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OVERVIEW OF THE DUTY TO DEFEND IN ILLINOIS

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The increasing complexities of duty to defend issues in Illinois have led us to take a careful look and provide our clients with what we hope is a useful overview on Illinois law.

A. GENERAL NATURE OF THE DUTY TO DEFEND

The insuring agreement of most standard form liability policies grants the insurer the right and duty to defend its insured in any suit seeking damages allegedly within the scope of coverage. Despite this relatively simple directive, there are many conditions and obligations inherent in the duty to defend that are important to understand, particularly if the insurance contract will be governed by Illinois law. Under Illinois law, the scope of the duty to defend is broad and the consequences for improperly ignoring it are dire. We discuss below some of the considerations for an insurer in determining the scope of its potential duty under Illinois law.

1. The duty to defend is a distinct obligation from the duty to indemnify

It is important to understand that the duty to defend is not simply a part or subset of the promise to indemnify; it is an independent obligation to the insured. In an insurance policy, the duty to defend and the duty to indemnify are separate and distinct obligations covered by different policy language. *Conway v. Country Cas. Ins. Co.*, 442 N.E.2d 245 (Ill. 1982). The duty to defend is broader than the duty to indemnify. *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 607 N.E.2d 1204 (Ill. 1992). It is the potential liability that gives rise to the insurer's duty to defend, even though there may not be a high probability of recovery under the terms of the contract. *Hertz Corp. v. Garrott*, 566 N.E.2d 337 (Ill. App. 1990).

Unlike the duty to defend, the duty to indemnify is determined based on whether the claim actually came within the policy and arises only when the insured becomes legally obligated to pay damages. *La Grange Memorial Hosp. v. St. Paul Ins. Co.*, 740 N.E.2d 21 (Ill. App. 2000). In fact, an insurer may have a duty to defend its insured even when it ultimately has no duty to indemnify the insured for the damages which are the subject of the lawsuit. *Zurich Ins. Co. v. Raymark Indus. Inc.*, 514 N.E.2d 150 (Ill. 1987).

The breadth of the duty to defend is notable upon the conclusion of a lawsuit, where, if there is a determination that there is no coverage for the claim under the policy, the insurer will not be obligated to indemnify its insured. However, in contrast with many other states, under Illinois law, the insurer is not entitled to recover its defense costs. The Illinois Supreme Court recently ruled that insurers have no right to recoup defense costs after the fact, notwithstanding any rights the insurer asserts to do so in its reservation of rights letter. *General Agents Ins. Co. of America v. Midwest Sporting Goods, Inc.*, 828 N.E.2d 1092 (Ill. 2005). In *General Agents*, the court stated that “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 of a later finding. *Id.* at 1102. Moreover, the court reasoned that in undertaking the defense of its insured, an insurer is protecting itself as least as much as it is protecting its insured and, thus, the insured is not unjustly enriched when it receives a defense, even if some or all of those claims are later revealed to be outside of coverage. *Id.*

2. The duty to defend is based on the allegations of the complaint

Whether an insurer has a duty to defend its insured in a lawsuit depends on the allegations of the complaint and the scope of the insurance policy. *Cincinnati Cos. v. West American Ins. Co.*, 701 N.E.2d 499 (Ill. 1998). It is well established in Illinois that the allegations of the complaint determine the duty to defend. When faced with a complaint against its insured, the insurer must determine whether it has a duty by comparing the allegations of the complaint with the terms of the policy. *Adman Products Co. v. Federal Ins. Co.*, 543 N.E.2d 219 (Ill. App. 1989). If the complaint alleges facts within the coverage of the policy or potentially within the coverage of the policy, the duty to defend is established. *Crum and Forster Managers Corp. v. Resolution Trust Corp.*, 620 N.E.2d 1073 (Ill. 1993); *Outboard Marine Corp.*, 607 N.E.2d at 699; *Maryland Cas. Co. v. Peppers*, 335 N.E.2d 24 (Ill. 1976). In fact, an insurer must defend its insured if the complaint alleges facts within the policy coverage even if the allegations are groundless, false or fraudulent. *Dixon Distributing Co. v. Hanover Ins. Co.*, 641 N.E.2d 395 (Ill. 1994).

3. An insurer must defend if it knows of facts that bring a claim within coverage

When evaluating potential coverage for purposes of the duty to defend, the insurer cannot read the allegations of the complaint too strictly. For example, the legal labels used by a plaintiff in a complaint to define its causes of action are not dispositive as to whether a duty to defend exists.

