

## **IDC Monograph**

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# **In the Wrong Place at the Wrong Time: Defense Counsel as *Ethically Challenged* or *Merely in a Position where Appearance of Impropriety* Exists when Insurer and Insured have Conflicts of Interest?**

## **Introduction**

Under Illinois law, an attorney hired by an insurer to defend an action against its insured owes fiduciary duties to two clients: the insurer and the insured.<sup>1</sup> Although an insurer's duty to defend typically includes the right to control the defense of litigation against its insured, Illinois law is settled that an insurer loses the right to control the defense when it issues a reservation of rights letter that creates a conflict of interest between the insurer and insured.<sup>2</sup> The most common example of a conflict of interest that gives rise to the right to independent defense counsel is where an insured is sued in a two-count lawsuit alleging negligence and intentional misconduct and the insurer agrees to cover damages because of negligence and reserves its rights to deny coverage for damages because of intentional conduct. Although both the insurer and the insured have a common interest in defeating the claim in its entirety, the insurer would also benefit from a finding of intentional misconduct, whereas the insured would benefit from a finding of negligence.

When such a conflict of interest arises, the insured has the right to reject a defense from insurer-appointed defense counsel and instead, select independent defense counsel to be paid for by the insurer.<sup>3</sup> Inherent in Illinois decisions discussing the right to independent counsel is a presumption that when a conflict arises, insurer-retained attorneys may favor their business relationship with the insurer over the attorney-client relationship with the insured and will not vigorously defend uncovered counts (*e.g.* fraud), thereby exposing the insured to liability for uncovered damages. Courts remedy any possibility that an insurer-retained attorney will subvert the insured's interests in favor of the insurer when a conflict arises by affording insureds the right to independent defense counsel, who does not owe any fiduciary duty to the insurer as a client, thereby eliminating the insurer's right to instruct the attorney on how to defend the case.

Many businesses and individuals are insureds on liability insurance policies that provide broad coverage for damages because of accidental bodily injury or property damage. Accordingly, many civil lawsuits for compensatory damages involve an insured defendant. With the increase in tort litigation, the potential for conflicts of interest creating the right to independent defense counsel have increased on sheer volume alone. With Illinois allowing the insured to retain counsel where an actual conflict exists, the cost to insurers is increased because Illinois provides for payment of insured-retained counsel fees, regulated through the judiciary only by a "reasonableness" standard, which typically is higher than "panel counsel" rates.

This monograph explores Illinois jurisprudence giving rise to *Maryland Casualty Insurance Company v. Peppers*,<sup>4</sup> the seminal Illinois decision regarding the right to independent counsel in conflict of interest situations, discusses *Peppers* and subsequent Illinois decisions regarding the interplay between defense counsel and conflicts of interest between the insurer and insured, looks to how courts outside of Illinois address conflicts of interest between the insurer and the insured, examines if there are superior ways to handle insurer-insured conflicts within the context of tort litigation and, as a subset of that discussion, examines whether there are practical ways to standardize the rates paid by insurers to insured-retained counsel in Illinois.

### **Illinois Decisions Prior to *Peppers***

Prior to *Peppers*, an insurer-retained attorney was deemed to represent only the insured, and conflicts of interest between the insured and the insurer, as a third-party payor, were evaluated on a case-by-case basis pursuant to the Illinois Rules of Professional Responsibility. For example, in *Apex Mutual Insurance Company v. Christner*, an insurer brought a declaratory judgment action in which it argued that an insured driver had breached the cooperation clause of a personal auto policy by failing to cooperate with the defense.<sup>5</sup> The insured argued that the insurer had waived the right to raise the breach of a cooperation clause as a defense because her insurer-appointed attorneys had continued to defend the underlying action after learning of the putative breach. The *Apex* court rejected the insured's argument, stating that:

[w]hile the attorney retained by the insurer in a case such as this represents the insured and not the insurer [citation omitted], no breach of duty will be imputed to him merely because his fee is not being paid by his client. Professional responsibility should be presumed until some evidence to the contrary is adduced.<sup>6</sup>

In so ruling, the court found it significant that the defense attorneys were not involved in the declaratory judgment action brought by the insurer, nor did they make any effort to obtain information from the insured that could bolster the insurer's coverage defenses.<sup>7</sup>

The *Apex*<sup>8</sup> court distinguished *Allstate Ins. Co. v. Keller*,<sup>9</sup> in which the court held that an insurer had waived the right to raise a breach of a cooperation clause in an automobile liability policy as a coverage defense based on inconsistent statements given by the insured driver because the insurer defended the underlying case for 16 months prior to raising the coverage defense.<sup>10</sup> In support of its holding, the court noted that the defense attorneys, who were employees of the insurer, had been aware that the insurer intended to raise a coverage defense but failed to disclose “this information or its significance” to the insured and, instead, “assumed complete control of the defense [and] proceeded to take their client’s deposition for the admitted purpose of placing their employer in a position to disclaim liability under the policy.”<sup>11</sup> As the court explained,

[w]here an insurer’s attorney has reason to believe that the discharge of his duties to his client, the insured, will conflict with his duties to his employer, the insurer, it becomes incumbent upon him to terminate his relationship with the client . . . . It was the duty of plaintiff’s attorneys upon learning of the possible conflict of interests between plaintiff and defendant, to immediately notify defendant of this fact. Their failure to take such action can be attributed only to their desire to strengthen plaintiff’s position in preparation for the filing of the instant suit. It would be untenable under such circumstances to allow plaintiff to disclaim liability under the policy . . . .<sup>12</sup>

Unlike in *Apex*, where there was no conflict because the defense attorneys were not involved with coverage issues, the court found there to be a conflict in *Keller* because the same attorneys employed by the insurer who were defending the underlying action also were involved with coverage issues, without advising the insured.<sup>13</sup>

In *Oda v. Highway Insurance Co.*,<sup>14</sup> the Appellate Court addressed the potential conflicts of interest between lawyers engaged by the insurer to defend multiple insureds under the same policy. In that case, building owners and lessees who operated a hotel in Chicago were sued by firefighters for injuries received when the building burned. Highway Insurance Company provided insurance on the building and responded to lawsuits against the owners and lessees by appointing two lawyers.<sup>15</sup> Those lawyers devised a joint defense between the owners and lessees, apparently attributing the deplorable condition of the building prior to the fire to the hotel guests.<sup>16</sup> In rejecting the contention of the insureds that there was a conflict between the owners and the lessees, making it improper for the insurer to provide counsel, the *Oda* court observed:

A traditional truism among lawyers is that nothing can be more ruinous to the defense of cases such as the personal injury cases here involved than for one defendant to seek to prove the liability of the other. On such occasions the plaintiff’s lawyer sits by and watches the show as one defendant slaughters the other, while the court, observing the spectacle, mediates on the folly of the defendants in not having agreed on a policy of cooperation, even though it meant that each had to assume some degree of risk thereby.<sup>17</sup>

The defense lawyers in *Oda* appear to have been salaried employees of the insurance company.<sup>18</sup> Payment by the insurer of judgments in excess of available limits was at issue in *Oda*, but the insurer there had timely provided its reservation of rights letter to the insureds with the recommendation that they retain counsel at their own cost to assist in the defense, which at least one insured did.<sup>19</sup> *Oda* teaches that, at least within its historical context, the insurer was not deemed to exercise control over legal strategy decisions.

Conflicts between the insurer, insured, and defense counsel were also discussed in *Cowan v. Insurance Company of North America*.<sup>20</sup> In recognizing a potential conflict of interest where a complaint against an insured included counts for both negligent and intentional acts, the *Cowan* court stressed that an insured must

be adequately informed of a potential conflict of interest so that the insured can intelligently make a decision as to whether to retain independent defense counsel or accept defense counsel from the insurer.<sup>21</sup> The *Cowan* court also noted that such situations raise both a conflict of interest between the insured and insurer and a professional conflict for an attorney appointed by the insurer. That professional conflict was something “the organized bar should strive to avoid,” but no other analysis was provided in the *Cowan* opinion.<sup>22</sup> Nonetheless, prior to *Peppers*, no Illinois decision provided clear guidance on how conflicts of interests between insurers and insureds should be resolved.

### **The Illinois Supreme Court’s Decisions in *Maryland Casualty Company v. Peppers* and *Thornton v. Paul***

The facts at issue in *Maryland Casualty Company v. Peppers* are relatively straightforward.<sup>23</sup> In *Peppers*, the insured was awakened by a noise, which he determined was someone trying to break into his property.<sup>24</sup> The insured went to the door and saw someone fleeing. He shouted for the person to stop and then fired his shotgun.<sup>25</sup> The injured person, James Mims, filed a three-count complaint against the insured alleging that the insured had assaulted him with a shotgun, that the insured had negligently and carelessly fired his shotgun, and that the insured had willfully and wantonly fired the shotgun.<sup>26</sup> The insurer initially appointed defense counsel, but withdrew from the defense shortly after the attorney filed an appearance. Both the trial and appellate courts found that the insured’s homeowner’s insurer had an obligation to defend the insured based on the negligence claims.<sup>27</sup>

The Illinois Supreme Court agreed that a duty to defend existed but expanded its discussion to address whether the insurer should be permitted to defend the case in light of the conflict between the interests of the insured and the insurer that arises when an insurer is obligated to defend a complaint with both covered and uncovered counts.<sup>28</sup> As the Illinois Supreme Court explained, if the insured was held liable, it would be in his best interest to be found negligent so that the loss would be covered by the insurer. On the other hand, it would be in the insurer’s best interest to obtain a determination that the insured’s actions were intentional, so that no coverage would be afforded for the loss. The court noted that this overriding problem had been recognized in various jurisdictions, but with “little accord as to the resolution of the problem.”<sup>29</sup>

Referencing the Illinois Code of Professional Responsibility, the court observed that this conflict raised serious ethical concerns for an insurer-appointed attorney. The court held that the ethical concerns could be alleviated if the insured, after full disclosure of the conflicting interests, agreed to accept the insurer’s defense. According to the court, the conflict of interest would also be eliminated if the insurer waives its defense of noncoverage for intentional acts. Absent these circumstances, the court held that the insured had the right to be defended in the lawsuit by an attorney of his own choice who would have the right to control the defense of the case. Since the insurer still had a contractual duty to defend, despite the conflict, the court held that it must reimburse the reasonable cost of defending the action. The *Peppers* court noted that the insurer was allowed to participate through its counsel in all aspects of litigation, but that the defense was subject to control by the insured’s attorney.<sup>30</sup>

Two years later, the court in *Thornton v. Paul*<sup>31</sup> took *Peppers* a step further, holding that not only does an insured have a right to independent defense counsel when a conflict of interest exists, but also that the insurer cannot participate in the defense and must satisfy its duty to defend by reimbursing the insured for the costs of defense. In *Thornton*, an insured was faced with a complaint alleging battery. The insurer took the position that battery, as an intentional act, was not covered. An amended complaint was later filed that alleged negligence.

