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Illinois Coverage Basics

A Primary Liability Insurer Can Be Deprived Of Its Coverage Defenses If It Sends An Incomplete Or Improper Reservation of Rights Letter.

It is now fairly well known that, under Illinois coverage law, a primary insurer may be estopped from raising coverage defenses unless it files a declaratory judgment action or defends its insured under a reservation of rights. (See Employers of Wausau v. Ehlco Liquidating Trust (1999), 186 Ill.2d 127, 708 N.E.2d 1122.) Less well known is the corollary that even when the insurer agrees to defend under reservation, an improper or incomplete reservation of rights letter may deprive the insurer of its coverage defenses. Proper draftsmanship in preparing a reservation of rights letter is critical.

A reservation of rights often creates a conflict of interest between the insurer and the insured. Under Illinois law, a conflict of interest exists if the interests of the insurer would be furthered by providing a less than vigorous defense to certain allegations against the insured. (Mobil Oil Corporation v. Maryland Casualty Company, 288 Ill.App.3d 743, 681 N.E.2d 552, 561 (1st Dist. 1997).) When a conflict of interest exists, an attorney chosen by the insurance company cannot properly represent the insured, unless the insured has been fully informed of the conflict and knowingly consents to such representation. (Maryland Casualty Company v. Peppers (1976), 64 Ill.2d 355 N.E.2d 24, 30-31.) This requires “full and frank disclosure” on the part of the insurer. (Preferred America Insurance v. Dulceak, 302 Ill.App.3d 990, 706 N.E.2d 529 (2nd Dist. 1999).) Absent informed consent by the insured or withdrawal of the reservation by the insurer, the insurer must pay for defense counsel selected by the insured. (Id.)

Generally, a proper reservation of rights letter is one that allows the insured to intelligently decide whether to hire independent counsel. (Mobil Oil, supra.) The case law instructs that a reservation of rights letter must contain three necessary elements, each of which must be stated with clarity. The reservation letter should (a) explain the insurer’s coverage defenses; (b) describe the conflict of interest created by the insurer’s assertion of the particular coverage defense; and (c) advise the insured of its right to independent counsel.

(a) Explanation of the coverage defenses. It is well established that “bare notice of a reservation of rights is insufficient.” (Royal Insurance Company v. Process Design Associates, 221 Ill.App.3d 966, 582 N.E.2d 1234, 1239 (1st Dist. 1991).) The reservation of rights letter must adequately inform the insured of the particular rights that the insurer intends to reserve. (Mobil Oil, supra; Royal, supra.) As a rule of thumb, the reservation must be comprehensible to

a policyholder of ordinary intelligence, although in actuality the subjective comprehension level of the particular insured may actually be greater. Ambiguities in a reservation of rights letter will always be construed against the insurer, as the drafter of the reservation letter. Quoting the policy language that forms the basis for the reservation of rights is usually the simplest way to express the reservation with clarity. However, further explanation as to how the policy language applies to the particular allegations of the complaint may also be required, where the applicability of the policy's limiting language is not immediately obvious.

(b) Description of the conflict of interest. It is not adequate to simply state that a conflict of interest exists. The reservation of rights letter must explain why there is a conflict of interest. The seminal Illinois case on reservation of rights letters (Peppers, supra) illustrates how that should be done. In Peppers, the court found that there was conflict of interest because the complaint filed against the insured contained one count alleging negligence and one count alleging intentional conduct. The Illinois Supreme Court explained the conflict as follows:

“In the personal injury action if [the insured] is held responsible, it would be to his interest to be found negligent, which, under the policy of insurance, would place the financial loss on [the insurer]. On the other hand it would be to [the insurer's] interest to have a determination that [the insured] intentionally injured [the claimant], which, by terms of the policy, would relieve [the insurer] of the obligation to pay the judgment.” (Peppers, supra, 355 N.E.2d at 30.)

Even if the insured does not fully understand all the ramifications of the conflict, this type of explanation is generally adequate to place him on notice that he may need independent counsel. A proper reservation of rights letter should seek to explain the nature of the conflict.

(c) Advising the insured of its right to independent counsel. Unless the insured accepts the representation of an attorney appointed by the insurance company following full disclosure of a conflict, the insurer is obligated to reimburse the insured for the reasonable cost of retaining a defense attorney chosen by the insured. A proper reservation of rights letter is one that advises the insured of that right. (Insurance Company of Illinois v. Federal Kemper Insurance Company, 291 Ill. App. 3d 384, 683 N.E.2d 947, 950 (1st Dist. 1997).) Failure to include this notification in a reservation of rights letter may invalidate the reservation. (Id.)

An improper or incomplete reservation of rights letter has the same value and effect as no reservation at all. To be effective to accomplish its intended purposes, a reservation of rights letter should include each of the three necessary elements, and do so with clarity and precision.

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If you have questions or would like to discuss reservation of rights letters 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.