U.S. Fidelity & Guar. Co. v. Wilkin Insulation Co., 578 N.E.2d 926 (Ill. 1991). Moreover, if the insurer has knowledge of facts not alleged in the complaint that bring the cause of action potentially within coverage, that knowledge can create a duty to defend even if the bald allegations of the complaint do not. *Associated Indem. Co. v. Insurance Co. of North America*, 386 N.E.2d 529 (Ill. App. 1979). In *Associated*, the court reasoned that “if the insurer has knowledge of true but unpleaded facts, which, when taken together with the complaint’s allegations, indicate that the claim is within or potentially within the policy’s coverage,” the insurer must defend. *Id.* at 536. The *Associated* court reasoned that it could not allow an insurer to “construct a formal fortress of the party’s pleadings and to retreat behind its walls.” *Id.* However, the court in *Associated* did not affirmatively impose an obligation on the insurer to investigate facts, but merely required that the insurer rely on facts it knows to be correct, even if they are not properly alleged in the complaint. *Id.* at 537.

Conversely, when an insurer has independent knowledge that the allegations of a complaint against its insured are untrue, it must still defend if the allegations on their face fall within coverage. *Sims v. Illinois National Cas. Co.*, 193 N.E.2d 123 (Ill. App. 1963). *Sims* involved a policy which excluded coverage for employees injured while engaged in their employment. The personal injury lawsuit filed against the insured by a former employee did not allege that the plaintiff was an employee of the insured at the time of his injury. Although the insurer knew the plaintiff was an employee, it was still obligated to defend based on the allegations of the complaint. *Id.* at 125. Similarly, in *Aetna Cas. & Sur. Co. v. Coronet Ins. Co.*, 358 N.E.2d 914 (Ill. App. 1976), the insurance company improperly refused to defend the driver of a vehicle based on the fact that the driver did not have the owner’s permission and, therefore, was not an “insured” under the terms of the policy. However, because the complaint against the driver did not raise that issue, the court found the claim potentially within coverage and the insurer obligated to defend. *Id.* at 917.

B. DETERMINING THE APPLICATION AND SCOPE OF THE DUTY TO DEFEND

1. The threshold for determining whether a duty to defend exists is low

The standard to determine whether a claim falls potentially within coverage is extremely low. *West Bend. Mut. Ins. Co. v. Sundance Homes, Inc.*, 606 N.E.2d 326 (Ill. App. 1992).

An example of how the duty to defend is established when the complaint falls “potentially” within coverage is seen in *Clemons v. Travelers Ins. Co.*, 430 N.E.2d 1104 (Ill. 1981). In *Clemons*, the underlying complaint alleged that the driver of a car owned by the Red Cross caused an accident. The insurer refused to defend the driver because the driver did not have permission from the Red Cross to drive the car. However, the court found that the complaint did not need to allege *permission* in order to trigger the duty to defend, noting that the possibility the driver had permission was enough to bring the complaint potentially within coverage. *Id.* at 1108.

In making the determination whether the claims fall within coverage, the allegations of the lawsuit must be read liberally in favor of coverage. *United States Fidelity & Guar. Co. v. Wilkin Insulation Co.*, 578 N.E.2d 926 (Ill. 1991). The insurer can only refuse to defend when the allegations of the lawsuit “cannot possibly cover the liability arising from the facts alleged.” *Illinois Emasco Ins. Co. v. Northwestern Nat'l Co.*, 785 N.E.2d 905 (Ill. App. 2003). In considering the duty to defend, “any ambiguous or equivocal expressions in the policy will be strictly construed against the insurer.” *Solo Cup Co. v. Federal Ins. Co.*, 619 F.2d 1178 (7th Cir. 1980). For example, the Illinois Appellate Court reviewed a complaint based on fumes emitted from a refuse dump owned by the insured. *LaRotunda v. Royal Globe Ins. Co.*, 408 N.E.2d 928 (Ill. App. 1980). The complaint did not assert that the dump was operated as a business, a fact which would exclude it from coverage. The court declared the insurer had a duty to defend because the complaint “left open the possibilities that the refuse dump was not a business or that the smoke came from a fire on part of the vacant premises that was not devoted to a business use” and it was therefore not clear from the allegations of the complaint that there was no coverage. *Id.* at 934.

2. When provisions of the policy are relied on to refuse a defense, their application must be clear

In order for an insurer to refuse to defend a complaint filed against its insured, it must show that there is no possibility of coverage for any claim alleged. An insurer may not refuse to defend unless it is clear from the face of the underlying complaint that the allegations fail to state facts which bring the case potentially within the policy’s coverage. *Maryland Casualty Co. v. Peppers*, 355 N.E.2d 24 (Ill. 1976).

