The Insurer’s Duty to Defend: How to Avoid Waiver and Estoppel in Illinois©
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This article was prepared as a general discussion. It is not intended to be a comprehensive survey of all applicable statutes or case law. The opinions expressed herein are those of the authors and not those of the clients of Tressler LLP.
I. INTRODUCTION

As with any other contract, parties to an insurance contract owe a variety of duties to each other which are imposed by the express terms of the contract and some of which are implied by law. Generally, in a liability insurance contract, the two principal duties of the insurer are the duty to defend the insured against a suit and the duty to pay or indemnify the insured for a settlement or judgment of a covered claim. This article focuses upon the insurer’s duty to defend, what triggers it and how the principles of waiver and estoppel may be used against the insurer to expand an insurer’s duty to defend and indemnify under Illinois law.

II. TO WHOM DOES THE INSURER OWE A DUTY TO DEFEND

The duty to defend is owed only to persons who qualify as insureds under the policy. See, Illinois Ins. Guar. Fund v. Chicago Ins. Co., 2015 IL App (5th) 140033, ¶ 31, 25 N.E.3d 669, 676; Transcontinental Ins. Co. v. National Union Fire Ins. Co., 278 Ill. App. 3d 357, 368, 662 N.E.2d 500, 508 (1st Dist. 1996) (insurer only has a duty to defend a party that is an insured under the policy); MFA Mutual Ins. Co. v. Crowther, Inc., 120 Ill. App. 3d 387, 390, 458 N.E.2d 71, 73 (1st Dist. 1983); Polzin v. Phoenix of Hartford Ins. Co., 5 Ill. App. 3d 84, 87-89, 283 N.E.2d 324, 326-28 (1st Dist. 1972) (as a distinct legal entity, a corporation’s coverage did not extend to one of the corporation’s officers when the officer did not request to be included as an insured on the policy). A person or organization need not be specifically named as an insured to be afforded a defense under an insurance policy. Unnamed additional persons or organizations can fall within the omnibus definition of “insured” in the policy, or an individual or entity can be added as an insured to the policy by endorsement. See, e.g., Clemmons v. Travelers Ins. Co., 88 Ill. 2d 469, 476-78, 430 N.E.2d 1104, 1108 (1981); West Bend Mutual Ins. Co. v. Sundance Homes, Inc., 238 Ill. App. 3d 335, 336, 606 N.E.2d 326, 326 (1st Dist. 1983).

Although an insured may assume an obligation to indemnify another for legal costs as part of an indemnified loss, such an obligation does not, standing alone, create insured status for the insured’s indemnitee, even if the policy provides coverage for that indemnity claim against the insured. GTE No., Inc. v. Henkels & McCoy, Inc., 245 Ill. App. 3d 322, 612 N.E.2d 1375 (4th Dist. 1993) (contract to defend an indemnitee is an aspect of the indemnification, it is not even a duty to obtain insurance). Newer versions of the insurance industry’s general liability policy contain provisions that allow the insurer to provide a defense to an insured’s indemnitee supplemental to the policy’s limits in some circumstances but this provision does not convert an insured’s indemnitee into an insured. At best, these provisions allow the insured’s indemnitee to be defended jointly with the insured without impairing the policy limits as a “Supplementary Payment.” Without these provisions, sums paid to reimburse an insured’s indemnitee for defense costs are treated as damages and are usually applied to exhaust the policy’s limits.
III. TRIGGERING AN INSURER’S DUTY TO DEFEND THE INSURED

A. Claim v. Suit

Typically, the insuring agreement in a liability policy sets forth the insurer’s duty to defend and also contains a provision allowing the insurer control the defense of its insured. Most policies utilize language that the insurer has “the right and duty to defend any ‘suit’ seeking damages,” subject to other terms and conditions in the policy. While the term “suit” was not defined in early policy forms, most policies now define “suit” as a “civil proceeding” in which covered damages are sought, including an arbitration or alternate dispute resolution proceeding to which the insurer consents. A “suit” as defined does not include a claim which has yet to become the subject of a civil proceeding.


