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Illinois Coverage Basics

Learning to Recognize Conflicts of Interest: a Critical Prerequisite for Preserving Coverage Defenses

Under Illinois law, liability insurers generally have a choice between two methods for preserving potential coverage defenses. An insurer can either provide a defense to its insured under a reservation of rights, or it can file a declaratory judgment action to obtain an adjudication of the coverage defense. But, when an insurer provides a defense under reservation of rights the defense that is provided must be free of conflicts of interest. If an insurer defends its insured in disregard of a conflict of interest, it may be precluded from later enforcing its coverage defenses.

Because a defense provided under a conflict of interest is not effective to preserve coverage defenses, it is critical for insurers to learn how to recognize conflicts of interest. Below, we describe four distinct types of conflicts of interest that can impact an insurer's obligations.

1. Conflicts Arising from an 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 may not be covered by the policy. The classic case in Illinois is Maryland Casualty Company v. Peppers, 64 Ill.2d 187, 355 N.E.2d 24 (1976). In Peppers, the underlying complaint contained a covered count alleging negligence and a non-covered count alleging intentional conduct. Illinois law requires that when any part of a complaint is covered by an insurance policy the insurer must pay for the defense of the entire complaint, including those parts that are not covered. The Illinois Supreme Court held that under these circumstances a conflict of interest exists between the insurer and its insured, which (a) precludes the insurer from selecting defense counsel, and (b) requires 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 it is in the insured's best interest to be found liable (if at all) only on covered counts, while it is in the insurer's best interest for the insured to be found liable (if at all) only on non-covered counts. The rationale of the Peppers conflict rule is that an insurer should not be allowed to control the defense of its insured where that power might be misused to control proof of facts that could shift the exposure from the insurer to the insured.

2. Conflicts Arising from Inconsistent Defenses of Multiple 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 a 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 an insurer controlling the defense of both insureds would be in a position to favor the defense of one insured to the detriment of the other.

Such a conflict may be found to exist even where the allegations of negligence against the insureds are interconnected and their defenses may be partially aligned. A common 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, 88 Ill.2d 444, 430 N.E.2d 1079 (1982).) In those circumstances a conflict could be found to exist, even though it would be in the best interest of the alleged agent and the alleged principal to obtain a verdict exonerating the agent. A conflict exists, because while the agent's primary interest would lie in being found not liable, its secondary interest would be to ensure that the alleged principal was also found liable, 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. 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. To that extent, the viability of Seibert remains in question.

4. Conflicts Caused By a "Nontrivial Probability" of an Excess Verdict

In R.C. Wegman Construction Co. v. Admiral Insurance Co., 629 F.3d 724 (7th Cir. 2011), the Seventh Circuit Court of Appeals ruled that a conflict of interest is created whenever a liability insurer learns that "a nontrivial probability" of an excess verdict exists in a case filed against its insured. Under R.C. Wegman, a liability insurer has a duty to advise its insured of the potential for an excess verdict when the insurer learns of the "nontrivial probability" of such a verdict. When an insurer advises its insured of the potential for an excess verdict, the insured then has the right to select a new defense lawyer to be paid by the insurer ("one whose loyalty will be exclusively to him"). The Court explained that an insured's right to select independent counsel at the insurer's expense can be triggered at any time, depending upon when the insurer learns of the potential for an excess verdict. Unfortunately, the Court in R.C. Wegman never explained what it meant by the phrase "a nontrivial probability" of an excess verdict, and no subsequent decision of the Seventh Circuit nor any other court has provided any clarification as to when a "a nontrivial probability" of an excess verdict may exist.

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