Illinois court decisions which have allowed insurers to refuse to defend have done so by ruling that the complaint contained allegations which excluded coverage under the policy. *Sheppard, Morgan & Schwabb, Inc. v. U.S. Fidelity & Guar. Co.*, 358 N.E.2d 305 (Ill. App. 1976). In *Sheppard*, the liability insurance policy of the insured engineering firm clearly excluded liability arising out of professional services. *Id.* at 308. Since the complaint alleged only damages due to the negligent performance of professional services, the insurer had no duty to defend. *Id.* The decision rendered by an Illinois appellate court in *Dorre v. Country Mut. Ins. Co.*, 363 N.E.2d 464 (Ill. App. 1977), also illustrates the rule. The *Dorre* complaint alleged that the insured “owned, operated, maintained, controlled and was possessed of premises” where the plaintiff was injured. *Id.* at 465. The policy excluded coverage for premises owned, rented, or controlled by the insured unless they were listed in the policy. *Id.* at 467. The premises where the injury occurred were not listed, and thus the court found no duty to defend. *Id.*

Despite the two cases cited above, we caution that if the insurer intends to rely on an exclusion in the policy’s coverage, that exclusion must be “clear and free from doubt” that it excludes coverage for the facts alleged. *Bituminous Cas. Corp. v. Fulkerson*, 571 N.E.2d 256 (Ill. App. 1991).

3. Only one cause of action or theory for recovery need fall within coverage to trigger the duty to defend

If the underlying complaint alleges several theories of recovery against an insured, the duty to defend arises even if only one theory is within the potential coverage of the policy. *Wilkin*, 578 N.E.2d at 930. In this matter, the plaintiffs pled several alternate causes of action and legal theories, and the court found that the insurer “has a duty to defend its insured if any theory of recovery alleges potential coverage” (emphasis in original). *Id.*

In *Management Support Assoc. v. Union Indem. Ins. Co.*, 473 N.E.2d 405 (Ill. App. 1984), an architectural and engineering partnership was sued by the owner of a hotel, who alleged that the partnership failed to properly maintain and repair the hotel property. The partnership’s insurer refused to defend on the grounds that the policy contained an exclusion for certain types of conduct. However, the court ruled that the allegations did not indicate whether the alleged failure was a result of negligent conduct or an intentional disregard of its duties and, if one was covered, the insurer was obligated to defend the insured in the litigation. *Id.* at 412.

4. If there is a duty to defend, the insurer must defend the entire action

Once the duty to defend arises and the insurer agrees to assume the defense of the lawsuit, that defense includes all of the claims within the complaint. *Maryland v. Peppers*, 355 N.E.2d at 28. As described above, if the underlying complaint alleges several theories of recovery, only one need fall within coverage to impose a duty to defend. *Wilkin*, 578 N.E.2d at 930. In *Wilkin*, the plaintiffs pled several alternate causes of action and legal theories, some of which were clearly outside of coverage, yet the court required the insured to defend the entire action. *Id.*

This somewhat strict rule means that the insurer cannot selectively defend only the counts of the complaint that fall within its coverage. *Bedoya v. Illinois Founders Ins. Co.*, 688 N.E.2d 757 (Ill. App. 1997). In *Bedoya*, a bar owner tendered its defense under a dram shop policy for a shooting which occurred in the bar. The insurer refused to defend claims alleged in the complaint for negligence and punitive damages, which fell outside of the dram shop policy. Although it acknowledged that several other states divide the duty to defend between the insurer and the insured, the *Bedoya* court followed *Maryland v. Peppers* in ruling that the insurer was obligated to defend all counts in the complaint regardless of the relevance to its policy coverage. *Id.* at 763.

In certain situations, insurers also argue that they should be entitled to allocate the costs of a defense to the insured during periods of self-insurance or among multiple insurers involved in a program of coverage. This question of allocation of defense expenses generally arises in progressive or “long tail” claims, frequently seen in the asbestos or environmental context. When the alleged injury occurs over a period of many years, triggering numerous insurance policies, some Illinois courts have permitted the pro-rata of indemnity costs between the policies under various allocation scenarios. However, no reported decisions have permitted the pro-rating of defense costs between multiple insurance policies.

In fact, a recent Illinois appellate court ruled that this type of pro-rata allocation is inappropriate for defense costs based on the “joint and several” liability imposed by commercial general liability policy language. *Caterpillar, Inc. v. Century Indemnity Co.*, No. 04-L-119 (Ill. App. 2007). In *Caterpillar*, the insurer challenged the allocation of the insured’s asbestos defense costs, arguing that it was unclear whether some of the costs appropriately fell within the insurer’s policy and that the defense costs should be apportioned between various insurers and the insured. The court denied the insurer’s request, reasoning that the insurer had a duty to defend all lawsuits in which the allegations potentially result in recovery from the insured, including those that did not allege dates of injury to demonstrate the losses were within the policy coverage. The *Caterpillar* court further reasoned that the policy language dictates an “all sums” allocation of defense costs.