The insurer maintained its position of no coverage. The court found that a duty to defend did in fact arise upon the filing of the amended complaint. The insured argued that the insurance company's failure to defend the insured for the amended complaint, coupled with its failure to file a declaratory judgment action to adjudicate its obligations, estopped it from asserting coverage defenses. The *Thornton* court disagreed that estoppel applied, holding that an insurer will not be estopped from asserting coverage defenses where conflicts of interest would otherwise preclude the insurer from participating in the defense of the case.

It is interesting to note that the *Peppers* doctrine was initially used by insurers to defend estoppel claims arising out of their failure to provide a defense. In *Murphy v. Urso*, for example, the driver of a school bus defaulted after being served with a summons and complaint in a suit brought by a passenger.<sup>32</sup> Travelers Insurance Company successfully defended the garnishment action by asserting it could not have defended the driver where the owner was also sued because the issue of whether the driver had permission to operate the school van after hours to help the victim move to another apartment created a conflict. The *Murphy* court found that the insurer was not obligated or permitted to participate in the driver's defense and, therefore, was not estopped from denying coverage.<sup>33</sup>

That defense to estoppel based on the failure to defend was not successful in *Clemmons v. Travelers Insurance Company* because the court found that there was no conflict that relieved the insurer of providing a defense.<sup>34</sup> The *Clemmons* case involved suit against a Red Cross blood transport driver sued by an injured passenger. The difference between that case and *Murphy*, in which the court found a conflict, was that the employer was not sued in *Clemmons* and, therefore, no conflict was created because the issue of permissive use would not be raised in the underlying case. Because Travelers did not defend the driver, it was estopped to contest coverage where the duty to defend was triggered.<sup>35</sup> Similarly, no conflict was found to absolve the insurer from failing to defend in *County of Massac v. United States Fidelity & Guaranty Co.*<sup>36</sup> That case involved a suit by a motorist who drove off a bridge during construction at night where no warnings were posted. The appellate court found no conflict because issues of independent contractor or the occurrence during a project stoppage or shut down would not be relevant or litigated in the tort case.<sup>37</sup>

## **The Development of the *Peppers* Doctrine in Illinois**

Since *Peppers* was decided, Illinois law regarding conflicts of interest and the right to independent counsel has continued to evolve. Generally, the rule in Illinois remains that an insurer's "duty to defend includes the right to control the defense."<sup>38</sup> The existence of a conflict between the insured and insurer creates an exception to this rule. Where there is a conflict, "the insurer ordinarily must pay the costs of independent counsel 'instead of participating in the defense itself.'"<sup>39</sup> As a consequence, it is critical to understand: (1) when a conflict of interest between an insurer and insured arises; (2) the duties of an insurer and insurer-retained counsel when a conflict arises; (3) the role of independent counsel; and (4) the extent of an insurer's obligation to compensate independent counsel.

### **1. The Creation of a Conflict of Interest Between an Insurer and Insured**

An insured is entitled to independent counsel when a conflict arises. Illinois courts have consistently held that an insurer's incentive to negate coverage for a claim is insufficient to create a conflict.<sup>40</sup> One appellate court has defined the test for determining the existence of a conflict of interest as follows:

To determine whether there is a conflict, we must compare the allegations of the underlying complaint against the insured to the terms of the insurance policy at issue. . . . If, after comparing the complaint to the insurance policy, it appears that factual issues will be resolved in the underlying suit that would allow insurer-retained counsel to “lay the groundwork” for a later denial of coverage, then there is a conflict between the interests of the insurer and those of the insured. . . . Put another way, if, in the underlying suit, insurer-retained counsel would have the opportunity to shift facts in a way that takes the case outside the scope of policy coverage, then the insured is not required to defend the underlying suit with insurer-retained counsel.<sup>41</sup>

Other courts have stated more generally that the “test of 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.”<sup>42</sup>

Under these tests, Illinois courts have typically held that a conflict of interest exists when the underlying complaint against the insured contains two mutually exclusive theories – one of which is potentially covered and the other is not.<sup>43</sup> Courts have also found the existence of a conflict when the insurer has a duty to defend two insureds in the same action and those insureds have diametrically opposed defenses.<sup>44</sup> Illinois courts, however, have found the existence of a conflict in less clear circumstances. Below is a discussion of several decisions in which courts have found the existence of a conflict despite the lack of mutually exclusive theories or diametrically opposed defenses.

**a. Timing of Damage:**

***American Family Mutual Insurance Company v. W.H. McNaughton Builders, Inc. and Illinois Masonic Medical Center v. Turegum Ins. Co.***

Illinois courts have found the existence of a conflict between an insured and insurer where the presence of coverage depends on the timing of the damage alleged in the underlying complaint. For instance, in *American Family Mutual Insurance Company v. W.H. McNaughton Builders, Inc.*,<sup>45</sup> W.H. McNaughton Buildings, Inc. (McNaughton) was insured under a CGL policy. The policy was issued in 1994 and only covered “property damage” caused by an occurrence after 1994.<sup>46</sup> The policy remained in force through 2004, but, after 2002, an endorsement was added excluding property damage caused by mold contamination.<sup>47</sup> In 2004, McNaughton was sued by customers who alleged that McNaughton “breached an implied warranty requiring it to install in a good and workmanlike manner an exterior insulation and finish system (EIFS).”<sup>48</sup> The customers also asserted that McNaughton’s failure resulted in mold contamination.<sup>49</sup> According to a contract attached to the complaint, the customers’ home was built in 1991 and 1992.<sup>50</sup>

After McNaughton submitted the claim under its CGL policy, its insurer agreed to defend under a reservation of rights. While reserving rights, the insurer “pointed out that: (1) the Policy did not cover property damage occurring prior to the Policy’s inception in 1994; (2) the Policy did not cover property damage that resulted from mold that occurred after December 31, 2002; and (3) the Policy did not cover property damage that McNaughton knew about before the Policy’s inception in 1994.”<sup>51</sup> Following receipt of the reservation of rights letter, McNaughton demanded independent counsel. When the insurer refused, McNaughton filed a complaint for declaratory judgment. The trial court ruled that McNaughton was not entitled to independent counsel because only a “possible or potential conflict of interest existed.”<sup>52</sup> McNaughton appealed, and the appellate court reversed.

On appeal, the court determined that an actual conflict of interest existed between McNaughton and its insurer, warranting the provision of independent counsel. The appellate court reasoned:

A conflict already exists here. A conflict does not arise at the time a lack of coverage is unequivocally established. A conflict arises when the divergent interests of the insurer and insured are apparent and the attorney representing the insured can no longer represent both clients' interests without prejudice to either client. A conflict already exists here because [the insurer's] interests would be served by fleshing out in discovery facts showing that the damage to the [customers'] home occurred prior to the inception of the Policy, while McNaughton's interests would be served by fleshing out facts showing that the damage occurred after the inception of the Policy. In this regard, an attorney representing [the insurer's] interests would be the enemy of McNaughton. As the supreme court has said, "[a] ruling that required an insured to be defended by what amounted to his enemy in the litigation would be foolish." . . . Thus, McNaughton should not be forced to use [the insurer's] attorneys to defend against the [customers'] claims.<sup>53</sup>

In coming to its decision, the appellate court rejected the argument of the insurer that no conflict existed because the timing of the damages was irrelevant to the underlying lawsuit. The appellate court found this argument "absurd" because it assumed that the customers could prevail against McNaughton in a lawsuit "in which they allege that McNaughton's poor workmanship caused damage to their home . . . without establish[ing] that the damage to their home stems from the time when McNaughton worked on their home."<sup>54</sup>

The appellate court used a similar analysis in *Illinois Masonic Medical Center v. Turegum Insurance Company*<sup>55</sup> to find the presence of a conflict of interest. In *Turegum*, a medical center, which was an insured under a professional liability policy that expired on December 1, 1977, was sued in a medical malpractice action alleging negligence during one or more of three hospitalizations.<sup>56</sup> One of the hospitalizations occurred prior to the expiration of the policy; the other two occurred after the expiration of the policy.<sup>57</sup> When notified of the claims, the professional liability insurer agreed to defend the medical center against claims arising prior to the expiration of the policy but insisted that the medical center retain separate counsel to defend the claims arising after the expiration of the policy.<sup>58</sup> The medical center filed a complaint for declaratory judgment and sought an order "directing [the insurer] to relinquish control of the defense . . . to counsel retained by [the hospital] and to reimburse [the hospital] for the reasonable costs incurred in that litigation."<sup>59</sup> The trial court granted the hospital's request, and the appellate court affirmed.

