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Illinois Coverage Basics

A Liability Insurer Is Estopped From Raising Coverage Defenses In Illinois Unless It Defends Under Reservation of Rights Or Files A Declaratory Judgment Action.

In Illinois, it is very easy for a liability insurer to lose its right to assert coverage defenses, and it is somewhat expensive to preserve those defenses. The reason for this unhappy situation is a unique rule of Illinois insurance law known as the rule of "estoppel." Under the rule of "estoppel," there are only two ways for a liability insurer to preserve its coverage defenses, and they both involve potentially significant expense. To preserve its right to raise coverage defenses, a liability insurer in Illinois must either: (1) defend the insured under a reservation of rights, or (2) file a declaratory judgment action. If the insurer does nothing more than deny coverage, it will be prohibited from raising its coverage defenses.

Although the rule of "estoppel" had an earlier history in the decisions of the Illinois Appellate Court, it was officially approved by the Illinois Supreme Court in the case of Employers of Wausau v. Ehlco Liquidating Trust (1999), 186 Ill.2d 127, 708 N.E.2d 1122. In Ehlco, the insurer had a solid late notice defense to coverage, but the Illinois Supreme Court held that the insurer could not rely on the late notice a reason for refusing to defend, because it had not properly preserved the coverage defense. The Court ruled that an insurer believing that it does not owe coverage has only two options for preserving its coverage position: (1) to defend the suit under a reservation of rights or (2) to seek a declaratory judgment that there is no coverage. Failing to avail itself of either one of these options, an insurer is estopped from relying on its coverage defenses.

The Court in Ehlco explained that this special rule of insurance estoppel has its roots in the common law doctrine of promissory estoppel, but it has evolved into an independent rule with exclusive application to liability insurers. Importantly, the insurance estoppel rule adopted by the Illinois Supreme Court in Ehlco applies whether or not the insured can prove prejudice. Insurance estoppel is essentially a public policy device designed to ensure that liability insurers do not take their coverage determinations too lightly, by imposing an additional cost on every decision to deny coverage.

Despite the contentions of the insurer in Ehlco that the notice provision of its liability policy stated an essential condition precedent for coverage, the Illinois Supreme Court held that an insurer "cannot simply abandon its insured." The Court refused to recognize an exception to the estoppel rule for the insurer's late notice defense. It allowed only that estoppel would not apply

in circumstances where no insurance policy is in existence, or where the insurer is given no opportunity to defend due to a conflict of interest.

Some insurers have taken hope in the Ehlco court's statement that "application of the estoppel rule is not appropriate if the insurer had no duty to defend" in the first place. But, as illustrated in the Ehlco case itself, this statement offers no reliable safe harbor, because an insurer can even be estopped to rely on clear violations of the conditions of coverage.

Another classic example of estoppel creating coverage is Chandler v. Doherty, 299 Ill.App.3d 797, 702 N.E.2d 634 (4th Dist. 1998). In Chandler, the policyholder owned two autos, one of which was insured and one of which was not insured. The policyholder was involved in an accident with the auto that was not insured. Subsequently, the injured party filed a suit alleging that the policyholder was "driving his vehicle," without identifying which of the two vehicles was involved. The insurer denied coverage because its investigation established that at the time of the accident the policyholder was not driving the only car that was insured under the policy. The Appellate Court did not dispute that the accident had in fact involved the car that was not insured under the policy, yet it held that the insurer was required to provide coverage because it failed to properly preserved its coverage defense by either defending under a reservation of rights or filing a declaratory judgment action.

Although the parameters of the Ehlco estoppel rule are not yet well defined by the decisions of the Illinois courts, the decisions do provide some practical guidance. The Ehlco opinion states that in order to effectively preserve a coverage defense, a declaratory judgment action must be filed before the underlying suit for damages is settled or goes to judgment. Other rulings suggest that additional time constraints may also apply to the filing of such an action.

Because the estoppel rule is rooted in an insurer's duty to defend, it seems well established that an excess insurer which has no defense obligation is not bound by the same estoppel rule that governs primary insurers. See Montgomery Ward and Company v. The Home Insurance Company, 753 N.E.2d 999 (1st Dist. 2001). Some courts also hold that estoppel will not be applied so long as one of the parties -- either the insurer or the insured -- files a declaratory judgment action on the coverage issues. See Bedoya v. Illinois Founders Insurance Company, 293 Ill.App.3d 668, 688 N.E.2d 757 (1st Dist. 1997).

It is important to know that Ehlco does not describe the only situation in which estoppel can be applied against an insurer. An insurer that files a coverage declaratory action after having mishandled the defense of its insured may be estopped from denying coverage based on its prejudicial handling of the defense. See Willis Carroon Corporation v. The Home Insurance Company, 203 F.3d 449 (7th Cir. 2000). Estoppel may also be imposed against an insurer that defends without reservation while possessing knowledge of a potential coverage defense. See Nationwide Mutual Insurance Company v. Filos, 285 Ill.App.3d 528, 673 N.E.2d 1099 (1st Dist. 1996).

If you have questions or would like to discuss the implications of the Illinois estoppel rule, 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.