

However, a contrary ruling on the same issue by the Illinois Supreme Court could supercede the federal ruling. R.C. Wegman was a diversity jurisdiction case and as such the Seventh Circuit's task was to apply the rule that it believed the Illinois Supreme Court would follow. If the Illinois Supreme Court subsequently looks at the same issue and concludes that the Seventh Circuit guessed wrong about the applicable rule of Illinois law in R.C. Wegman, the ruling of the Illinois Supreme Court would trump the Seventh Circuit's opinion in R.C. Wegman.

Second, while R.C. Wegman is a binding rule of decision for federal courts, it is not binding on any Illinois state court. If a state court disagrees with R.C. Wegman, it can choose not to follow the ruling. However, as a practical matter this does not provide a safe harbor for most insurers. Federal diversity jurisdiction can be obtained over any out-of-state insurer. Consequently, parties seeking to implement R.C. Wegman against most insurers can file their actions in federal court or invoke federal removal jurisdiction to relocate cases initially filed in state court. Ultimately, the applicability of R.C. Wegman depends not on where the underlying malpractice claim has been filed (state court versus federal court), but on where an action against the insurer could be prosecuted. Except for insurers that are citizens of Illinois, those actions can be maintained in federal court, where R.C. Wegman will control.

Third, if an insurer acknowledges a potential excess verdict exposure with respect to a claim, that acknowledgment creates a conflict of interest under R.C. Wegman, which will require the insurer

to provide the insured with independent counsel at the insurer's cost. This means that, after R.C. Wegman, insurers should be careful about making statements regarding the possible excess verdict potential of claims, unless they have reason to believe a claim actually has excess potential. Form letters that routinely warn of the excess potential of all claims may be costly.

Fourth, the R.C. Wegman opinion requires insurers to reevaluate files on an ongoing basis to determine whether claims have developed to a point where an excess potential exists. The Court of Appeals' opinion specifically requires that if an excess verdict potential is first recognized in the midst of a case, the insurer must at that point advise the insured of the conflict and of the insured's right to independent counsel. This may entail a change of defense counsel.

Fifth, the Seventh Circuit's R.C. Wegman analysis was expressly based on an analogy to the more familiar Peppers conflict of interest rule. As such, it appears that a conflict under R.C. Wegman can be safely handled under the same practices and procedures that an insurer uses to handle Peppers-type conflicts.

Sixth, some of the harsh effects of R.C. Wegman might be avoided by simply talking to an insured about the R.C. Wegman issues before a formal letter informing the insured of the conflict is sent. It may be helpful to let the insured know that the letter is coming and why it is being sent, and also explain why panel counsel has been retained to defend the insured (highlighting the defense attorney's qualifications). Even when a conflict exists under R.C. Wegman, an insured has the option of waiving the conflict and accepting the insurer's recommended counsel.

Seventh, the consequences of ignoring the R.C. Wegman conflict rule may be severe. We do not know for sure, because the issue decided in R.C. Wegman was simply whether a cause of action had been properly pleaded against the insurer. The Seventh Circuit did not discuss what will happen to insurers that refuse to follow the dictates of the R.C. Wegman conflict analysis. It is reasonable to expect, however, that if an insurer ignores a R.C. Wegman-type conflict and does not properly advise an insured of its right to independent counsel pursuant to the Seventh Circuit's opinion, courts will provide a remedy to the insured.

In a Peppers situation, a conflict of interest exists when the insurer and insured have competing interests with respect to a coverage defense. If an insurer ignores a conflict in a Peppers situation, the remedy is to prohibit the insurer from asserting the coverage defense. In an R.C. Wegman situation, a conflict of interest exists when the insurer and insured have competing interests with respect to the indemnity limits of the policy. By analogy, if an insurer ignores a conflict in an R.C. Wegman situation, the remedy may be to prohibit the insurer from asserting the indemnity limits of the policy. Such a claim might be pursued on an expanded bad faith theory founded upon the insurer's violation of the R.C. Wegman requirements.

In sum: like it or not, R.C. Wegman is now the law and it calls for changes in the way that insurers handle claims, particularly claims that may have an excess verdict potential.

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