On appeal, the insurer argued that no conflict of interest existed because "there will be no adjudication as to the timing of the negligence, if any, in the underlying case." Rather, according to the insurer, the plaintiff in the underlying case only has "to prove the Hospital was negligent during one or more of the three hospital stays," and "[i]t was not part of her proof to establish when that negligence took place."<sup>60</sup> The appellate court disagreed, stating:

Irrespective of whether the timing of the malpractice, if any, would be established in the underlying suit, we agree with the Hospital that because [the plaintiff's] complaint alleges that negligence occurred during one or more of three separate hospitalizations and because two of those confinements took place after the policy expired – and, hence, were not covered by it – [the insurer's] best interest (a) lie in a finding that the malpractice, if any, occurred during one or both of the two post-policy periods and (b) would be furthered by a less than vigorous defense to the allegations relating thereto; and that . . . a conflict of interests therefore exists which requires [the insurer] to relinquish control of the defense of [the plaintiff's] action to the Hospital's counsel of choice.<sup>61</sup>

**b. Assertion of Punitive Damages:**  
***Nandorf, Inc. v. CNA Insurance Co.***

Conflicts of interest can arise in certain situations where punitive damages are sought. The court in *Nandorf, Inc. v. CNA Insurance Co.*<sup>62</sup> found that a conflict of interest existed where a complaint against an insured sought substantial punitive damages as compared to the compensatory damages sought. In *Nandorf*, the insurer reserved its rights based solely on coverage for punitive damages.<sup>63</sup> The court stated that while the insured and the insurer had the same interest in finding no liability, if liability was found, their interests diverged. According to the appellate court, the insurer had an interest in providing a less than vigorous defense as its interests were as well served by an award of minimal compensatory damages and substantial punitive damages.<sup>64</sup> On the other hand, the insured's interest if liable was best served by an award of compensatory damages, but no punitive damages.<sup>65</sup> Based on these facts, the court found an actual conflict between the insured and the insurer and further found it improper for the insurer to retain control of the litigation.<sup>66</sup>

*Nandorf* has not been uniformly followed for the proposition that a prayer for punitive damages will trigger a *Peppers* conflict. For example, the court in *National Casualty Co. v. Forge Industrial Staffing, Inc.*, rejected the insured's argument that the potential for punitive damages from an EEOC employment discrimination charge allowed it choice of counsel.<sup>67</sup> In addition to noting that the EEOC does not award punitive damages, the *National Casualty* court also observed that even if the EEOC charge evolved into a lawsuit, the basis for compensatory and punitive damages would be tied to same facts, thereby aligning the interests of the insured and insurer.<sup>68</sup>

**c. Potential for Excess Liability:**  
***R.C. Wegman Construction Co. v. Admiral Insurance Company***

A recent Seventh Circuit Court of Appeals case, *R.C. Wegman Construction Co. v. Admiral Insurance Co.*, decided under Illinois law, could be construed as holding that a conflict of interest arises between the insurer and the insured when it becomes clear to the insurer that a judgment against the insured in **excess of policy limits is a “nontrivial probability.”**<sup>69</sup> In *R.C. Wegman Construction Co.*, a worker at a construction site managed by the insured was seriously injured in a fall and subsequently sued the insured.<sup>70</sup> The insured tendered its defense to its liability insurer under a policy that had a \$1 million limit.<sup>71</sup> The insurer accepted the defense and retained counsel to defend the insured.<sup>72</sup> The worker's suit proceeded to trial, and a judgment in excess of \$2 million was entered against the insured.<sup>73</sup>

The insured then sued the insurer, alleging that the insurer breached its good faith duty to settle and was liable for the entire judgment. The insured alleged that the insurer knew that there was a “realistic possibility” of an excess judgment but failed to warn the insured of this possibility.<sup>74</sup> The insured further alleged that, had it known of the likelihood of an excess judgment, it would have promptly notified its excess insurer.<sup>75</sup> The insured did not learn of the potential for excess until a few days before the trial from a casual discussion with a non-involved attorney.<sup>76</sup> At that time, the insured immediately notified its excess insurer, but the excess insurer refused coverage on the grounds that it had not received timely notice.<sup>77</sup>

The insurer filed a motion to dismiss, which was granted by the trial court. The Seventh Circuit reversed, finding that the dismissal was premature. The Seventh Circuit found that the allegations were sufficient to support a claim for breach of its good faith duty to its insured. In so holding, the Seventh Circuit focused on the argument that the insurer's knowledge of the likelihood of an excess judgment, its failure to advise the insured of this likelihood, and its lawyer's admission that it was taking a “gamble” on obtaining a reduction in

damages based on Illinois' joint and several liability statute, created a conflict of interest between the insured and the insurer and demonstrated a breach of fiduciary duty.<sup>78</sup>

The Seventh Circuit further stated that where a potential conflict of interest such as this arises, the insurance company's duty of good faith requires it to notify the insured.<sup>79</sup> In that scenario, the Seventh Circuit said the insured would then have the option of hiring a new lawyer, at the insurer's expense, whose loyalty would be exclusive to it.<sup>80</sup> The court also noted that notification of the risk of excess would have enabled the insured to notify its excess carrier.<sup>81</sup>

While at first glance, the *Wegman* case may appear to stand for the proposition that the possibility of an excess verdict creates a conflict of interest, *Wegman* appears to be a breach of good faith case decided on a particularly egregious set of facts. This interpretation is supported by the opinion provided by the Seventh Circuit in response to the insurer's motion for rehearing. In the court's opinion on petition for rehearing, the Seventh Circuit stated that the insurer mischaracterizes the holding as being that "where there is a possibility of a verdict in excess of policy limits, there is a conflict of interest between the insurer and the insured."<sup>82</sup> The court stated that this characterization "ignores the facts that led us to find a conflict."<sup>83</sup>

The court went on to list the facts considered as: (1) the severity of the plaintiff's injury; (2) the settlement demand in excess of limits; (3) the trial setting; (4) plaintiff's securing an award double the limits; (5) the admission of the insurer that its strategy was to downplay responsibility, rather than deny liability; and (6) the failure of the insurer to warn the insured of the possibility of an excess judgment and decision to "gamble."<sup>84</sup> The court made clear that its opinion was based on the totality of these facts and that instead of notifying the insured and allowing it to attempt to negotiate a settlement or, at the minimum, notify its excess carrier, the insurer gambled on obtaining a reduction in damages on the basis of Illinois' joint and several liability statute.<sup>85</sup> As stated in the opinion on the petition for rehearing, "Admiral's gamble created a conflict of interest that entitled [the insured] to choose its own attorney to represent its interests, yet [the insurer] failed to warn [the insured] of what it was doing."<sup>86</sup> The opinion on the petition for hearing, in our opinion, limits the scope of the court's holding to the particular facts at issue in that case, stresses the importance of communicating the potential for excess, and confirms that the Seventh Circuit did not hold generally that the possibility of an excess judgment creates a conflict of interest.

Interestingly, the Seventh Circuit itself has previously held that the mere possibility of an excess verdict does not create a conflict of interest depriving an insurer of the right to control the defense.<sup>87</sup> The *Wegman* decision does not even acknowledge this case, further evidencing that *Wegman* does not stand for this proposition. Additionally, the only reported decision discussing *Wegman* for this proposition, *United States Specialty Ins. Co. v. Burd*,<sup>88</sup> states that *Wegman* was a bad faith claim, and not a conflicts claim, and that the *Wegman* court merely held that an insurer has a duty of good faith to keep its insured informed. Nonetheless, the *Wegman* case can be interpreted as standing for the proposition that a potential for verdicts or settlements in excess of policy limits creates a conflict of interest.

## **2. Duties of an Insurer and Insurer-Retained Counsel When a *Peppers* Conflict Arises**

When a conflict of interest arises between an insured and insurer, the insurer and insurer-retained counsel (if one has been retained) must inform the insured of the conflict. Failure to apprise the insured of the conflict of interest will likely prevent the insurer from later asserting the non-coverage defense that created the conflict of interest.<sup>89</sup> Additionally, the failure of insurer-retained defense counsel to inform the insured of the conflict would likely constitute a breach of the Rules of Professional Conduct if counsel continues to represent the

insured without obtaining the insured's informed consent to the conflicted representation. Illinois Rule of Professional Conduct 1.7 provides:

- (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
1. the representation of one client will be directly adverse to another client; or
  2. there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.<sup>90</sup>

Once a conflict arises, if adequate information about the conflict is conveyed to the insured and the insured consents to representation by insurer-retained counsel, then insurer-retained counsel may appropriately represent the insured. The information conveyed to the insured must permit the insured to make an informed decision. As a district court has stated,

If the insurer proceeds to defend the insured in the face of a conflict of interest, it must reserve its rights in a manner that will "fairly inform the insured of the insurer's position." . . . In informing the insured of the conflict, "the insurer must act openly and with the utmost loyalty to its insured both in initially explaining the insurer's position in the matter and in the actual defense of the tort litigation." . . . "[B]are notice of a reservation of rights is insufficient unless it makes specific reference to the policy defense which may ultimately be asserted and to the potential conflict of interest."<sup>91</sup>

This process of "fairly informing" the insured requires that the insurer send the insured a proper reservation of rights letter, which "allows the insured to choose intelligently between accepting the insurer's defense counsel and retaining his own counsel."<sup>92</sup> Where a conflict of interest exists, a proper reservation of rights letter contains the following elements:

- Identification of the relevant policy language;
- Identification of the conflict of interest;
- An explanation of the conflict of interest;
- A statement that the insurer pays insurer-retained counsel;
- A statement that the insurer regularly retains this insurer-retained counsel; and
- An explanation of the insured's right to independent counsel at the insurer's expense.<sup>93</sup>

Furthermore, even if the insured consents to representation by insurer-retained counsel after disclosure of the conflict, insurer-retained counsel cannot continue in his or her representation unless he also believes that he can provide competent and diligent representation to the insured despite the conflict.<sup>94</sup>

### **3. The Role and Compensation of Independent Counsel**

Independent defense counsel is an attorney selected by the insured, rather than the insurer. After his or her retention, independent defense counsel has "the right to control the conduct of the case."<sup>95</sup> The right to control the defense of the case gives independent counsel the freedom to formulate a defense strategy without the

insurer's consent or approval.<sup>96</sup> However, the right to independent counsel does not obviate an insured's duty to keep the insurer informed of the litigation or cooperate with the insurer.<sup>97</sup>

In Illinois, an insurer must reimburse the insured for the "reasonable" cost of independent counsel as such costs are incurred by the insured.<sup>98</sup> The determination of "reasonableness" is left to the sound discretion of the trial court.<sup>99</sup> The insured bears the burden to show that independent counsel's fees were reasonable and, "to justify a fee, more must be presented than a mere compilation of hours multiplied by a fixed hourly rate or bills issued to the client. . . since this type of data, without more, does not provide the court with sufficient information as to their reasonableness."<sup>100</sup> Instead, a "petition for fees must specify the services performed, by whom they were performed, the time expended thereon and the hourly rate charged therefor."<sup>101</sup>

When assessing whether fees are reasonable, the court takes into account a number of factors, including "the skill and standing of the attorneys, the nature of the case, the novelty and/or difficulty of the issues and work involved, the importance of the matter, the degree of responsibility required, the usual and customary charges for comparable services, the benefit to the client . . . , and whether there is a reasonable connection between the fees and amount involved in the litigation."<sup>102</sup> Moreover, a court can consider whether a bill has been paid as evidence of its reasonableness,<sup>103</sup> and courts have held that the fact that defense fees are incurred and paid by the insured in the ordinary course of business establishes that the fees were *prima facie* reasonable.<sup>104</sup> Finally, the obligation to pay independent counsel's reasonable fees starts once the conflict arises and the insured has insisted upon independent counsel. Consequently, where the insured and insurer are contesting the insured's right to independent counsel, the insurer may be obligated to reimburse the insured for expenses incurred during the pendency of a declaratory judgment action if a court later determines that a conflict of interest exists warranting independent counsel.<sup>105</sup>

## **Conflicts of Interest and the Right to Independent Counsel Outside of Illinois**

Besides Illinois, a number of other states also have addressed whether an insurer has an obligation to provide independent counsel at the insurer's expense when the insurer has decided to defend the insured under reservation of rights. Some states only have facially addressed this issue, if at all, while others have devoted a substantial amount of jurisprudence to the topic. Generally speaking, courts in these other states have embraced one of three approaches: (1) the insured is entitled to independent counsel whenever the insurer defends under a reservation of rights; (2) the insured is entitled to independent counsel only when a conflict of interest exists; or (3) the insured is entitled to independent counsel only when the insurer fails to abide by an "enhanced duty of good faith". Additionally, in some states, the legislature has taken this issue out of the courts' hands and enacted statutory schemes which specify an insurer's obligations where conflicts arise. While an in-depth discussion of the manner in which each of the other 49 states address this topic is beyond the scope of this paper, below are a few examples of how other states have decided to tackle this issue.