Although an insurer is generally not compelled to defend its insured absent a “suit,” see Keystone Consol. Indus., Inc. v. Employers Ins. Co. of Wausau, 456 F.3d 758, 762 (7th Cir. 2006); See also Cent. Ill. Light Co. v. Home Ins. Co., 213 Ill.2d 141, 290 Ill.Dec. 155, 821 N.E.2d 1092, 1096-18 (Ill.2004), an insurer may still consider retaining counsel to defend its insured against a demand or claim. Early legal representation may effectuate a settlement without the necessity or expense of litigation, or it can aid in the proper posturing of a case for defense once suit is filed.

B. Requirement of Actual Notice

The Illinois Supreme Court has held that an insured need not actually tender a “suit” to the insurer and request a defense in order to trigger an insurer’s defense obligation. West American Ins. Co. v. Yorkville National Bank, 238 Ill. 2d 177, 189, 939 N.E.2d 288, 296 (2010); Cincinnati Cos. v. W. Am. Ins. Co., 183 Ill. 2d 317, 327-28, 701 N.E.2d 499, 504 (1998); see also, Dearborn Ins. Co. v. Int’l Surplus Lines Ins. Co., 308 Ill. App. 3d 368, 373-74, 719 N.E.2d 1092, 1096-97 (1st Dist. 1999); see also Direct Auto Ins. Co. v. Zaidan, 2016 IL App (1st) 160538-U, ¶ 31. Where the insurer has “actual notice” of the “suit,” regardless of the sophistication of the insured, it cannot be a bystander. Id. An insurer must evaluate whether it has a duty to defend any suit against its insured of which it has knowledge sufficient to locate and defend the case. In other words, the insurer must know that a cause of action has been filed against its insured.
under a policy it issued and have knowledge of the location of the suit itself. Once it has this information, the insurer must determine whether the complaint falls potentially within the scope of the coverage of one of its policies. If the complaint potentially falls within the terms of coverage, it must defend absent a contrary instruction from its insured.

“Actual notice” of the suit against the insured requiring the insurer to evaluate its defense obligation can come from collateral sources, such as other insurers, co-insureds, claimants or co-defendants. See, e.g., LaGrange Memorial Hospital v. St. Paul Ins. Co., 317 Ill. App. 3d 863, 871, 740 N.E.2d 21, 28 (1st Dist. 2000) (insurer received notice from a third party that its own insured was demanding coverage for a claim); Illinois Founders Ins. Co. v. Barnett, 304 Ill. App. 3d 602, 607-08, 710 N.E.2d 28, 32-33 (1st Dist. 1999) (insurer had notice of suit where insurer’s broker and investigator knew of the suit).

An insurer does not have to provide a defense where the insured has knowingly forgone the insurer’s assistance by instructing the insurer not to involve itself in the litigation. Cincinnati Cos., 183 Ill. 2d at 326, 701 N.E.2d at 503-04. This occurs with some frequency in Illinois as it has adopted the selective or targeted tender doctrine. Specifically, when a loss is covered under more than one insurance company’s policy, the insured has the right, absent a specific prohibition in the policy, to pick one insurer to the exclusion of all others to defend and indemnify it. Kajima Constr. Servs. v. St. Paul Fire & Marine Ins. Co., 227 Ill. 2d 102, 107, 879 N.E.2d 305, 309 (Ill. 2007). Typically an insured notifies its insurer of the “suit” but advises that it does not want its involvement or deactivates a prior tender. When this occurs, the insurer has no duty or obligation to defend. Rather, only the targeted insurer owes a defense and coverage to the insured. Legion Ins. Co. v. Empire Fire & Marine Ins. Co., 354 Ill. App. 3d 699, 703, 822 N.E.2d 1, 4-5 (1st Dist. 2004). Illinois courts recognize that there are many reasons why an insured may forgo coverage under a particular insurance company’s policy, including an “insured’s fear that premiums would be increased, or the policy [is] cancelled, in the future.” Cincinnati Cos., 183 Ill. 2d at 326, 701 N.E.2d at 503.

