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ILLINOIS LAW MANUAL

CHAPTER XI

INSURANCE COVERAGE AND DEFENSES

D. DUTIES OF THE INSURER TO DEFEND AND INDEMNIFY

1. Because the Duty to Defend is Broader than the Duty to Indemnify, Review Both Complaint and 337 Investigative Materials to Determine if Coverage is Possible

Both the business and homeowners policies provide for the "right and duty" to defend any claim or suit seeking damages payable under the policy even though the allegations may be "groundless, false or fraudulent."

Two requirements must be met before any duty to defend arises. First, a suit must be filed against an insured. The duty to defend is not limited to the named insured, but also extends to any other persons who come within the policy definition of an insured, or an addition to the policy as an additional insured by endorsement. An insurance company has no duty to defend a party which does not qualify as an insured. Murphy v. Peterson, 129 Ill. App. 3d 952 (1984); Federal Ins. Co. v. Economy Fire & Cas. Co., 189 Ill. App. 3d 732 (1989).

If a party qualifies as an insured, the company has a duty to defend whenever a complaint pleads facts within or potentially within the risks covered by the policy. State Farm Fire & Cas. Co. v. Hatherley, 250 Ill. App. 3d 333 (1993). The rules set forth below are easy to state but more difficult to apply in a given case.

The threshold for pleading coverage is minimal. Travelers Ins. Co. v. P. C. Quote, Inc., 211 Ill. App. 3d 719 (1991). Unless the complaint on its face clearly alleges facts which, if true, would exclude

coverage, the potential for coverage is present, and the insurer has a duty to defend. Western Cas. & Surety Co. v. Adams Co., 179 Ill.

App. 3d 752 (1989). "Potentially covered" means that the insurer's duty to defend its insured arises whenever the allegations contained within the complaint give rise to the possibility of recovery under the policy. There need not be a probability of recovery. Id. The fact that a complaint fails to state a legal cause of action does not excuse the duty to defend. Reis v. Aetna Casualty & Surety Co., 69 Ill. App. 3d 777 (1979). The duty to defend depends on the factual allegations rather than the precise legal theory. Travelers, 211 Ill. App. 3d 719. The complaint need not allege or use language affirmatively bringing the claim(s) within the scope of the policy, as questions of coverage should not hinge exclusively on the draftsmanship skills or whims of the pleader. International Minerals & Chemical Corp. v. Liberty Mut. Ins. Co., 168 Ill. App. 3d 361 (1988). The complaint against the insured will be liberally construed and any doubts about potential coverage resolved in the insured's favor. La Rotunda v. Royal Globe Ins. Co., 87 Ill. App. 3d 446 (1980).

The duty to defend is not annulled by the insurer's knowledge that the allegations of the complaint are untrue. If the complaint shows potential coverage but the insurer's investigation shows no coverage, there is still a duty to defend. Sims v. Illinois National Cas. Co., 43 Ill. App. 2d 184 (1963); Tuell v. State Farm Fire & Cas. Co., 132 Ill. App. 3d 449 (1985) (recognizing potential coverage for negligent supervision where motor vehicle exclusion applied to negligent entrustment).

The reverse is not true. If the facts alleged in the complaint show no coverage but the insurer's investigation shows possible coverage, there is a duty to defend. Associated Indemnity Co. v. Insurance Co. of North America, 68 Ill. App. 3d 807 (1979). The insurer cannot safely ignore unpleaded facts within its knowledge, which it knows to be correct, and which, when taken together with the allegations, indicate that the claim asserted against the insured is potentially within coverage. The duty to defend exists even where the pleadings allege several causes of action or theories of recovery, only one of which falls within coverage under the policy. This is based on the oft-quoted principle that the duty to defend is broader than the duty to indemnify. Tuell, 132 Ill. App. 3d 449.

An insurer in a declaratory judgment action may introduce evidence outside of the policy and underlying complaint in certain circumstances. Charles Eichelkraut & Sons, Inc. v. Bituminous Casualty Co., 166 Ill. App. 3d 550 (1988). Evidence beyond the policy and complaint is admissible to show that a claim is not covered if the evidence does not bear on an ultimate issue of fact in the underlying action, so that a court presiding over a declaratory judgment action will not make a factual finding which may have a preclusive effect in the underlying action.

2. The Effect of an Unjustified Refusal to Defend: A Carrier is Barred from Raising Policy Defenses in a Later Action Following Judgment or Settlement

Where an insurer believes that a policy does not provide coverage to an insured, for a lawsuit, the insurer must either defend the suit under a reservation of rights or secure a declaratory judgment as to coverage obligations before trial or settlement of the underlying action. Casualty Ins. Co. v. Northbrook Property & Cas. Ins. Co., 150 Ill. App. 3d 472 (1986). Where the insurer fails to do either, its failure to defend, if incorrect, is unjustified, and it may be estopped to raise policy

defenses in a later action by the insured or the insured's subrogee or assignee. Reis, 69 Ill. App. 3d 777.