A minority of courts in other states have held that an insured's right to independent counsel is triggered whenever an insurer elects to defend under a reservation of rights. Case law suggests that courts in Alaska,<sup>106</sup> Arkansas,<sup>107</sup> Maine,<sup>108</sup> Massachusetts,<sup>109</sup> Michigan<sup>110</sup> and Mississippi<sup>111</sup> have at various times embraced this approach. The theory behind this bright-line rule lies in the belief that "[o]nce the insurer 'reserves its rights' to contest its obligation to make indemnity payments, the interests of the insurer and those of the insured come into conflict."<sup>112</sup>

Some of these states contend that insurers may be tempted to take unfair advantage of this supposedly inherent conflict. For example, the Supreme Court of Alaska in *CHI of Alaska, Inc. v. Employers Reinsurance*

*Corp.*, outlined at least three ways an insurer could improperly use this conflict against its insured. First, an insurer may “only go through the motions of defending” the insured if it knows that it can later assert non-coverage.<sup>113</sup> Second, an insurer could “conduct the defense in such a manner as to make the likelihood of a plaintiff’s verdict greater under [an] uninsured theory.”<sup>114</sup> Third, the insurer “might gain access to confidential or privileged information in the process of the defense which it might later use to its advantage in litigation concerning coverage.”<sup>115</sup>

Other states which have adopted this *per se* approach focus on the “financial catastrophe” which this conflict could impose on the insured.<sup>116</sup> The Supreme Court of Maine explained in *Patrons Oxford Insurance Company v. Harris* that if an insurer “could continue to control the insured’s defense despite reserving its rights to later deny coverage, it could assert a liability defense and insist on fully litigating the insured’s case, thus exposing the insured to personal liability if there is a verdict favorable to the claimant.”<sup>117</sup> If the claimant received such a verdict, the court in *Patrons Oxford* noted that the insurer would have an opportunity to avoid liability by litigating coverage in a declaratory judgment action.<sup>118</sup> The insured would risk “financial catastrophe” if held liable, while the insurer could “save itself by litigating both issues—the insured’s liability and the coverage defense—and winning either.”<sup>119</sup> Only by allowing the insured to “control his own case” with independent counsel “when the insurer issues a reservation of rights” can the insured “protect himself ‘from the sharp thrust of personal liability’.”<sup>120</sup>

Most states, however, do not automatically provide the insured with the right to independent counsel whenever the insurer decides to defend under a reservation of rights. Like Illinois, a plurality of states require some showing of a conflict of interest between the insurer and its insured before the insured’s right to independent counsel arises. These states examine whether a conflict exists on a case-by-case basis. Courts in states such as Arizona,<sup>121</sup> Connecticut,<sup>122</sup> Delaware,<sup>123</sup> Georgia,<sup>124</sup> Hawaii,<sup>125</sup> Indiana,<sup>126</sup> Maryland,<sup>127</sup> Minnesota,<sup>128</sup> New York,<sup>129</sup> Ohio,<sup>130</sup> Oklahoma,<sup>131</sup> Pennsylvania,<sup>132</sup> Rhode Island,<sup>133</sup> South Carolina,<sup>134</sup> Texas,<sup>135</sup> Utah<sup>136</sup> and Wisconsin<sup>137</sup> have seemed to adopt some form of this approach. What constitutes a conflict of interest worthy of independent counsel, however, varies amongst these states.

Take, for example, the state of New York. In *Public Service Mutual Insurance Company v. Goldfarb*, the insurer issued a dental liability policy to the Dental Society of the State of New York.<sup>138</sup> A member of that organization, Dr. Saul Goldfarb, received coverage under that policy.<sup>139</sup> One of Dr. Goldfarb’s former patients filed suit against him and alleged that he had sexually abused her during the course of treatment.<sup>140</sup> The policy in question provided coverage for “all sums, including punitive damages . . . because of injury resulting from professional dental services rendered . . . and resulting from any claim or suit based upon . . . [m]alpractice, error, negligence or mistake, assault, slander, libel [or] undue familiarity.”<sup>141</sup> The New York Court of Appeals held that this policy language required the insurer to pay compensatory and punitive damages arising out of unlawful or inappropriate physical contact which occurs during the course of dental treatment.<sup>142</sup> Because the claimant had alleged that such conduct occurred, the court held that the insurer had a duty to defend Dr. Goldfarb.<sup>143</sup>

The court, however, noted that the jury could conclude that such unlawful contact had occurred, but that it did not occur in the course of dental treatment.<sup>144</sup> The claimant under those circumstances still could recover from Dr. Goldfarb, but the policy would not require the insurer to indemnify the judgment against him.<sup>145</sup> Moreover, the court further noted that New York public policy would permit liability coverage for an insured “whose intentional act causes an unintended injury”, but not for an insured “who intentionally injures another.”<sup>146</sup> The claimant alleged that Dr. Goldfarb both committed intentional acts which caused unintended injury *and* intentionally caused her injury.<sup>147</sup> Again, the insurer would have a duty to indemnify under the former theory but not the latter.<sup>148</sup>

As such, the New York Court of Appeals concluded that the insured was entitled to independent counsel because the “insurer’s interest in defending the lawsuit is in conflict with the defendant’s interest.”<sup>149</sup> The court explained that New York law did not require separate counsel in every case where multiple claims are alleged.<sup>150</sup> Instead, independent counsel is required only in cases “where the defense attorney’s duty to the insured would require that he defeat liability on any ground and his duty to the insurer would require that he defeat liability only upon grounds which would render the insurer liable.”<sup>151</sup> “On the other hand,” the court continued, “where multiple claims present no conflict—for example, where the insurance contract provides liability coverage only for personal injuries and the claim against the insured seeks recovery for property damage as well as for personal injuries—no threat of divided loyalty is present and there is no need for the retention of separate counsel.”<sup>152</sup> The court held that the insurer must provide independent counsel when the “question of insurance coverage is...intertwined with the question of the insured’s liability.”<sup>153</sup>

In contrast, Minnesota focuses on whether the insurer would have the ability to manipulate the evidence in favor of non-coverage. In *Mutual Service Casualty Insurance Company v. Luetmer*,<sup>154</sup> after an insured was sued for slander, the insurer agreed to defend under a reservation of rights.<sup>155</sup> The attorney retained by the insurer to defend the insured had been hired to represent the insurer in coverage litigation before, but his role in this case would be limited to defending the slander lawsuit.<sup>156</sup> After the insured rejected insurer-retained counsel, maintaining that it had the right to select its own counsel at the insurer’s expense, the insured initiated a declaratory judgment action.<sup>157</sup> On appeal, the Minnesota Court of Appeals found that the insured was not entitled to independent counsel at the insurer’s expense.

Specifically, the Minnesota appellate court held that an “actual conflict of interest, rather than an appearance of a conflict of interest, must be established” before the insured is entitled to select its own defense counsel.<sup>158</sup> The court rejected the notion that an insurer wanting to “remain fully informed of the progress of the litigation in the main action while also litigating a declaratory judgment action” met the “actual conflict” standard.<sup>159</sup> Rather, it held that a “a finding of conflict of interest must rest on more substantial evidence, such as actions which demonstrate a greater concern for [the insurer’s] interests than the [insured’s] interest.”<sup>160</sup> The insured at least would have to show an “opportunity for manipulation of liability toward non-covered claims” before an “actual conflict” would arise.<sup>161</sup>

Other jurisdictions apply even more variations on this conflict theme. In determining if a conflict existed, a federal district court in Indiana focused on whether appointed defense counsel would be “materially limited” in his representation of the insured as a result of his “relationship” with the insurer and the insurer’s reservation of rights.<sup>162</sup> An appellate court in Ohio looked to whether the insurer’s reservation of rights “renders it impossible for the company to defend both its own interests and those of its insured.”<sup>163</sup> A federal district court in Hawaii applied yet another standard: a conflict arises when the insured is being sued for damages “potentially covered under the policy and either the insurer or its co-defendants have conflicting interests as to the determination of the factual causes of the damages being claimed.”<sup>164</sup> The decisions requiring the showing of a “conflict” rest along a wide continuum from making the appointment of independent counsel difficult to almost requiring appointment whenever a reservation of rights is at issue.

