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Illinois Coverage Bulletin

Illinois Supreme Court Destroys Insurers' Right to Recover Defense Expenses Paid Under Reservation of Rights

In General Agents Insurance Company v. Midwest Sporting Goods Company (2005 WL 674685; filed March 24, 2005), the Illinois Supreme Court significantly changed the course of Illinois coverage law by prohibiting 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 is contrary to the majority rule followed in most other jurisdictions. This ruling places Illinois in the clear minority of jurisdictions now refusing to adopt the recovery rule articulated by the California Supreme Court in Buss v. Superior Court, 16 Cal.4th 35, 939 P.2d 766 (1997).

In the underlying action that was the subject of the General Agents case, Midwest Sporting Goods was sued on a public nuisance theory for selling guns to inappropriate customers. In response, Midwest Sporting Goods tendered the defense of the underlying action to its liability insurer, General Agents. However, General Agents' position was that there was no potential for coverage, because the underlying action alleged intentional conduct falling outside the periods of the General Agents policies, and did not allege any potentially covered bodily injury or property damage. General Agents filed a declaratory judgment action to obtain a ruling on whether it owed Midwest Sporting Goods a defense. At the same time, General Agents agreed to defend Midwest Sporting Goods under a reservation of rights until the coverage action was decided by the court. In its reservation of rights letter General Agents specifically reserved the "right to recoup any defense costs paid in the event that it is determined that the Company does not owe the Insured a defense in this matter."

Ultimately, the declaratory judgment action was decided in favor of General Agents, with a declaration that the insurer owed no duty to defend the underlying suit. Based on that ruling, General Agents brought a recovery action against Midwest Sporting Goods to recoup the defense expense that had been paid pursuant to the reservation of rights.

In General Agents' recovery action, both the trial court and the Appellate Court ruled in favor of the insurer, finding that General Agents had a right to recoup the amount of defense expense that it had advanced pursuant to its reservation of rights. No Illinois Supreme Court previously existed on this issue; consequently, the Court granted Midwest Sporting Goods' petition for leave to appeal the lower court rulings. The specific issue that the Illinois Supreme Court agreed to address in General Agents was:

> "[W]hether, following a declaration that an insurer has no duty to defend its insured, the insurer is entitled to reimbursement of the amounts paid for the defense of its insured in the underlying lawsuit?"

The Illinois Supreme Court acknowledged that the majority of jurisdictions that have addressed this issue have ruled that an insurer may recover defense expense paid under a reservation of rights after a

court determines that there is no duty to defend. Following the California Supreme Court's groundbreaking ruling in Buss, several courts - - including one federal district court in Illinois - - had followed the California analysis in finding that an insurer has a right to recover such payments. The Court in General Agents perceived that those decisions were generally based on implied contract or unjust enrichment theories. The Illinois Supreme Court acknowledged that under the majority rule, General Agents would have a right to recover the defense expense that it had paid on behalf of Midwest Sporting Goods under reservation of rights.

Nevertheless, the Illinois Supreme Court determined that the rationale underlying the minority line of cases on the issue was more persuasive. The minority rationale is that when an insurer's duty to defend is in doubt, the policy requires the insurer to defend, and unless the policy contains provisions specifically authorizing the insurer's recovery of defense costs or an allocation of such costs, there can be no recovery or allocation. Courts subscribing to the minority rule hold that an insurer may not unilaterally modify the provisions of the policy to create such a right by means of a reservation of rights letter. Further, those courts perceive that the insured is not unjustly enriched by receiving a defense from the insurers under these circumstances, because the defense provides a mutual benefit to the insurer and the insured alike.

The Illinois Supreme Court explained its reasons for adopting the minority rule 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. We recognize that courts have found an implied agreement where the insured accepts the insurer's payment of defense costs despite the insurer's reservation of a right to reimbursement of defense costs. However . . . 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 opinion specifically suggested that if an insurance carrier believes no coverage exists, it should deny the defense from the onset, rather than providing a defense and later seeking reimbursement for the defense costs.

While the relative merits of the majority rule and the minority rule can be debated, the Illinois Supreme Court's analysis in General Agents is subject to challenge on grounds that it ignores the practical effects of the ruling within the context of pre-existing Illinois coverage law. Under Illinois law, an insurer is not required to both defend under reservation of rights and file a declaratory judgment action to avoid estoppel. Rather, an insurer with doubts as to its duty to defend may fully preserve its coverage defenses simply by filing a declaratory judgment action, without providing a defense to its insured. By destroying insurers' right to recover defense expenses that have been paid under reservation of rights the General Agents ruling will discourage insurers from offering a defense when a coverage dispute is being litigated.

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