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ILLINOIS LAW MANUAL
CHAPTER XII
EXCLUSIONS TO COVERAGE

I. WAIVER/ESTOPPEL & RESERVATION OF RIGHTS

An insurer must defend its insured where the allegations in the underlying complaint fall within, or potentially within, the policy's coverage provisions. Outboard Marine v. Liberty Mut. Ins. Co., 154 Ill. 2d 90, 108 (1992). Failure of an insurer to defend under a reservation of rights or to secure a declaratory judgment as to coverage estops an insurer from raising coverage defenses thereafter. Murphy v. Urso, 88 Ill. 2d 444, 430 (1981). Assumption and control of the insured's defense, absent a reservation of rights, raises the issue of prejudice and may estop the insurer from questioning policy coverage. Doe v. Illinois State Medical Inter-Insurance Exchange, 234 Ill. App. 3d 129, 134 (1992). However, an exception to the general rule for waiver/estoppel and reservation of rights exists where there is a conflict of interest between the insurer and insured. The insurer still remains bound to provide the insured with a defense and must allow the insured to be represented by counsel of its own choosing. The insurer then must reimburse the insured for the reasonable cost of defending the action. Santa's Best Craft, L.L.C. v. Zurich American Ins. Co., 408 Ill.App.3d 173 (1st Dist. 2010).

1. Reservation of Rights

An insurer that wishes to reserve its rights under a policy must notify the insured "without delay" or "with reasonable promptness." Apex Mut. Ins. Co v. Christner, 99 Ill. App. 2d 153, 169 (1968). A long delay without explanation in asserting a policy defense is an element in determining the reasonableness of an insurer's conduct, but alone normally not enough to constitute a waiver. Kenilworth Ins. Co. v. McDougal, 20 Ill. App. 3d 615, 620 (1974).

An insurer properly reserves its rights under a policy by sending the insured, via certified mail, a letter setting forth each applicable coverage exclusion or limitation that would preclude or limit coverage. Failure to set forth a policy exclusion or limitation within a "reasonable" time will result in waiver of the rights sought to be reserved. American States Ins. Co. v. National Cycle, Inc., 260 Ill. App. 3d 299, 306 (1994). But an insurer's reservation of rights letter does not shield it from any estoppel created by later admissions of coverage to the insured. Lumbermen's Mut. Cas. Co. v. Sykes, 384 Ill.App.3d 207, 226, (1st Dist. 2008).

2. Waiver

Waiver consists of the intentional relinquishment of a known right and may be express or implied from the insurer's acts, words, conduct, or knowledge. Western Cas. & Sur. Co. v. Brochu, 105 Ill. 2d 486, 499 (1985). In the absence of a reservation of rights, an insurer waives all questions of policy coverage when it assumes an insured's defense. Apex, 99 Ill. App. 2d at 161-62. An insurer may waive a policy defense by continuing under a policy when it knows, or in the exercise of ordinary diligence could have known, the facts in question giving rise to the defense. If the insurance company is fully advised of the facts bearing on its policy defense and does not then raise the defense, but instead continues to recognize the validity of the policy, an intention to

waive the policy defense would follow. Kenilworth, 20 Ill. App. 3d at 620.

However, it has also been recognized that insurance coverage cannot be "waived" if the policy provides no coverage for the subject property. State Farm Fire & Cas. Co. v. Kleckner, 194 Ill. App. 3d 371, 380 (1990).

3. Estoppel

As under the doctrine of waiver, an insurer may be estopped from asserting any policy defenses it may have if it does not reserve its rights under the policy. Maryland Cas. Co. v. Peppers, 64 Ill. 2d 187, 195 (1976). However, unlike waiver, estoppel may be an involuntary relinquishment of rights and requires the insured's prejudicial reliance. Western Cas., 105 Ill. 2d at 499-500. Estoppel applies where the duty to defend was undertaken but then disputed, and the insurer is not estopped from denying coverage unless prejudice exists. United Farm Family Mut. Ins. Co. v. Frye, 381 Ill.App.3d 960, 969 (4th Dist. 2008). Ordinarily, the insured asserts prejudice on the ground that he surrendered the right to control his defense, Peppers, 64 Ill. 2d at 196, and completely relied for his entire defense upon the insurer. Gilbraltar Ins. Co. v. Varkalis, 46 Ill. 2d 481, 488 (1970). However, prejudice will not be conclusively presumed from the mere entry of an appearance and assumption of the defense. Peppers, 64 Ill. 2d at 196. The insured has the burden of establishing prejudicial reliance by clear, concise, and unequivocal evidence. Old Mut. Cas. Co. v. Clark, 53 Ill. App. 3d 274, 279 (1977).

Timing of Insurer's Actions

The initiation of a declaratory judgment action by the insured, rather than the insurer, is sufficient to avoid estoppel. The insurer must, however, act "promptly" or in a "timely manner" in reserving rights, or filing or responding to a declaratory judgment action. L.A. Connection v. PennAmerican Ins. Co., 363 Ill. App. 3d 259 (1st Dist. 2006). Illinois courts have generally applied one of three standards to measure an insurer's promptness:

(1) a declaratory judgment action is timely as long as it was filed before the underlying lawsuit ends;

(2) whether the insured waited until trial or settlement was imminent; and

(3) whether an insurer sought declaratory relief within a "reasonable time" of learning of the underlying lawsuit. Id.

Because each case must be decided on its own facts, courts favor the more flexible "reasonable time" test. Id. at 265. Under this test, for an insurer to avoid being estopped from raising policy defenses to coverage, status of the underlying suit can be a factor in determining whether the insurer timely filed the declaratory judgment action. State Auto. Mut. Ins. Co. v. Kingsport Development, LLC, 364 Ill.App.3d 946, 960 (2nd Dist. 2006).