A third and noticeably smaller group of states normally does not require the insurer to provide the insured with independent counsel at all in the reservation of rights context. Instead, these states allow the insurer to select defense counsel but impose an “enhanced obligation for fairness” upon the insurance company.<sup>165</sup> Only when the insurer breaches this “enhanced obligation” is the insured entitled to select its own defense counsel.<sup>166</sup> This novel approach was first developed in the state of Washington and subsequently has been adopted by Alabama.<sup>167</sup>

For instance, in *Johnson v. Continental Casualty Company*,<sup>168</sup> a lawyer-insured was sued for malpractice in a complaint alleging, in different counts, that the insured was negligent and that he suborned perjury.<sup>169</sup> The insured reported the claim under his professional liability policy, which contained an exclusion for “any dishonest, fraudulent, criminal, or malicious acts or omission.”<sup>170</sup> The insurer provided a defense to the insured after advising the insured through a reservation of rights letter that (1) some allegations against the insured, if proved, would be covered and some would not, (2) that his policy had a \$250,000 limit of liability, and (3) that the insured may want to retain his own counsel at his expense.<sup>171</sup> The insured hired his own attorney but submitted his fees to his insurer, asserting that the existence of a conflict of interest entitled the insured to the appointment of independent counsel. After the insurer refused, the insured filed a complaint for declaratory judgment against the insurer seeking to recoup attorneys’ fees.<sup>172</sup>

The Washington Court of Appeals denied the insured’s request, finding that the insured was not entitled to independent counsel. According to the court, in Washington, the insurer and insurer-retained counsel owe the insured an “enhanced obligation of fairness” when defending an insured under a reservation of rights.<sup>173</sup> These obligations were different for the insurer and insurer-retained counsel. The insurer’s “enhanced obligation of fairness” required that:

- (1) the company must thoroughly investigate the claim; (2) it must retain competent counsel for the insured, and both retained counsel and the insurer must understand that only the *insured* is the client; (3) the company must inform the insured of the reservation of rights defense and *all* developments relevant to policy coverage and progress of the lawsuit; [and] (4) the company must refrain from any activity that would show a greater concern for its monetary interest than for insured’s financial risk.<sup>174</sup>

Likewise, the insurer-retained counsel must also understand that “he represents the insured, not the company” and that he “owes an ongoing duty to the insured to disclose (1) conflicts of interest under [Rule of Professional Conduct] 1.7; (2) all information relevant to the insured’s defense; and (3) all offers of settlement as they are presented.”<sup>175</sup> In this case, the appellate court found that the insurer and the insurer-retained counsel met these obligations, and, therefore, the imposition of attorneys’ fees for independent counsel was unwarranted.<sup>176</sup>

While many state courts have resolved the question of whether the insured is entitled to independent counsel when the insurer reserves its rights by adopting one of the three general approaches outlined above, a handful of state legislatures have enacted statutes which offer their own unique solutions. Florida’s statute, for example, requires the insurer to retain independent counsel who is “mutually agreeable to the parties.”<sup>177</sup> If the parties cannot agree on the lawyer’s reasonable fees, the statute permits the court to settle the dispute.<sup>178</sup> Alaska’s statute explicitly allows the insured to select independent counsel in the reservation of rights context.<sup>179</sup> The statute, however, imposes certain requirements on that counsel, such as that the lawyer have malpractice insurance and “at least four years of experience in civil litigation, including defense experience in the general area at issue in the civil action.”<sup>180</sup> The insurer must pay only the rate “actually paid by the insurer to an attorney in the ordinary course of business in the defense of a similar civil action in the community in which the claim arose or is being defended.”<sup>181</sup> Any dispute over such fees can be resolved through arbitration.<sup>182</sup>

Under California law, where there is a conflict of interest between the insurer and policyholder because the insurer has reserved its rights under the policy, the insured is entitled to select independent defense counsel.<sup>183</sup> This holding in *Cumis* was codified by the California legislature in California Civil Code Section 2860, which specifies that a conflict of interest creating the right to independent counsel “may exist” when “an insurer

reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim . . . .”<sup>184</sup> Section 2860 further specifies that “[n]o conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.”<sup>185</sup>

California Civil Code Section 2860 limits the rates payable to independent “*Cumis*” counsel, stating that the “obligation to pay fees to the independent counsel . . . is limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions . . . .”<sup>186</sup> The statute provides that when an insured has selected independent defense counsel, the insurer may require that the independent counsel possess certain minimum qualifications, such as at least five years of relevant experience and professional liability insurance coverage.<sup>187</sup> Further, the statute specifies that disputes concerning attorneys’ fees “shall be resolved by final and binding arbitration by a single neutral arbitrator selected by the parties to the dispute.”<sup>188</sup>

### **Should the Rate Determination Be Changed for *Peppers* Counsel?**

It has been estimated that insurers spend more than \$25 billion each year defending more than one hundred thousand lawsuits filed against their insureds.<sup>189</sup> It should be no surprise, therefore, that disputes regarding the cost to an insurer of providing *Peppers* counsel frequently arise. When selecting a defense attorney to defend a lawsuit against an insured, the insurer typically selects an attorney employed by the insurer (“captive” or “in-house” counsel) or an attorney with whom the insurer has pre-arranged formal agreements (“panel” counsel). Inherent in panel counsel agreements with insurers is that in return for a high volume of cases, the attorney will charge discounted rates and abide by the insurer’s litigation guidelines. Panel counsel has found that lower rates can be justified because insurers provide a steady stream of work and collections rates are high. On the other hand, non-panel defense counsel generally charge rates based on a business model of marketing to and serving a greater number of clients, with more peaks and valleys in their workload. Due to the differences in their business models, non-panel counsel rates are generally higher than those of insurer panel counsel.

Some states have placed statutory limitations on the rates that insurers must pay for independent counsel. For example, California Civil Code § 2860 limits an insurer’s obligation to pay independent counsel “the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended.” Given that few, if any, insureds can promise the stream of repeat business that insurers offer when seeking rate concessions from their panel counsel, from the insured’s perspective, it is not reasonable to expect that an insured can secure independent counsel at panel counsel rates, even if the insured were to hire the same firms that their insurers typically hire. In other words, rates “actually paid by insurers” to panel counsel (or captive counsel) are generally not market rates and should not be used to benchmark reasonable rates for independent defense counsel. To further expound on this argument, a rule limiting independent counsel rates to those rates charged by panel counsel is neither fair to insureds nor to non-panel defense attorneys. However, the counter argument is that it is fair to expect reduced rates in exchange for the contract right to select counsel, and defense counsel is free to decline representation if the rates are too low.

In many cases, unless the insured’s chosen independent counsel is willing to work at the insurer’s panel counsel rate, the insured is forced to bear a significant cost for each hour spent on the defense of the case based on the difference between panel counsel rates and the rates charged by their independent counsel. Many insureds cannot afford to pay the difference between panel counsel rates and non-panel counsel rates, thereby

presenting their chosen defense attorneys with the difficult choice of declining the representation, potentially facing difficulties in collecting fees from the insured, or dropping their rates to a level that the insurer will pay. In light of the fact that the defense of many civil lawsuits is funded by commercial general liability insurers, a rule capping the rates that an insurer must pay for independent counsel at rates charged by panel counsel ultimately could reduce the rates that many non-panel counsel defense attorneys could charge to rates charged by panel counsel.

In Illinois, *Peppers* and its progeny require conflicted insurers to pay the “reasonable rates” of independent defense counsel. It is viewed by Illinois courts as unreasonable to impose panel counsel rates on non-panel independent counsel. A seemingly more equitable approach is rooted in Illinois Rule of Professional Conduct 1.5, which lists the following factors to be considered when determining whether an attorney’s fees are reasonable:

- (1) The time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
- (2) The likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
- (3) The fee customarily charged in the locality for similar legal services;
- (4) The amount involved and the results obtained;
- (5) The time limitations imposed by the client or by the circumstances;
- (6) The nature and length of the professional relationship with the client;
- (7) The experience, reputation, and ability of the lawyer or lawyers performing the services; and
- (8) Whether the fee is fixed or contingent.<sup>190</sup>

There is debate within the defense bar whether the randomness of court-determined reasonable fee rates, which vary from region to region, county to county, and court to court within circuits, is the most desirable approach. Insurers pricing risks within Illinois have little to no certainty what *Peppers* counsel rates will be. The insurance-buying public would seem to be benefited if there were more standardization of rates within geographic regions in Illinois.

At this point in time, if the randomness of rates is perceived as a problem to insurers and others, the solution is not obvious. A response from the General Assembly, *ala* California’s *Cumis* statutory framework, seems to favor insurers over insureds’ counsel. Regional variation is a major obstacle to fairness, as well. Local bar associations are theoretically better poised to determine local rates because they represent a broad-spectrum of the bar including insurance and other defense. Local bar associations would be better able to achieve a consensus on rates for particular types of litigation and could present a reasonable range of rates to the chief judges of judicial circuits.

Providing that such an approach would not run afoul of anti-competitive or similar limitations, it is a potential solution that should be explored. Prior to attempting that, however, the insurance industry will have to provide empirical data to support the largely anecdotal notion that *Peppers* rates in Illinois vary too widely between regions and do not enable more accurate projections for insurers to set premiums.

## **An Irrebuttable Presumption of Defense Counsel as Ethically Challenged is Not Supported by Fact or Grounded in Legal Principle**

The so-called “majority rule”<sup>191</sup> imposed on insurer-insured conflicts, where the insurer’s contractual right to defend is excised and only the obligation to pay remains coupled with the insured’s selection of counsel and direction of defense, is imposed without any factual support.<sup>192</sup> No reason arguably exists to presume private defense counsel selected by the insurer necessarily will favor the insurer over the insured.<sup>193</sup> The main support for the theory that insured-selected defense counsel will cure an actual insurer-insured conflict is the thinking that insurer-appointed defense counsel cannot divorce profit motivation in the form of future cases from the immediate need of the insured for a vigorous defense.<sup>194</sup>

Profit motivation is the self-interest of the lawyer. Fiduciary relationships require the fiduciary to subjugate personal interests in order to perform:

To suggest that human nature prevents the harnessing of action motivated by self-interest is to contend that fiduciary relationships are unworkable. The law soundly rejects this contention.<sup>195</sup>

Therefore, the presumption of the defense counsel appointed by the insurer favoring the insurer runs contrary to the theme of lawyer as a trusted fiduciary.<sup>196</sup>

Many of the states that find that a conflict of interest does not allow the insured to select counsel to be paid by the insurer recognize that the threat of malpractice liability and discipline by bar authorities is an adequate protection against improper conduct. *See Travelers Indemnity Company of Illinois v. Royal Oak Enterprises, Inc.*<sup>197</sup> for a survey of cases on both sides of the issue. The court in *Federal Insurance Company v. X-Rite, Inc.*, noted the lack of evidence of a violation of ethical rules or malpractice. Absent such evidence, it could not alter the insurance policy:

. . . the court may not interfere with the terms of the parties’ agreement. To hold that the insurer who, under a reservation of rights, participates in selection of counsel, automatically breaches its duty of good faith is to indulge the conclusive presumption that counsel is unable to fully represent its client, the insured, without consciously or unconsciously compromising the insured’s interests. The [c]ourt is unable to conclude that Michigan law professes so little confidence in the integrity of the bar of this state.<sup>198</sup>

Lack of evidence of specific infractions is sparse in Illinois law. As noted by commentators outside of Illinois, when one considers the volume of cases handled by insurers, the lack of more reported decisions involving improper conduct by defense counsel suggests that there is no widespread problem.<sup>199</sup> Illinois reported cases containing evidence of insurer-retained counsel acting improperly are rare. In the case of *Allstate Insurance Company v. Keller*,<sup>200</sup> the attorney was the employee on staff for Allstate. He admitted to acting in the insurer’s interest in setting up the insured, who was himself engaged in insurance fraud, for a subsequent declaratory judgment action.<sup>201</sup>

In *Williams v. American Country Insurance Company*,<sup>202</sup> a police officer dragged by a taxi cab sued the driver and the cab company. The insurer appointed separate counsel to defend each. However, the insurer did not inform the cab driver that he had the right to independent counsel. In finding estoppel against the insurer, the *Williams* Court noted that the cab driver’s defense counsel denied agency in the answer and otherwise responded to written discovery to raise a defense that the driver was an independent contractor. Certainly the

fact that the insurance company and the cab company were owned by the same parent company factored into the decision. What is not fleshed out in the decision is whether the facts would have justified having counsel make the assertion that the driver was an employee of the cab company.

