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Illinois Coverage Basics

An Insurer Loses Its Right to Select Defense Counsel Where The Underlying Complaint Creates A Conflict of Interest

Most liability policies allow the insurer to select defense counsel and control the defense. But in Illinois an insurer loses those rights if the underlying complaint creates a conflict of interest. When a conflict of interest exists, the right to select defense counsel and control the defense are transferred, by operation of law, from the insurer to the insured.

Illinois case law describes three situations in which a conflict of interest may be found:

(1) **Conflicts arising from the insurer's coverage position.**

The most common type of conflict of interest occurs where a complaint filed against an insured contains some counts that are covered and some that are not covered by the policy. The classic example in Illinois is Maryland Casualty Company v. Peppers (1976), 64 Ill.2d 187, 355 N.E.2d 24, in which the underlying complaint contained both a covered count alleging negligence and a non-covered count alleging intentional conduct. Illinois law required the insurer to pay for the defense of the entire complaint, because at least one part of the complaint was covered. Under these circumstances, the Illinois Supreme Court held that a conflict of interest between the insurer and the insured would preclude the insurer from exercising its right to select defense counsel, and it required the insurer to pay for defense counsel chosen by the insured.

A Peppers conflict exists in cases involving some covered counts and some non-covered counts, because if a jury finds the insured liable it is in the insured's best interest to be found liable only on covered counts, while it is in the insurer's best interest for the insured to be found liable only on non-covered counts. The rationale of the Peppers conflict rule is that an insurer should not be allowed to control the defense where that power could be misused to control proof of certain facts that could shift the exposure from the insurer to the insured.

(2) **Conflicts arising from inconsistent defenses of insureds.**

The second most common type of conflict of interest occurs when an insurer is defending two or more insureds in the same case and the liability defenses of those insureds are inconsistent. The clearest example of this type of conflict occurs where two insureds are charged with mutually exclusive independent acts of negligence, creating the potential that each might point the finger of blame at the other. A conflict exists between the insurer and its insureds in

this circumstance, not due to the insurer's coverage position, but because the insurer would be in a position to favor one insured over the other if it controlled the defense of both insureds.

Such a conflict may be found to exist even where the allegations of negligence against the insureds are interconnected. A classic example is a case in which one insured is charged with negligence as an agent and another insured is charged with vicarious liability for the conduct of that agent. (See Murphy v. Urso (1982), 88 Ill.2d 444, 430 N.E.2d 1079.) In those circumstances a conflict is said to exist, because while the agent's primary interest would lie in being found not negligent, failing that, its secondary interest would be to ensure that the alleged principal was also found guilty, in order to spread the loss.

(3) Conflicts arising from claims for punitive damages.

A less common type of conflict arises in situations where punitive damages are sought against an insured. Although punitive damages claims are not unheard of, some question exists concerning the vitality of the rule that punitive damages claims necessarily create conflicts of interest. In Nandorf, Inc. v. CNA Insurance Companies, 134 Ill.App.3d 134, 479 N.E.2d 988 (1st Dist. 1985), the First District Appellate Court found that a conflict of interest existed where the underlying complaint sought a large amount of punitive damages against the insured compared to the claimed compensatory damages (\$100,000 punitive versus \$5,000 compensatory). In Nandorf, the insurer had disclaimed responsibility for the punitive damages, but refused to surrender control of the defense. While finding a conflict of interest on these facts, the Nandorf court was careful to limit its holding to the particular case.

Subsequently, the Fourth District Appellate Court announced a blanket rule that punitive damages claims automatically create conflicts of interest in Illinois Municipal League Risk Management Association v. Seibert, 223 Ill.App.3d 864, 585 N.E.2d 1130 (4th Dist. 1992). Under Seibert, a conflict of interest exists whenever a plaintiff asserts a claim for punitive damages, because an insurer's interests and an insured's interests diverge in the way that a compensatory claim and a punitive claim may be defended. The Fourth District's opinion in Seibert has been largely ignored by most other courts in the state, and it has not been addressed by the Illinois Supreme Court. As such, the viability of the Seibert rule remains in question.

Why worry about conflicts? There is a practical reason why insurers need to be concerned with Illinois' conflict of interest rules. It is this: if an insurer selects defense counsel and controls the defense in a case where a conflict of interest exists, it may be estopped from asserting any coverage defenses in the event of an adverse verdict. Further, if an excess verdict results, the insurer's disregard of the conflict rules, in conjunction with its failure to avail itself of reasonable opportunities to settle, may be considered as evidence in a subsequent action for bad faith. Therefore, where a conflict of interest exists, the conflict must govern an insurer's decisions about how to handle a file in Illinois.

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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.