A targeted insurer generally cannot pursue non-selected insurers or rely on its “other insurance” clause to share in or avoid its obligation. John Burns Constr. Co. v. Indiana Ins. Co., 189 Ill. 2d 570, 578, 727 N.E.2d 211, 217 (Ill. 2000). Importantly, targeted tender cannot defeat horizontal exhaustion, which requires that the insured exhaust all primary insurance before seeking coverage from an excess or umbrella insurer. Kajima, 227 Ill. 2d at 117, 879 N.E.2d at 315 (general contractor can target subcontractor’s primary policy as an additional insured but general contractor’s primary policy applies before the subcontractor’s excess policy is implicated). However, in Illinois School District Agency v. St. Charles Community Unit School Dist. 303, 2012 IL App (1st) 100088, the appellate court held that the targeted tender doctrine should be limited to concurrent coverage and not be applied to situations involving consecutive primary insurers.

An insured is even allowed to deselect a tender to one insurer to target another insurer both before and after settlement or judgment. Statewide Ins. Co. v. Houston Gen. Ins. Co., 397
However, in AMCO Insurance Co. v. Cincinnati Insurance Co., 2014 IL App (1st) 122856, the appellate court held that a targeted insurer was not allowed to 1) settle a case, 2) take an assignment of rights from its insured as part of that settlement, 3) deselect itself and 4) try to make a post-settlement targeted tender to another insurer.

Upon receipt of a notice of a suit against an insured from a collateral source, the insurer should contact the insured to ascertain whether a defense is desired. See, Federated Mutual Ins. Co. v. State Farm Mut. Auto. Ins. Co., 282 Ill. App. 3d 716, 668 N.E.2d 627 (2d. Dist. 1996). Unless the insured instructs the insurer not to respond, the insurer must investigate coverage and assuming coverage potentially exists, defend the insured. If the carrier fails to contact the insured and clarify the insured’s intent, it may be found to be in breach of its defense obligation which, as discussed below, can have significant repercussions on its duty to pay a settlement or judgment against the insured.

C. The Effect Of The Allegations Of The Complaint

The duty of the insurance company to defend a suit against its insured is determined, in the first instance, from a comparison of the allegations of the complaint with the terms of the policy. See, Maryland Casualty Co. v. Peppers, 64 Ill. 2d 187, 193-94, 355 N.E.2d 24, 28 (1976); Am. Serv. Ins. Co. v. China Ocean Shipping Co., 402 Ill. App. 3d 513, 521, 932 N.E.2d 8, 16 (1st Dist. 2010). Generally speaking, if the complaint alleges facts, as opposed to legal theories, potentially within the coverage of the policy, the insurer’s duty to defend is established. This duty to defend extends to an entire case even when the complaint alleges several causes of action or theories of recovery against the insured, only one of which is potentially within the coverage of the policy. See, Valley Forge Ins. Co. v. Swiderski Elecs., Inc., 223 Ill. 2d 352, 363, 860 N.E.2d 307, 314-15 (2006); United States Fidelity & Guar. Co. v. Wilkin Insulation Co., 144 Ill. 2d 64, 73, 578 N.E.2d 926, 930 (1991); Country Mut. Ins. Co. v. Dahms, 2015 IL App (1st) 141392-U, ¶ 30. In general, an insurer may justifiably refuse to defend its insured only where it is apparent from a comparison of the allegations of the complaint and the terms of the policy that the complaint fails to state any claim that may potentially give rise to a duty to pay or indemnify under the policy. See Outboard Marine Corp. v. Liberty Mut. Ins. Co., 154 Ill. 2d 90, 108, 607 N.E.2d 1204, 1212 (1992); Am. Zurich Ins. Co. v. Wilcox & Christopoulos, L.L.C., 2013 IL App (1st) 120402, at ¶28, 984 N.E.2d 86, 95.