Most decisions from Illinois make mention of the ability of defense counsel to somehow influence the defense to drive a finding of liability on a non-covered count and the like.<sup>203</sup> The same suggestion is made that insurer-retained counsel would be able to raise certain issues or facts in defense to lay the groundwork for eventual denial of coverage.<sup>204</sup> The decisions do not explain how this could be achieved if lawyers are constrained by Supreme Court Rule 137 and RPC 3.3 by putting forth a fact-based defense.<sup>205</sup>

Illinois Rule of Professional Conduct 1.7 governs conflicts among a lawyer's current clients. That rule provides that a lawyer shall not represent a client if there is a concurrent conflict of interest, which includes when there is a "significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client . . . third person or by a personal interest of a lawyer."<sup>206</sup> Defense counsel are not retained by the insurer to represent the insurer in the litigation or to become involved in coverage matters.<sup>207</sup> In addition, Rule 5.4 (c) prohibits a person who "pays the lawyer to render services to another to direct or regulate the lawyer's professional judgment in rendering such legal services."<sup>208</sup>

Given the relative lack of example in reported decisions of actual defense counsel misconduct, dearth of empirical evidence,<sup>209</sup> and stringent Rules of Professional Conduct governing lawyer conduct where a third party pays the fee, it would appear that in Illinois defense counsel are not prone or motivated to subvert the interests of their clients in favor of the insurer. Provided that the engagement terms set by the insurer do not extend beyond zealous defense of the insured, and specifically do not include coverage-related work,<sup>210</sup> the defense counsel selected by the insurer appears independent. It is not clear, in this context, that the presumption applied under the *Peppers* doctrine is founded.

## Conclusion

An insurer's obligation to indemnify an insured is limited by the language of the insured's policy. This characteristic, inherent in all insurance policies, can create tension in the relationship between an insurer and its insured. This tension becomes pronounced when coverage for a particular claim against the insured is uncertain – whether the complaint against the insured alleges both covered and uncovered causes of action or when it is unclear whether the claim arose during the policy period. For the past fifty years, courts across the country have grappled with this issue and have reached different conclusions about what is appropriate when the interests of the insured and insurer seemingly diverge.

Illinois has the *Peppers* doctrine. Under *Peppers*, where a "conflict of interest" exists between an insured and insurer, the insured is entitled to independent counsel. While the *Peppers* doctrine has alleviated some concerns, it also has problems. For instance, *Peppers* assumes a real risk that insurer-retained defense counsel will favor the interests of the insurer over those of the insured despite the attorney's professional and ethical obligations to the insured. Such an assumption is unfair to defense counsel and largely unwarranted. Moreover, the *Peppers* doctrine lacks clarity on certain important issues such as the appropriate compensation of independent counsel. Although questions left by the ambiguities of the *Peppers* doctrine provide for no easy answer, hopefully further discussion will ensure the creation of a framework that provides clear guidance to insurers, insureds, and defense counsel and that fairly accounts for the legitimate interests of each concerned party.

**(Endnotes)**

<sup>1</sup> See *Nandorf, Inc. v. CNA Ins. Co.*, 134 Ill. App. 3d 134, 137, 479 N.E.2d 988, 991 (1st Dist. 1985).

<sup>2</sup> See *Maryland Cas. Co. v. Peppers*, 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

<sup>3</sup> *Id.* at 198-99.

<sup>4</sup> *Id.* at 198-99.

<sup>5</sup> *Apex Mut. Ins. Co. v. Christner*, 99 Ill. App. 2d 153, 240 N.E.2d 742 (1st Dist. 1968).

<sup>6</sup> *Apex*, 99 Ill. App. 2d at 173. The holding in *Apex* was that an insurer's timely filing and service on the insured of a declaratory judgment complaint serves as a reservation of rights so as to avoid application of waiver to the insurer of its policy defenses through continued defense of the insured without non-waiver agreement or reservation of rights.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 168-69, 172-73.

<sup>9</sup> *Allstate Ins. Co. v. Keller*, 17 Ill. App. 2d 44, 149 N.E.2d 482 (1st Dist. 1958).

<sup>10</sup> *Id.* at 51-52.

<sup>11</sup> *Id.* at 52.

<sup>12</sup> *Id.*

<sup>13</sup> The *Keller* court observed that the "automobile insurance policy is more than a simple agreement between two parties" because it protects the motoring public, important in light of the "millions of vehicles operating on our highways." *Keller*, 17 Ill. App. 2d at 48-49. Surprisingly, however, those observations did not lead to the conclusion that innocent victims have to be protected and compensated for their injuries. Instead, the discussion focuses on the pricing of insurance being affected by collusive suits and the need for insurers to rely on the veracity of their insureds to provide truthful information. Therefore, strict compliance with cooperation conditions was required to preclude raising insurance premiums to make insurance prohibitive for the motoring public. *Id.* at 49.

<sup>14</sup> *Oda v. Highway Ins. Co.*, 44 Ill. App. 2d 235, 194 N.E.2d 489 (1st Dist. 1963).

<sup>15</sup> *Id.* at 241.

<sup>16</sup> *Id.* at 253.

<sup>17</sup> *Id.* at 248.

<sup>18</sup> The insureds in *Oda* cited a document titled "'Statement of the Illinois State Bar Association Regarding Representation of Insureds by Salaried Employees of Insurance Corporations'" to bolster their argument that there was a conflict of interest and the insurer should be precluded under waiver or estoppel from contesting the excess limits verdict or paying the amount in excess of the limits. *Id.* at 250.

<sup>19</sup> *Id.* at 244.

<sup>20</sup> *Cowan v. Ins. Co. of North Amer.*, 22 Ill. App. 3d 883, 318 N.E.2d 315 (1st Dist. 1974).

<sup>21</sup> *Id.* at 896. The court specifically stated that the “insurer must act openly and with the utmost loyalty to its insured both in initially explaining the insurer’s position in the matter and in the actual defense of the tort litigation.” *Cowan* contains the suggestion found in earlier cases that the insured had an option of accepting the defense offered by the insurer or, instead, going it alone and potentially preserving rights to indemnity. That is why the insurer was required to adequately disclose the policy defenses it was asserting. *Id.* The *Cowan* court cited to the Michigan decision of *Meirthew v. Last*, 376 Mich. 33, 135 N.W.2d 353 (1965). In *Meirthew*, the commercial auto insurer defended the insured without specific reservation until the garnishment proceeding following judgment on jury verdict when, for the first time, it raised the policy defense of rented or leased auto exclusion. The *Meirthew* court noted that the insured, if apprised at an earlier point, could have negotiated settlement or presented available evidence that the vehicle was not leased or rented at the time of the occurrence. *Meirthew*, 376 Mich. at 36-37.

<sup>22</sup> *Cowan*, 22 Ill. App. 3d at 894. The facts in *Cowan* involved a traffic dispute where the insured was arguing with another motorist, with contact causing the other to lose his balance and fall to the ground. The insured filed suit after verdict in the tort suit. The insurer contended that it had no duty to indemnify the insured because of an intent-based exclusion in the policy. After denying the insurer’s motion to dismiss, the trial court granted summary judgment for the insured, based on a finding that collateral estoppel precluded the insurer from re-litigating the issue of the insured’s intent, and the underlying case did not foreclose indemnity coverage. The First District Appellate Court in *Cowan* held that the insurer was not foreclosed by collateral estoppel from asserting its defense to coverage, because it had defended under reservation of rights, and remanded the case for trial to resolve the issue of the insured’s intent to injure. As to the alleged conflict, the insured argued that the insurer-retained counsel had failed to seek a special interrogatory on intent, and the resulting ambiguities were caused by defense counsel. *Id.* at 893. This argument was rejected by the court, which found that had defense counsel submitted the special interrogatory it may have resulted in a higher verdict against the insured.

<sup>23</sup> *Peppers*, 64 Ill. 2d 198-99.

<sup>24</sup> The insured owned three contiguous parcels in East St. Louis. A Pizza Hut was located on the parcel farthest from where the insured’s home was located. The Pizza Hut had been burglarized on numerous occasions, so that on the night of the incident, Robert Peppers was staying at the building with his shotgun. *Peppers*, 64 Ill. 2d at 191-92.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> The appellate decision is found at *Maryland Casualty Company v. Peppers*, 29 Ill. App. 3d 26, 329 N.E.2d 788 (5th Dist. 1975). It is noted that, while the Supreme Court relayed that the restaurant at issue was a Pizza Hut, the appellate opinion states that the insured’s restaurant that had been burglarized was “Tincy’s Pizza House.” *Peppers*, 29 Ill. App. 3d at 27.

<sup>28</sup> The appellate court in *Peppers* reversed the trial court’s finding that St. Paul Insurance Company was not required to indemnify the insured. *Peppers*, 29 Ill. App. 3d at 29. The coverage case started in the trial court as a declaratory action brought by Maryland Casualty Insurance Company into which the insured Peppers third partied his homeowner’s insurer, St. Paul Fire and Marine Insurance Company. A trial was conducted in which Maryland Casualty was found to insure a parcel not at issue in the claim. The trial court found St. Paul did not have to indemnify Mr. Peppers because it found his conduct intentional and within the policy’s exclusion. *Id.* at 27. The *Peppers* appellate court held that St. Paul’s retained counsel’s involvement in this case for 24 days constituted assumption of defense without adequate reservation, and held St. Paul was required through waiver to provide indemnity coverage. That indemnity decision was reversed by the Supreme Court.

<sup>29</sup> *Peppers*, 64 Ill. 2d at 198.