5. When defending litigation, an insurer must protect the interests of its insured

An insurer which assumes the defense of litigation has an obligation to the insured to properly defend and properly settle claims. Generally, providing a vigorous defense of the insured presents little problem, as it is in the interest of the insurer to minimize any liability to its insured. With the exception of specific conflicts which arise between the interests of the insurer and its insured based on the pursuit of claims which impact the insured’s coverage, as described in a separate section of this paper, the interests of the insurer and the insured are generally aligned in the goal of obtaining a verdict in favor of the insured. However, potential problems between the insurer and the insured frequently arise during the course of settlement negotiations with the plaintiff.

The insurer who controls the defense of its insured also controls the settlement negotiations. Of course, the insurer’s obligation to protect the interests of its insured applies to any negotiations. *Krutsinger v. Illinois Cas. Co.*, 141 N.E.2d 16 (Ill. 1957). However, conflicts between the insurer and its insured can often arise in the handling of settlement negotiations. For example, when a plaintiff issues a settlement demand approaching the policy limits, an insurer may decide to try the case with the hope of a lower verdict. However, if the potential exposure in the case exceeds the policy limits, the insurer is making a decision which impacts the insured’s finances. To protect the insured from the risk that its insurer will irresponsibly gamble with the insured’s money, courts imply a duty on the insurer to act on the insured’s behalf and enter into reasonable settlements. As a result, when a claim against the insured presents a reasonable probability of a finding in excess of policy limits, an insurer that fails to settle within the policy limits may be liable for any verdict in excess of the policy limits. *Haddick v. Valor Ins.*, 763 N.E.2d 299 (Ill. 2001).

C. THE INSURER MAY DEFEND THE LAWSUIT UNDER A RESERVATION OF RIGHTS

1. An insurer must reserve its rights to disclaim coverage

When an insurer assumes the defense of an action, it must advise its insured of the potential defenses it maintains with respect to its obligation to indemnify the insured. This advice to the insured commonly takes the form of a “reservation of rights” letter.

If the insurer fails to advise the insured of the potential defenses, the insurer will reasonably expect coverage for any liability. As a result of the expectation it created, the insurer will often be estopped from raising defenses to coverage at the conclusion of the lawsuit. *Doe v. Illinois State Medical Inter-Insurance Exchange*, 599 N.E.2d 983 (Ill. App. 1992). Courts reason that an insurer who elects to assume the defense of an insured notwithstanding its doubts as to the duty to defend or indemnify the insured may be estopped from denying liability because it has prejudiced the insured’s right to control his own defense by inducing the insured to rely on the insurer. *Certain Underwriters at Lloyd’s v. Professional Underwriters Agency, Inc.*, 848 N.E.2d 597 (Ill. App. 2006) (citing *Apex Mut. Ins. Co. v. Chistner*, 240 N.E.2d 742 (Ill. App. 1968)). Thus, Illinois courts require the insurer to notify its insured of potential policy defenses in a timely manner, through a reservation of rights or the filing of a declaratory judgment action to determine coverage. If the insurer fails to take one of those steps, the insurer risks waiving its policy defenses to coverage. *Employers Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122 (Ill. 1999).

There have been cases in which Illinois courts have refused to impose the harsh penalty of estoppel on an insurer that did not reserve its rights. In *Crum and Forster Managers Corp. v. Resolution Trust Corp.*, 620 N.E.2d 1073 (Ill. 1993), the court found that the allegations of unfair business practices and intentional business torts did not fall even potentially within the error-and-omissions policies and, thus, did not trigger a duty to defend. However, the insured claimed that the insurer waived its right to deny coverage under the policy because the insurer raised noncoverage in a related action and then failed to pursue it in that action. *Id.* at 1080. The court found that argument meritless, stating that the insurer had not intentionally relinquished a known right, and therefore could still deny coverage under the policy. *Id.* Similarly, in *West Bend Mutual Ins. Co. v. Sundance Homes, Inc.*, 606 N.E.2d 326 (Ill. App. 1992), the insurer was not estopped from asserting coverage defenses because of its initial agreement to handle the claim without a reservation of its rights. In *West Bend*, the insurer’s initial response to the insured’s tender was made without the benefit of the complaint and therefore cannot be considered an intentional relinquishment of known rights. *Id.* at 337. Moreover, the court concluded that the insured did not prejudicially rely on the insurer’s agreement to defend and, thus, estoppel was inappropriate. *Id.*