If, after comparing the allegations of the complaint to the scope of coverage provided, the insurance company would not be required to indemnify the insured in the event that the claimant or plaintiff prevailed, the insurer need not defend the lawsuit. Wilkin, 144 Ill. 2d at 81, 578 N.E.2d at 934; L.J. Dodd Construction, Inc. v. Federated Mutual Insurance Co., 365 Ill. App. 3d 260, 262, 848 N.E.2d 656, 302 Ill. Dec. 357 (2006); Ill. Emasco Ins. Co. v. Northwestern Nat’l Cas. Co., 337 Ill. App. 3d 356, 359-60, 785 N.E.2d 905, 908 (1st Dist. 2003). If the complaint is silent or does not state facts with sufficient definiteness so as to clearly determine coverage, the insurer should generally defend the action under a reservation of rights and/or file a
declaratory judgment action. Under certain circumstances, an insurer may rely upon and cite to extrinsic evidence in the course of the coverage action to defeat the duty to defend.

D. The Effect Of Extrinsic Facts

An insurer is obligated to conduct the insured’s defense in Illinois if the insurer has knowledge of true but unpleaded facts which, when taken together with the complaint’s allegations, indicate that the claim is within or potentially within the policy’s coverage. See, e.g., Am. Econ. Ins. Co. v. Holabird & Root, 382 Ill. App. 3d 1017, 1025, 886 N.E.2d 1166, 1173 (1st Dist. 2008) (citing Associated Indemnity Company v. Insurance Company of North America, 68 Ill. App. 3d 807, 816-17, 386 N.E.2d 529, 536 (1st Dist. 1979)). Knowledge by an insurer of certain unpleaded or extraneous assertions, including facts supplied by the insured alone which the insurer has no way of knowing are true or correct, and which if true would trigger coverage, are generally insufficient to create a defense obligation. See, Pekin Ins. Co. v. Precision Dose, Inc., 2012 IL App (2d) 110195, at ¶44, 968 N.E.2d 664, 676-77 (2d Dist. 2012); Shriver Ins. Agency v. Utica Mut. Ins. Co., 323 Ill. App. 3d 243, 251, 750 N.E.2d 1253, 1259 (2nd Dist. 2001); Associated Indemnity Co. v. Ins. Co. of North America, 68 Ill. App. 3d 807, 816, 386 N.E.2d 529, 536 (1st Dist. 1979); and Farmers Automobile Ins. Assn. v. Neumann, 2015 IL App (3d) 140026 (3rd Dist. 2015) (insurer need not consider insured’s self-serving affidavit that he had not acted with intent to injure in assaulting the claimant).

Illinois courts have generally not allowed the putative insured’s own pleading or denial of the underlying complaint’s allegations to create a duty to defend. See, e.g., State Farm Fire & Cas. Co. v. Young, 2012 IL App (1st) 103736 ¶¶17, 19, 968 N.E.2d 759, 764-65 (1st Dist. 2012) (insured’s denials in his answer in the underlying suit irrelevant); National Fire Insurance of Hartford v. Walsh Construction Co., 392 Ill. App. 3d 312, 321-22, 909 N.E.2d 285, 292-93 (1st Dist. 2009) (court cannot consider putative insured’s own third-party complaint in deciding whether there is a duty to defend). Courts, however, have looked to an insured’s pleading where the policy contains a self-defense exception to the intentional act exclusion. See, Wilson, 237 Ill. 2d at 465-66, 930 N.E.2d at 1020-22 (proper to consider insured’s counterclaim to see if the self-defense exception applies noting that it would be unlikely that the underlying plaintiff would not plead facts showing the insured acted in self-defense); Farmers Auto. Ins. Ass’n v. Danner, 2012 IL App (4th) 110461 ¶¶51, 967 N.E.2d 836, 847 (4th Dist. 2012) (court should not consider insured’s affirmative defense of self-defense when the policy’s intentional act exclusion does not contain a self-defense exception).