<sup>30</sup> *Id.*

<sup>31</sup> *Thornton v. Paul*, 74 Ill. 2d 132, 384 N.E.2d 335 (1978).

<sup>32</sup> *Murphy v. Urso*, 88 Ill. 2d 444, 430 N.E.2d 1079 (1981).

<sup>33</sup> *Urso*, 88 Ill. 2d at 448-89.

<sup>34</sup> *Clemmons v. Travelers Ins. Co.*, 88 Ill. 2d 469, 430 N.E.2d 1104 (1981).

<sup>35</sup> *Id.* at 478-79.

<sup>36</sup> *County of Massac v. United States Fid. & Guar. Co.*, 113 Ill. App. 3d 35, 446 N.E.2d 584 (5th Dist. 1983).

<sup>37</sup> *Id.* at 43. *See also O'Bannon v. Northern Petrochemical*, 113 Ill. App. 3d 734, 447 N.E.2d 985 (1st Dist. 1983) (where insurer not allowed to intervene in structural work act settlement, no conflict existed prior to settlement because issue of whether plaintiff's injuries were related to work performed by employer for insured was not relevant in tort case); *Home v. Lorelei Rest. Co.*, 83 Ill. App. 3d 1083, 404 N.E.2d 895 (1st Dist. 1980) (insurers not allowed to intervene in subrogation suit where they failed to defend in a fire damage case, where owners or persons related to corporation were alleged by insurers to have started fire).

<sup>38</sup> *Illinois Masonic Med. Ctr. v. Turegum Ins. Co.*, 168 Ill. App. 3d 158, 163, 522 N.E.2d 611, 613 (1st Dist. 1988) (this general rule is rooted in an insurer's interest to "protect [its] financial interest in the outcome of the litigation" and to "minimize unwarranted liability claims.")

<sup>39</sup> *Utica Mut. Ins. Co. v. David Agency Ins.*, 327 F. Supp. 2d. 922, 929 (N.D. Ill. 2004) (*quoting Urso*, 88 Ill. 2d at 451-52).

<sup>40</sup> *See, e.g., Illinois Masonic Med. Ctr.*, 168 Ill. App. 3d at 163; *Nandorf*, 134 Ill. App. 3d at 137-38.

<sup>41</sup> *American Family Mut. Ins. Co. v. W.H. McNaughton Builders, Inc.*, 363 Ill. App. 3d 505, 511, 843 N.E. 2d 492, 498 (2d Dist. 2006).

<sup>42</sup> *Illinois Masonic Med. Ctr.*, 168 Ill. App. 3d at 163; *see also Royal Ins. Co. v. Process Design Assoc., Inc.*, 221 Ill. App. 3d 966, 975-76, 582 N.E.2d 1234, 1240 (1st Dist. 1991); *Nandorf*, 134 Ill. App. 3d at 137; *David Agency*, 327 F. Supp. 2d at 928.

<sup>43</sup> *Peppers*, 64 Ill. 2d 187.

<sup>44</sup> *Urso*, 88 Ill. 2d 444 (in action arising out of accident involving a school's van, a conflict existed when driver and school were sued and the school and insurer were best served by showing that the driver was not a permissive user while the driver was best served by showing that he was a permissive user).

<sup>45</sup> 363 Ill. App. 3d 505.

<sup>46</sup> *Id.* at 507.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 508.

<sup>52</sup> *Id.* at 509.

<sup>53</sup> *Id.* at 514 (quoting *Urso*, 88 Ill. 2d at 454-55).

<sup>54</sup> *McNaughton*, 363 Ill. App. 3d at 513.

<sup>55</sup> *Illinois Masonic Med. Ctr.*, 168 Ill. App. 3d 158.

<sup>56</sup> *Id.* at 161.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.* at 162.

<sup>60</sup> *Id.* at 166.

<sup>61</sup> *Id.* at 167-68.

<sup>62</sup> *Nandorf*, 134 Ill. App. 3d 134.

<sup>63</sup> *Id.* at 135.

<sup>64</sup> *Id.* at 138.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> 567 F.3d 871, 875-76 (7th Cir. 2009).

<sup>68</sup> *Id.* at 876.

<sup>69</sup> 629 F. 3d 724 (7th Cir. 2011).

<sup>70</sup> *Id.* at 725-26.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 724.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 728-29.

<sup>79</sup> *Id.* at 729.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *R.C. Wegman Constr. Co. v. Admiral Ins. Co.*, 634 F.3d 371, 371 (7th Cir. 2011)

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Littlefield v. McGuffey*, 979 F.2d 101, 108 (7th Cir. 1992).

<sup>88</sup> No. 6:09-cv-231-Orl-31KRS, 2011 U.S. Dist. LEXIS 62877, 11-12 (M.D. Fla. June 14, 2011).

<sup>89</sup> *Allstate Ins. Co. v. Carioto*, 194 Ill. App. 3d 767, 777, 551 N.E.2d 382, 387-88 (1st Dist. 1990); *David Agency*, 327 F. Supp. 2d. 928-30. Although estoppel requires prejudice to the insured, where an insurer has improperly reserved rights despite the existence of a conflict, the insured can show prejudice by demonstrating that it surrendered control of its defense without being appropriately informed of the conflict of interest. *See Process Design Assoc., Inc.*, 221 Ill. App. 3d 966.

<sup>90</sup> Illinois Rule of Professional Conduct 1.7: Conflict of Interest: Current Clients (Adopted July 1, 2009, effective January 1, 2010) (paragraph (b) of Rule 1.7 outlines the scenario where the attorney can represent clients with concurrent conflicts, which requires, among other things, informed consent).

<sup>91</sup> *David Agency*, 327 F. Supp. 2d. at 930 (*quoting Cowan*, 22 Ill. App. 3d at 893).

<sup>92</sup> *Id.* at 929-30.

<sup>93</sup> *See Carioto*, 194 Ill. App. 3d at 776-78 (analyzing the reservation of rights letter sent to the insured and discussing whether the reservation of rights letter sufficiently complied with the principles set forth in *Peppers* and permitted the insurer to later contest coverage). *See also* Ill. R. Prof. Cond. 1.7, cmt. 18 (“Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See Rule 1.0(e) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including the possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved. *See* Comments 30 and 31 (effect of common representation on confidentiality).”)

<sup>94</sup> Ill. R. Prof. Cond. 1.7(b)(2).

<sup>95</sup> *Peppers*, 64 Ill. 2d at 199.

<sup>96</sup> *See Illinois Masonic Med. Ctr.*, 168 Ill. App. 3d at 171-72 (discussing role of independent counsel).

<sup>97</sup> *See Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co.*, 144 Ill. 2d 178, 579 N.E.2d 322 (1991).

- <sup>98</sup> *Ins. Co. of Pa. v. Protective Ins. Co.*, 227 Ill. App. 3d 360, 368, 592 N.E.2d 117, 123 (1st Dist. 1992).
- <sup>99</sup> *Kaiser v. MEPC Am. Prop., Inc.*, 164 Ill. App. 3d 978, 983, 518 N.E.2d 424, 427 (1st Dist. 1987)
- <sup>100</sup> *Kaiser*, 164 Ill. App. 3d at 983-84.
- <sup>101</sup> *Id.* at 984.
- <sup>102</sup> *Id.*
- <sup>103</sup> *AMEC Constr. Mngt., Inc. v. Regent Ins. Co.*, No. 03 C 2880, 2004 WL 816720 at 5 (N.D. Ill., March 12, 2004).
- <sup>104</sup> *Am. Serv. Ins. Co. v. China Ocean Shipping Co.*, 402 Ill. App. 3d 513, 520, 932 N.E.2d 8, 15-16 (1st Dist. 2010) (citing *Taco Bell Corp. v. Cont'l Cas. Co.*, 388 F.3d 1069, 1077 (7th Cir. 2004)).
- <sup>105</sup> *See Illinois Masonic Med. Ctr.*, 168 Ill. App. 3d 158 (insurer was required to reimburse the insured for expenses associated with the retention of independent counsel after the court found that a conflict of interest existed between the insured and insurer.).
- <sup>106</sup> *CHI of Alaska, Inc., v. Employers Reinsurance Corp.*, 844 P.2d 1113 (Alaska 1993). Alaska later codified its approach to this issue by statute. See Alaska Stat. § 21.96.100 (2012).
- <sup>107</sup> *Union Ins. Co. v. Knife Co., Inc.*, 902 F. Supp. 877 (W.D. Ark. 1995).
- <sup>108</sup> *Patrons Oxford Ins. Co. v. Harris*, 905 A.2d 819 (Me. 1980).
- <sup>109</sup> *Hartford Cas. Ins. Co. v. A & M Assocs., Ltd.*, 200 F. Supp. 2d 84, 90 (D. R.I. 2002) (applying Massachusetts law).
- <sup>110</sup> *Cent. Mich. Bd. of Trustees v. Employers Reinsurance Corp.*, 117 F. Supp. 2d 627 (E.D. Mich. 2000).
- <sup>111</sup> *Moeller v. Am. Guar. & Liab. Ins. Co.*, 707 So. 2d 1062, 1069 (Miss. 1996).
- <sup>112</sup> *Cent. Mich. Bd. of Trustees*, 117 F. Supp. 2d at 633.
- <sup>113</sup> *CHI of Alaska, Inc.*, 844 P.2d at 1116.
- <sup>114</sup> *Id.*
- <sup>115</sup> *Id.*
- <sup>116</sup> *Patrons Oxford*, 905 A.2d at 826.
- <sup>117</sup> *Id.*
- <sup>118</sup> *Id.*
- <sup>119</sup> *Id.*
- <sup>120</sup> *Id.*
- <sup>121</sup> *Joseph v. Markovitz*, 551 P.2d 571, 577 (Ariz. Ct. App. 1976).
- <sup>122</sup> *See generally Steadfast Ins. Co. v. Purdue Frederick Co.*, No. 0122259, 2005 WL 3624482 (Conn. Super. Ct. Dec. 6, 2005).