2. Conflicts may arise between the interests of the insurer and the insured

During the defense of litigation, conflicts of interest often arise between the insurer and its insured. For example, if the question of whether damages will ultimately be covered under the policies turns on factual issues to be decided in the litigation, the insurer has an interest adverse to its insured. The test for whether a conflict exists is if, in comparing the allegations of the complaint to the terms of the policy, the insurer's interests would be furthered by providing a less than vigorous defense to the allegations. *Williams v. American Country Ins. Co.*, 833 N.E.2d 971 (Ill. App. 2005). An insurer's general interest in negating policy coverage does not, alone, create a sufficient conflict to preclude the insurer from assuming the defense of the insured. *Nandorf, Inc. v. CNA Ins. Co.*, 479 N.E.2d 988 (Ill. App. 1985). Rather, a conflict exists when the underlying action asserts claims that are covered by the insurance policy along with other causes which the insurer is required to defend, but asserts are not covered by the policy. *Id.* at 992.

A review of the case law in Illinois illustrates the types of situations courts believe raise conflicts between an insurer and its insured:

- Complaint alleged negligent acts occurring both during and after policy period. *Illinois Masonic Med. Ctr. v. Turegum Ins. Co.*, 522 N.E.2d 611 (Ill. App. 1988).
- Complaint alleged battery and negligence, but insurer would not indemnify insured if found guilty of battery. *Thornton v. Paul*, 384 N.E.2d 335 (Ill. 1978).
- Complaint alleged negligence and intentional acts, but intentional acts were excluded from coverage. *Maryland Cas. Co. v. Peppers*, 335 N.E.2d 24 (Ill. 1976).

Conflicts may also arise when an insurer is obligated to provide defenses for two or more insureds with adverse interests, either to each other or to the insurer:

- Insured's employee entitled to independent counsel to defend claims of negligence. *Williams v. American Country Ins.*, 833 N.E.2d 971 (Ill. App. 2005).
- Additional insured entitled to own defense counsel because its interests conflicted with that of named insured. *Murphy v. Urso*, 430 N.E.2d 1079 (Ill. 1981).

In each of the above-cited cases, the insurer was obligated to cede control of the defense to the insured and to reimburse the insured for its defense expenses.

Unlike some other jurisdictions, Illinois courts also view cases involving allegations of punitive damages to be the subject of potential conflict. In *Nandorf*, the complaint sought punitive damages, which were not covered under the policy, based on a claim that the insured's employees acted in

bad faith. *Nandorf*, 479 N.E.2d at 992. The *Nandorf* court found that the insurer would have little interest in seeking a finding of good faith on the insured's behalf, as that finding would only impact the claim for punitive damages and not the claim for liability. *Id.* The court ruled that this divergence of interests created an actual conflict which rendered it improper for the insurer to retain control of the litigation. *Id.* Similarly, in *Illinois Municipal League Risk Mgmt. Ass'n v. Seibert*, 585 N.E.2d 1130 (Ill. App. 1992), the court found a conflict existed when the plaintiff sought both compensatory and punitive damages, which were excluded from coverage, and again forced the insurer to cede control of the defense. In *Illinois Municipal*, the court reasoned that although the potential conflict did not involve mutually exclusive claims which would shift liability from the insurer to the insured, there was a conflict between the parties' interests in the way the punitive damages claim might be defended. *Id.* at 1139.

3. In the event of a conflict, the insured has the right to control the defense

When an insurer assumes the defense of its insured, the counsel selected owes fiduciary duties to two clients, the insured and the insurer. Illinois courts have recognized that the attorneys hired to defend the matter may have a stronger relationship with the insurer and a "more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured." *Nandorf*, 479 N.E.2d at 991. When there is a conflict of interest between the insurer and the insured, Illinois courts are concerned that the insurer will further its own interests in the development of issues in the case or will provide "less than a vigorous defense" for its insured. *Insurance Co. of Illinois v. Markogiannakis*, 544 N.E.2d 1082 (Ill. App. 1989).

In some situations, a potential conflict between the insured and the insurer can be resolved by full disclosure of the conflict and consent from the insured to the defense. *Nandorf*, 479 N.E.2d at 991 (citing *Maryland Casualty*, 335 N.E.2d at 198). However, if the insured chooses not to accept the defense in the face of a potential conflict, the insured is entitled to control its own defense and retain counsel of its choosing, to be paid by the insurer. If that occurs, the insurer will satisfy its duty to defend by reimbursing the insured for the costs of defense counsel the insured has retained. *Thornton*, 384 N.E.2d at 343.