The Illinois Supreme Court has clarified that if an insurer does not either defend a lawsuit under a reservation of rights or file a declaratory action before the underlying action is resolved, the insurer will be barred from raising any coverage defenses, including late notice, even if a defense would have otherwise barred coverage. Employers Ins. Co. of Wausau v. Ehlco Liquidating Trust, 186 Ill. 2d 127 (1999). An insurer does not have an unlimited amount of time in which to file a declaratory judgment action. It must do so within a reasonable time after the tender of defense, and in no event may it wait until after the underlying action is resolved. West American Insurance Company v. J.R. Construction, 334 Ill. App. 3d 75 (2002).

As set forth more fully below, once a company has unjustifiably failed to defend, the insurer not only is prevented from raising policy defenses, it also has liability for:

- (1) the amount of the judgment rendered against the insured or for the amount of the settlement;
- (2) expenses incurred by the insured in defending the suit; and
- (3) any additional expenses caused by the breach of the insurance contract.

Conway v. Cas. Ins. Co., 92 Ill. 2d 388 (1982).

However, this does not necessarily mean that the company is liable for more than its policy limits. Unless the insurer has acted in bad faith by refusing to defend its insured (or by failing to act reasonably to settle a claim within its policy limits), it is not liable for that portion of the judgment or settlement in excess of its policy limits. Aetna Cas. & Surety Co. v. Coronet Ins. Co., 44 Ill. App. 3d 744 (1976).

By wrongfully refusing to defend, the company loses the right to control the defense and cannot take advantage of a clause prohibiting the insured from settling without the company's permission. Krutsinger v. Illinois Cas. Co., 10 Ill. 2d 518 (1957). Also, the insured is released from the duty to comply with the condition that it pay the judgment before bringing a direct action (Kinnan v. Charles B. Hurst Co., 317 Ill. 251 (1925)), and from the obligation to cooperate with the company and assist in the defense. Coulter v. American Employers Ins. Co., 333 Ill. App. 631 (1948).

As also set forth more fully below, an unjustified refusal to defend does not arise where the refusal to defend is based upon a conflict of interest. Further, an insurer has not unjustifiably refused to defend where it has offered a defense under a reservation of rights, but the insured rejects the reservation of rights. Where coverage is in question, the insurer is not required to provide an unconditional defense. Pekin Ins. Co. v. Home Ins. Co., 134 Ill. App. 3d 31 (1985).

The lack of prejudice to the insured is not a defense available to an insurer which has unjustifiably refused to defend. The contract is no less breached because of the fortuitous existence of another carrier which meets its own obligations. Cas. Ins. Co. v. United States Fidelity & Guaranty Co., 150 Ill. App. 3d 479 (1986).

3. The Effect of Exhaustion of Policy Limits by Payment of Judgment(s) or Settlement(s) May Relieve the Insurer of Any Further Duty to Defend

Most policies contain a standard clause which provides that the "right and duty to defend" ends when the company has used up the applicable limit of insurance in the payment of judgments or settlements. The Illinois Supreme Court has limited this clause to relieve the insurer of the obligation to defend only where payment was made pursuant to a judgment or settlement which terminated the litigation against the insured. In Conway, 92 Ill. 2d 388, the court rejected the company's contention

that its payment of its \$10,000 policy limit to a claimant discharged its duty to defend its insured where that payment did not end the litigation, since otherwise the insurer could essentially buy out its duty to defend by tendering its policy limits where the payment was not pursuant to either a judgment or a settlement. This situation is to be distinguished from Oda v. Highway Ins. Co., 44 Ill. App. 2d 235 (1963), where it was held that the insurer did not have to defend a second action arising out of the same incident where it had already exhausted its liability limits in concluding an earlier action.

In Zurich Ins. Co. v. Raymark Industries, Inc., 118 Ill. 2d 23 (1987), the Illinois Supreme Court held that carriers had no duty to defend other claims in the same suit following the payment of judgments and settlements which exhausted policy limits, as its withdrawal from the defense was orderly and there were other co-insurers which were defending the claim against the insured. In other words, where the insurer has no potential obligation to indemnify once it has exhausted its limits by payment of other claims, it has no duty to defend remaining claims in the same action.

4. The Duty to Defend Includes the Duty to Hire Counsel and the Right to Control the Litigation

The policies not only give the company the "right and duty" to defend, but also to "settle any claim or suit" at its discretion. Under the terms of the policy, the insurer has the complete control of the litigation for which it might have a duty to indemnify. River Valley Cartage Co. v. Hawkeye Security Ins. Co., 17 Ill. 2d 242 (1959). Under limited circumstances where certain conflicts of interest arise, the insurer may be required to give up control of the defense to its insured. This is more fully addressed in Section H of this chapter.