- <sup>123</sup> See *Shephard v. Reinoehl*, No. C.A. 99C-06-030-JTV, 2000 WL 973079 (Del. Super. Ct. Mar. 29, 2000).
- <sup>124</sup> See *Am. Family Life Assurance Co. of Columbus, Ga. v. U.S. Fire Co.*, 885 F.2d 826, 831 (11th Cir. 1989) (applying Georgia law).
- <sup>125</sup> *National Union Fire Ins. Co. v. Allstate Ins. Co.*, 699 F. Supp. 238 (D. Haw. 1988).
- <sup>126</sup> *Armstrong Cleaners, Inc. v. Erie Ins. Exch.*, 364 F. Supp. 2d 797, 817 (S.D. Ind. 2005).
- <sup>127</sup> *Allstate Ins. Co. v. Campbell*, 639 A.2d 652, 657 (Md. 1994).
- <sup>128</sup> *Mut. Serv. Cas. Ins. Co. v. Luetmer*, 474 N.W.2d 365, 368 (Minn. Ct. App. 1991).
- <sup>129</sup> *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 425 N.E.2d 810, 442 N.Y.S.2d 422 (N.Y. 1981).
- <sup>130</sup> *Lusk v. Imperial Cas. & Indem. Co.*, 603 N.E.2d 420, 423 (Ohio Ct. App. 1992).
- <sup>131</sup> *Nisson v. Amer. Home Assurance Co.*, 917 P.2d 488, 490 (Okla. Civ. App. 1996).
- <sup>132</sup> *Bedwell Co. v. D. Allen Bros.*, No. 1328, 2006 WL 6545326 (Pa. Com. Pl. Dec. 7, 2006).
- <sup>133</sup> See *Employers' Fire Ins. Co. v. Beals*, 240 A.2d 397, 404 (R.I. 1968), *abrogated on other grounds by Peerless Ins. Co. v. Viegas*, 667 A.2d 785 (R.I. 1995).
- <sup>134</sup> *Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Bev. Co. of S.C.*, 433 F.3d 365, 374 (4th Cir. 2005) (applying South Carolina law).
- <sup>135</sup> *N. Cnty. Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 689 (Tex. 2003).
- <sup>136</sup> See *United States Fid. Guar. Co. v. Louis A. Roser Co., Inc.*, 585 F.2d 932, 939 (1978) (applying Utah law).
- <sup>137</sup> See *HK Sys., Inc. v. Admiral Ins. Co.*, No. 03C0795, 2005 WL 1563340 (E.D. Wis. June 27, 2005) (applying Wisconsin law); *but see Nowacki v. Federated Realty Group, Inc.*, 36 F. Supp. 2d 1099 (E.D. Wis. 1999) (holding that a reservation of rights letter per se entitles the insured to control its defense and select its own counsel).
- <sup>138</sup> 53 N.Y.2d at 396.
- <sup>139</sup> *Id.*
- <sup>140</sup> *Id.*
- <sup>141</sup> *Id.* at 398.
- <sup>142</sup> *Id.*
- <sup>143</sup> *Id.*
- <sup>144</sup> *Id.* at 398-99.
- <sup>145</sup> *Id.* at 399.

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> *Id.* at 401.

<sup>150</sup> *Id.* at 401 n.

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> 474 N.W.2d 365.

<sup>155</sup> *Id.* at 366.

<sup>156</sup> *Id.* at 367.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.* at 368.

<sup>159</sup> *Id.* at 368-69.

<sup>160</sup> *Id.* at 369.

<sup>161</sup> *Id.*

<sup>162</sup> *Armstrong Cleaners*, 364 F. Supp. 2d at 817.

<sup>163</sup> *Lusk*, 603 N.E.2d at 423.

<sup>164</sup> *National Union*, 699 F. Supp. at 240.

<sup>165</sup> *Johnson v. Cont'l Cas. Co.*, 788 P.2d 598 (Wash. Ct. App. 1990); *L & S Roofing Supp. Co. v. St. Paul Fire & Marine Ins. Co., Inc.*, 521 So. 2d 1298 (Ala. 1987).

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Johnson*, 788 P.2d at 599. For another case discussing how Washington courts address conflicts of interests between insurers and insureds, see *Jaco Envtl., Inc. v. Amer. Int'l Specialty Lines Ins. Co.*, No. 2:09-cv-0145, 2009 WL 1591340 (W.D. Wash. May 19, 2009).

<sup>169</sup> *Johnson*, 788 P.2d at 599.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* at 600, quoting *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1135 (Wash. 1986). In coming to this rule, the court recognized that a defense under a reservation of rights does not necessarily mean that a conflict will arise and that “such a defense is frequently a ‘valuable service to the insured.’” *Johnson*, 788 P.2d at 600, quoting *Tank*, 715 P.2d at 1139.

<sup>174</sup> *Johnson*, 788 P.2d at 600.

<sup>175</sup> *Id.*

<sup>176</sup> *Id.* at 600-01. The Washington Court of Appeals, however, noted repercussions for the insurer and insurer-retained counsel if they fail to satisfy their obligations. After recognizing that the “insurer has no obligation before-the-fact to pay for its insured’s independently hired counsel,” the court stated that “[a]ny breach of the ‘enhanced obligation of fairness’ in a reservation of rights situation might lead to after-the-fact liability of the insurer, retained defense counsel, or both. *Id.* at 601.

<sup>177</sup> *Am. Empire Surplus Lines Ins. Co., v. Gold Coast Elevator, Inc.*, 701 So. 2d 904, 906 (Fla. Dist. Ct. App. 1997); Florida Stat. Ann. § 627/426.

<sup>178</sup> *Id.*

<sup>179</sup> Alaska Stat. § 21.96.100 (2012).

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> See *San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal. App. 3d 358 (1984).

<sup>184</sup> Cal. Civ. Code § 2860(b).

<sup>185</sup> *Id.*

<sup>186</sup> Cal. Civ. Code § 2860(c).

<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> Randy Paar, et al., *Duty to Defend: Getting What You Pay For*, RISK MANAGEMENT (Feb. 2003).

<sup>190</sup> Ill. R. Prof. C. 1.5.

<sup>191</sup> Douglas Richmond, *Independent Counsel in Insurance*, SAN DIEGO L. REV. 857, 879 (August/September 2011).

<sup>192</sup> See *CHI of Alaska, Inc.*, 844 P.2d at 1130 (Compton & Moore, J., dissenting).

<sup>193</sup> *Central Mich. Bd. Trustees v. Employers Reinsurance Corp.*, 117 F. Supp. 2d 627, 636 (E.D. Mich. 2000).

<sup>194</sup> As pointed out by the dissent in *CHI of Alaska, Inc.*, 844 P.2d at 1130, if defense counsel will follow the dollar and not the rules of professional conduct, why isn't there a similar concern of the ethics of insured-appointed counsel? Why aren't courts concerned with insured-retained counsel slanting the facts in favor of the insured? It is not clear as to the basis for selecting sides. As pointed out by the Seventh Circuit Court of Appeals in *Solo Cup Co. v. Fed. Ins. Co.*, 619 F.2d 1178, 1187 (7th Cir. 1980), “[p]lacing a limitation on the clear meaning of an insurance policy is, however, a restraint on the rights of parties to fashion their own contract [citations omitted] and is a step which courts have taken only where contracts were argued to extend coverage to knowledgeable and intentional, or the criminal wrongdoer.[citation omitted]”

As pointed out by both the concurring and dissenting justices in *CHI*, if the clear contract right of defending claims is to be taken from the insurer, then the basis ought to be explained in terms of established principles of contract, to support this clear abrogation of contract rights. *CHI of Alaska, Inc.*, 844 P.2d at 1124, 1130.

<sup>195</sup> *Central Michigan Board of Trustees v. Employers Reinsurance Corp.*, 117 F.Supp. 2d at 636.

<sup>196</sup> *But see e.g., United States Fid. & Guar. Co. v. Louis A. Roser Co.*, 585 F.2d 932, 938 n.5 (8th Cir. 1979), where the contrary view was expressed: “Even the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client the one who is paying his fee and from whom he hopes to receive future business[.]”

<sup>197</sup> 344 F. Supp. 2d 1358, 1373 (M.D. Fla. 2004). The unreported decision in *Safeco Ins. Co. Amer. v. Liss*, 2005 ML 932, 2005 Mont. Dist. LEXIS 1073 (5th Dist. Mont. Mar. 11, 2005), also contains an extensive survey of the differing states’ positions and listing of case citations.

<sup>198</sup> 748 F. Supp. 1223, 1229 (W.D. Mich. 1990).

<sup>199</sup> Richmond, 48 SAN DIEGO L. REV., 862-63.

<sup>200</sup> 17 Ill. App. 2d 44, 149 N.E.2d 482 (1st Dist. 1958).

<sup>201</sup> *Id.* at 47.

<sup>202</sup> 359 Ill. App. 3d 128, 833 N.E.2d 971 (1st Dist. 2005).

<sup>203</sup> *Williams*, 359 Ill. App. 3d at 137-38.

<sup>204</sup> *Stoneridge Dev. Co., Inc. v. Essex Ins. Co.*, 382 Ill. App. 3d 731, 743, 888 N.E.2d 633, 645 (2d Dist. 2008) (citations omitted).

<sup>205</sup> Supreme Court Rule 137 requires lawyers to refrain from filing frivolous pleadings, under pain of sanction and is somewhat similar to the better known Rule 11 in the Federal Rules of Civil Procedure. Illinois Rules of Professional Conduct Rule 3.3 requires the lawyer to be truthful to a tribunal. Rule 3.4 requires the lawyer to be fair to opposing parties and their counsel, including the prohibition against falsifying evidence.

<sup>206</sup> Ill. R. Prof. Cond. 1.7(2).

<sup>207</sup> The decision in *Brocato v. Prairie State Farmers Ins. Assoc.*, 166 Ill. App. 3d 986, 520 N.E.2d 1200 (4th Dist. 1988), suggests that the insurer’s involvement in the litigation is similarly limited, where the court held that the insurer was not responsible for the excess limits verdict under the facts, because the insurer was prohibited from practicing law. Citing to *Oda*, 44 Ill.App.2d at 253, the court in *Brocato* stated the insurer could not take actions beyond hiring counsel or it would otherwise be practicing law.

<sup>208</sup> Rule of Professional Conduct 1.8(f) further addresses the issue of another paying the fees. The lawyer is not to accept compensation from another unless “there is no interference with the lawyer’s independence or professional judgment or with the client-lawyer relationship[.]”

<sup>209</sup> Richmond, 48 SAN DIEGO L. REV., 870.

<sup>210</sup> *Id.* at 876.

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## About the IDC

The Illinois Association Defense Trial Counsel (IDC) is the premier association of attorneys in Illinois who devote a substantial portion their practice to the representation of business, corporate, insurance, professional and other individual defendants in civil litigation. For more information on the IDC, visit us on the web at [www.iadtc.org](http://www.iadtc.org).

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