When the insured declines representation by the insurer and demands control of its own defense, the insurer is no longer permitted to participate in the defense. Once the insurer cedes control of the defense of the litigation, the insurer is said to have "renounced control of the litigation and thereby thrust the responsibility for the litigation wholly upon the insured and its counsel." *Markogiannakis*, 544 N.E.2d. at 567. Similarly, if the insured controls the defense, it will also have the right to control its own settlement negotiations. In those negotiations, the insurer will not participate, nor will it have a right to prevent a settlement. *Commonwealth Edison Co. v. National Union Fire Ins. Co.*, 752 N.E.2d 555 (Ill. App. 2001).

D. REFUSAL TO DEFEND

Despite the strict eye with which Illinois courts view the duty to defend, complaints are filed that simply do not fall within the scope of coverage, or contain allegations triggering valid coverage defenses. An insurer has no duty to defend where it is clear from the face of the underlying complaint that the allegations fail to state facts that bring the case within, or potentially within, coverage. *Connecticut Indem. Co. v. DER Travel Service, Inc.*, 328 F.3d 347 (7th Cir. 2003) (citing *Lapham-Hickey Steel Corp. v. Protection Mut. Ins. Co.*, 655 N.E.2d 842 (Ill. 1995)).

When the insurer believes it has no obligation under the policy, it has three options: (1) defend under a reservation of rights; (2) file a declaratory judgment action seeking a ruling from the court as to the issues of coverage; or (3) deny coverage. Courts have stated that an insurer which chooses to deny coverage without other action does so at its peril, because if it is later found to have wrongfully refused to provide a defense, it will have breached the insurance contract. *Certain Underwriters at Lloyd's v. Professional Underwriters Agency, Inc.*, 848 N.E.2d 597 (Ill. App. 2006).

An insurer that seeks a declaration of its coverage protects itself from certain penalties associated with a blanket refusal to defend, including waiver of its coverage defenses. However, filing a declaratory judgment action against the insured, of course, forces the insurer to incur the costs of an additional litigation. *Certain Underwriters at Lloyd's*, 848 N.E.2d at 605. When denying coverage, Illinois courts do not require that the insurer first receive a declaration that the lawsuit is not covered, but they do require that the insurer immediately file its lawsuit to determine the question of coverage. *See State Farm Fire & Cas. Co. v. Martin*, 710 N.E.2d 1228 (Ill. 1999).

1. Consequences for refusing to defend

Insurers evaluating whether to defend an insured that has been sued in Illinois must consider the consequences carefully before refusing to defend. The sanctions for wrongfully refusing to defend can be quite severe, making the duty to defend extremely difficult to avoid. If a court later determines that the insurer should have defended its insured, the insurer can be liable for: (1) the amount of a judgment against the insured or a settlement made by the insured; (2) expenses and fees incurred by the insured in defending the lawsuit; and (3) any additional damages attributable to the refusal to defend. *Sims v. Illinois Nat'l Cas. Co.*, 193 N.E.2d 123 (Ill. App. 1963). The additional damages could include interest and fees payable on the defense costs and possibly the costs associated with recovery from the insurer. *Conway v. Country Cas. Ins. Co.*, 442 N.E.2d 245 (Ill. 1982). In more severe cases, insurers could be liable for the full amount of the judgment or settlement, even if it exceeds the policy limits. *Reis v. Aetna Cas. & Surety Co. of Illinois*, 387 N.E.2d 700 (Ill. App. 1978). A remedy in excess of policy limits generally limited to situations in which the insurer's refusal to defend was made in bad faith. *See Conway*, 442 N.E.2d 245.

Perhaps most important, if an insurer fails to defend the insured without justification, the insurer will be estopped from raising policy defenses to coverage and in extreme situations may be exposed to claims of bad faith. Courts impose the penalty of estoppel under the rationale that, by wrongfully refusing to defend its insured, the insurer has breached its contract. This breach estops the insurer from asserting any defense based on non coverage, because “the insurer has no right to insist that the insured be bound by the provisions of the insurance contract inuring to its benefit when it has already breached the contract by violating the provisions inuring to the benefit of the insured.” *Certain Underwriters at Lloyd’s*, 848 N.E.2d at 604 (citing *Sims*, 193 N.E.2d at 134.)

2. An insurer cannot discharge its duty to defend by tendering the policy limits

It is not uncommon for the litigation expenses associated with defending an insured in protracted litigation to exceed the indemnity limits of the insured’s policy. Yet, under many insurance policies, the defense costs are “in addition to” the policy limits. In these situations, the insurer must pay for the defense costs in addition to any indemnity obligation it will incur through settlement or judgment. As a result, some insurers have attempted to discharge their more costly defense obligations by simply tendering the policy limits. Illinois courts do not allow this without the insured’s consent. *Douglas v. Allied American Ins.*, 727 N.E.2d 376 (2000). Despite the sometimes disproportionate costs of litigation, the insurer must continue to defend until it has exhausted the indemnity limits of its policy. *Conway*, 442 N.E.2d at 249.