The right to control the litigation has been referred to as the consideration for the insurer's duty to defend the insured against all suits within the scope of the policy, even if the suit is groundless, false, or fraudulent. In return, the law places upon the insurer the duty of giving the interests of the

insured equal consideration with its own interests and dealing fairly with the insured, as set forth more fully in Chapter XIII.

Except where there is a conflict of interest as described in Section H, the insurer has the right to select the attorney who will defend the insured in the underlying litigation. Brocato v. Prairie State Farmers Ins. Ass'n., 166 Ill. App. 3d 986 (1986). This is a contractual right founded on the theory that, because the insurance company's money is used to pay a judgment, it should have the right to choose an attorney in whom it has confidence. If the insured wants to retain his own attorney for further protection, usually when the potential value of the suit exceeds the limits of the policy or where punitive damages are sought, it is at the insured's own expense. An insurer is not required to pay attorney's fees to counsel hired by the insured to guard against a judgment in excess of insured's policy limits where the insurer has not by its actions forced the insured to engage its own attorneys. Reis, 69 Ill. App. 3d 777.

Although the carrier has control of the defense, it does not have a license to act unreasonably. The question of cooperation involves the good faith of the insured as well as the insurer. State Farm Fire & Cas. Co. v. First National Bank & Trust Co. of Pekin, 2 Ill. App. 3d 768 (1972). This does not include the right to control or supervise the actual conduct of any litigation since the carrier cannot practice law, and once it hires an attorney, any complaints the insured might have about the conduct of litigation must be directed to the attorneys themselves. Brocato, 166 Ill. App. 3d 986.

An attorney, even though chosen and paid by the carrier, owes the insured the same obligation of fidelity and good faith that he would owe had the insured retained him personally and must disclose to the insured those facts and circumstances which might be likely to affect the performance of that duty. Allstate Ins. Co. v. Keller, 17 Ill. App. 2d 44 (1958); Carito v. Allstate Ins. Co., 194 Ill. App. 3d 767 (1990).

If there is no duty to defend, there is no duty to indemnify. Hatherley, 250 Ill. App. 3d 333.

The right and duty to control the defense also includes the right and duty to settle an action. Illinois courts have long recognized that an insurer has a duty to its insured to act reasonably to settle a claim within the available policy limits if there is a reasonable opportunity to do so, coupled with a potential that the value of the claim may exceed the available limits. Cramer v. Insurance Exchange Agency, 174 Ill. 2d 513 (1996). More recently, courts have recognized that this duty to settle runs not only to the insured, but also to any excess insurer. Schal Bovis, Inc. v. Casualty Ins. Co., 314 Ill. App. 3d 562 (2000).

5. The Duty to Indemnify May Include the Accrual of Post-Judgment Interest on the Entire Judgment and Costs

The homeowners and business policies both provide that the amount that the company "will pay for damages is limited as described in Limits of Insurance." The duty to pay is simple: the company must pay any judgment entered against the insured resulting from a loss covered by the policy up to the amount of the limits of liability for the coverage afforded.

Many insurance policies are "liability" rather than "indemnity" policies. Whereas an "indemnity" policy provides indemnity against loss but requires the insurer to make payment to the insured only after the insured has paid or been compelled to pay a claim, the "liability" policy shields the insured from the requirement of making any payment on a claim for liability imposed by law.

In addition to the limit of insurance, the company also agrees to pay with respect to any claim or suit which it defends certain claim expenses, including:

- (1) costs taxed against the insured;
- (2) the cost of bonds in amounts not greater than the limits of insurance;

- (3) prejudgment interest awarded against the insured on that part of the judgment that the company pays; and
- (4), interest on the entire judgment which accrues after the entry of judgment and before the company pays or tenders payment or deposits in court that part of the judgment which does not exceed the limit of liability that applies.

6. Tender Must Include Post-Judgment Interest on Judgment in Full Amount

If the company tenders only the face amount of the policy and interest only on the amount of the policy rather than post-judgment interest on the entire judgment, the tender is not valid to terminate the continuing obligation for interest on the entire judgment. River Valley, 17 Ill. 2d 242. A primary

insurer whose policy agreed to pay post-judgment interest is likewise not relieved of this obligation by the fact that an excess policy covered part of the ultimate loss. Hartford Accident & Indemnity Co. v. Aetna Ins. Co., 132 Ill. 2d 79 (1989).

7. “Costs” Include Attorney Fees Assessed Against Insured in Prevailing Party's Favor

“Costs” include attorney's fees charged against the insured in a suit which the company defends. Argento v. Village of Melrose Park, 838 F.2d 1483 (7th Cir. 1988). This is true even where there is no duty to indemnify the insured for the judgment. Littlefield v. McGuffey, 979 F.2d 101 (7th Cir. 1992).