E. RIGHTS AND OBLIGATIONS OF THE INSURED

Generally, once an insured is sued, it provides notice to its liability insurer and requests that the insurer provide a defense in the lawsuit. We discuss below some issues raised by situations in which the insured does not provide notice of a lawsuit to its insurer.

1. An insured’s failure to give notice may waive its right to a defense

Contracts for insurance generally impose an obligation on the insured to notify the insurer in the event of both an “occurrence,” as defined by the policy, and a claim against the insured. Generally, notice is required “as soon as practicable,” which Illinois courts have interpreted to mean within a “reasonable” period of time. *Barrington Consol. High School v. American Ins. Co.*, 319 N.E.2d 25 (Ill. 1974).

There is a line of cases in Illinois holding that breaching a policy’s notice provisions by failing to give reasonable notice will defeat the right of the insured party to recover under the policy. See e.g., *Simmon v. Iowa Mut. Cas. Co.*, 121 N.E.2d 509 (Ill. 1954). Many of the cases that have followed *Simmon* have denied coverage for an insured who fails to provide notice to its insurer of an “occurrence” under the policy, rather than a lawsuit potentially covered by the policy. Other cases have required that the insurer demonstrate prejudice in order to deny coverage based on a failure of

the insured to notify its insurer of a lawsuit. *Rice v. AAA Aerostar, Inc.*, 690 N.E.2d 1067 (Ill. App. 1998). However, the Illinois Supreme Court recently applied the *Simmon* line of case law to an insured who failed to provide timely notice of the lawsuit filed against it. *Country Mutual Ins. Co. v. Livorsi Marine, Inc.*, 856 N.E.2d 338 (Ill. 2006). In *Country Mutual*, the court ruled that because the insurer did not receive reasonable notice of the lawsuit, the insured could not recover under the policy, regardless of whether the lack of notice prejudiced the insurer. *Id.* at 346. The court reasoned that in determining whether an insured unreasonably failed to provide notice of a lawsuit, sufficient to forego its rights to policy coverage, courts should consider the specific language of the policy's notice provision, the insured's sophistication in insurance matters, the insured's awareness of an event which could trigger insurance coverage, the insured's diligence in ascertaining whether policy coverage was available, and any prejudice to the insurer. *Id.* at 344.

2. An insurer's independent knowledge of a lawsuit can trigger a duty to defend

Occasionally, an insured fails to give notice to an insurer of a lawsuit potentially falling within coverage, but the insurer becomes aware of the lawsuit through some other source. Illinois courts have held that an insurer has "actual notice" of a lawsuit against its insured when it has "notice sufficient to permit the insurer to locate and defend the lawsuit." *Cincinnati Cos. v. West American Ins. Co.*, 701 N.E.2d 499 (Ill. 1998). Actual notice therefore requires that the insurer know that a cause of action has been filed and that the complaint falls within or potentially within the scope of its coverage. *Id.* at 505.

Once the insurer has actual notice of the lawsuit against its insured, its duty to defend is potentially triggered. At this point, the obligation falls on the insurer to inquire as to whether the insured desires a defense in the litigation. *Cincinnati*, 701 N.E.2d at 504. Interestingly, the level of sophistication of the insured is not a factor in determining whether actual notice will trigger the duty to defend. Despite arguments that a sophisticated insured should be held to a higher standard in advising its insurer of lawsuits filed against it, in Illinois, even an insured who is well-versed in business and insurance matters will be excused from tendering the defense to its insurer if the insurer has actual notice of the suit. *Id.*

3. The insured has the right to elect whether it seeks a defense

Despite an insurer's actual notice of a lawsuit, the duty to defend is still not triggered until the defense is accepted by the insured. Once the insurer discovers the lawsuit, it can discharge its duty to defend by inquiring whether the insured does, in fact, seek a defense to the lawsuit. In *Cincinnati*, the court reasoned that the "insurer is not required to actually defend every claim against its insured of which it has actual notice." *Cincinnati*, 701 N.E.2d at 504. More importantly, an insurer is not required to interpret its insured's silence as desire for a defense. *Id.* Therefore, if an insured does not respond to an insurer's offer of defense or refuses to cooperate with the insurer, the insurer's duty to defend will be discharged. *Id.*

It is important to remember that an insured is not required to accept a defense from its insurer. In fact, there may be legitimate commercial reasons for an insured to decline the insurer's offer to defend the action or to pay for the defense. Similarly, if more than one insurer is potentially obligated to defend a lawsuit, an insured has the right to select exclusive coverage and defense from one of its insurers. *See, e.g., John Burns Const. Co. v. Indiana Ins. Co.*, 727 N.E.2d 211 (Ill. 2000); *Cincinnati*, 701 N.E.2d at 503; *Institute of London Underwriters v. Hartford Fire Ins. Co.*, 599 N.E.2d 1311 (Ill. App. 1992). Under this line of cases, an insured may knowingly forgo an insurer's assistance by instructing the insurer not to involve itself in the defense in favor of a defense from another insurer. *Cincinnati*, 701 N.E.2d at 503. This instruction is commonly referred to as a targeted tender or selective tender. In Cincinnati, the court reasoned that the selective tender rule is intended to protect the rights of the insured to forgo coverage. *Id.* at 503.

Courts also allow an insured who has tendered the defense to one insurer to withdraw the tender or deactivate coverage with that insurer, even mid-way through litigation, in favor of assistance from another insurer. *Alcan United, Inc. v. West Bend Mut. Ins. Co.*, 707 N.E.2d 687 (Ill. App. 1999). The extent of this principle has not yet been tested by Illinois courts, as the *Alcan* case involved a situation where the insured selected the new insurer once it became aware of the coverage afforded under that policy. We note that if the Illinois courts continue down this path of allowing insureds to deactivate coverage, it could open the door to permit insureds to manipulate coverage in potentially harmful ways during the course of litigation in order to maximize coverage or to minimize the impact of potential policy exclusions in certain policies.

4. An insurer is not liable for claims of contribution where the insured has knowingly foregone coverage

Targeted or selective tender arises most frequently in lawsuits involving multiple policy periods or when the insured has its own general liability policy and is named as an additional insured on another policy. The reasons an insured may wish to elect a defense from the insurer of another party, rather than its own insurer, seem obvious and courts appear to endorse that right. In these circumstances, Illinois courts have reasoned that the insured has the right to choose or knowingly forgo an insurer's assistance in the defense. *John Burns*, 727 N.E.2d at 211.

Moreover, when the insured makes a targeted or selective tender, the duty to defend falls solely on the selected insurer and that insurer may not seek equitable contribution from the non-designated insurers. *See, Legion Ins. v. Empire Fire and Marine Ins. Co.*, 822 N.E.2d 1 (Ill. App. 2004); *John Burns*, 727 N.E.2d 211, *Institute of London*, 599 N.E.2d at 1311. In each of these cases, the insured deliberately chose to tender its defense to an insurer who provided it coverage under a policy issued to another party (an employer or a subcontractor), rather than seeking a defense from its own commercial general liability insurer. At the conclusion of the lawsuits, each of these courts found that the insured had the right to select which insurer would defend the lawsuit and refused to allow the defending insurer to recover costs associated with the defense from the insured's own liability insurer. The Legion court reasoned that when an insured has knowingly chosen to forego an

insurer's assistance by instructing an insurer not to involve itself in the litigation, that insurer is relieved of all obligations to defend. In that situation, the targeted insurer has sole responsibility to defend the lawsuit and it may not seek equitable contribution from other insurers. *Legion*, 882 N.E.2d at 6.

In reaching its decision on the question of contribution between insurers, the *John Burns* court directly addressed the "other insurance" clause, contained in many insurance policies, which would appear to be an insurer's strongest basis for a claim of contribution. The "other insurance" clause generally prioritizes coverage among "other valid and collectible insurance" available to the insured for the same loss. Although the argument for contribution between multiple insurers seems compelling when faced with an "other insurance" clause, the *John Burns* court ruled that the non-tendered policy was simply not "available" insurance under the terms of the clause and found the clause inapplicable when an insurer who is covered by multiple policies makes a knowing designation. *John Burns*, 727 N.E.2d at 217. The court reasoned that an "other insurance" clause in a policy will not reach into coverages provided under other policies merely because such policies are in existence. *Id.*

F. CONCLUSION

Insurers should be aware of the stern approach Illinois courts take in considering the obligations imposed by the duty to defend. Specifically, a few points distinguish Illinois from many states in its pro-insured approach to the defense of potentially covered claims. First, under Illinois law, it is extremely difficult to deny coverage without undertaking the costs associated with filing a declaratory judgment action. Second, and perhaps even more unusual, Illinois law permits an insured to select whether and which of its insurers will provide a defense. With relatively free reign, an insured can, for reasons of strategy or cost, selectively tender its defense to one insurer to the exclusion of another. In this situation, the selected insurer may not seek equitable contribution from other insurers. Finally, although several other states grant an insurer the right to reimbursement of non-covered defense costs, Illinois does not. Under a recent decision from the Illinois Supreme Court, underscoring the distinct nature of the duty to defend from the duty to indemnify, insurers will not be able to recover defense costs, even if they have expressly asserted that option in a reservation of rights letter.

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