In Illinois, an insurer need not conduct an extensive independent investigation to determine if coverage could potentially be triggered by true and unpleaded facts extrinsic to the complaint. Konstant Prods. v. Liberty Mut. Fire Ins. Co., 401 Ill. App. 3d 83, 87-88, 929 N.E.2d at 1204 (1st Dist. 2010); Associated Indemnity Co., 68 Ill. App. 3d at 817, 386 N.E.2d at 537. Rather, Illinois only requires that the insurer not ignore true unpleaded facts within its knowledge, supplied by the insured or others, which might bring the suit within the scope of coverage.
Extrinsic facts may be used to defeat a duty to defend when they do not contradict the allegations of the suit. An insurer need not defend an insured when undisputed extrinsic facts demonstrate the suit is not covered. See, e.g., Pekin Ins. Co v. Wilson, 237 Ill. 2d 446, 461-62, 930 N.E.2d 1011, 1020-21 (Ill. 2010); Am. Econ. Ins. Co. v. Holabird & Root, 382 Ill. App. 3d 1017, 1031-32, 886 N.E.2d 1166, 1178-79 (1st Dist. 2008). The extrinsic facts relied upon must not tend to determine an ultimate issue in the underlying proceedings against the insured. See, Pekin Ins. Co., 237 Ill. 2d at, 461-62, 930 N.E.2d at 1020-21; Enadeghe v. Dahms, 2014 IL App (1st) 142193-U, ¶ 16; and Landmark Am. Ins. Co. v. NIP Grp., Inc., 2011 IL App (1st) 101155, at ¶59, 962 N.E.2d 562, 579 (1st Dist. 2011). If the extrinsic facts are such that they tend to determine a liability issue in the underlying case, the insurer will not be permitted to deny a defense based on those facts. Id. In general, if an insurer is going to rely upon extrinsic facts to defeat the duty to defend, the insurer should determine whether it is required to file a declaratory judgment action to avoid estoppels on that particular issue.

Extrinsic facts generally cannot be used to contradict the allegations of a suit against the insured because the duty to defend, for the most part, flows from the allegations of the complaint. See, Ill. Tool Works Inc. v. Travelers Cas. & Sur. Co., 2015 IL App (1st) 132350, ¶¶ 20-21, 389 Ill. Dec. 331, 337, 26 N.E.3d 421, 427; Konstant Prods., 401 Ill. App. 3d at 84, 929 N.E.2d at 1202; Chandler v. Doherty, 299 Ill. App. 3d 797, 801, 702 N.E.2d 634, 638 (4th Dist. 1998); and Jandrisits v. Village of River Grove, 283 Ill. App. 3d 152, 158, 669 N.E.2d 1166, 1170-71 (1st Dist. 1996). In other words, extrinsic facts typically cannot be relied upon to expand or defeat the insurer’s duty to defend when those facts merely contradict the allegations in the complaint.

Allegations of negligence generally cannot be used to trigger insurance coverage after an insured has been found guilty of a criminal act. An insured or claimant is collaterally estopped from re-litigating the issue of intent in a declaratory judgment action after a criminal conviction despite allegations of negligence in the underlying complaint. See, American Family Mutual Ins. Co. v. Savickas, 193 Ill. 2d 378, 391-93, 739 N.E.2d 445, 453-54 (Ill. 2000); Allstate Indemn. Co. v. Heiber, 2014 IL App (1st) 132557 ¶20-22, 24 N.E.3d 139, 144-45 (1st Dist. 2014); Am. Country Ins. Co. v. Williams, 339 Ill. App. 3d 835, 844, 791 N.E.2d 1268, 1275 (1st Dist. 2003). If the issue in the criminal case is identical with the one presented in the civil suit, a final judgment on the merits is rendered in the criminal case and the party against whom estoppel is asserted was a party or in privity with a party to the prior adjudication, estoppel will be applied unless it is unfair to do so, taking into consideration the party’s incentive to litigate the issue in the criminal action. Id. In other words, if an insured is convicted of an intentional act, the insured or claimant generally cannot argue he was negligent in order to trigger insurance coverage.

If an insured pleads guilty, whether the guilty plea has preclusive effect in the coverage litigation depends on the circumstances, including what offense the insured pleaded guilty to and the detail of admissions or facts in the plea. Compare, Allstate Insurance Co. v. Kovar, 363 Ill. App. 3d 493, 502-04, 842 N.E.2d 1268, 1276-77 (2d Dist. 2006)(finding that guilty plea to battery was insufficient to have preclusive effect in coverage action where the plea did not set
forth any of the underlying facts to show that the issue in the criminal case was the same issue in the civil case and insured did not have a strong incentive to litigate the issue because the insured pleaded guilty for a light sentence); *Metro. Prop. & Cas. Ins. Co. v. Pittington*, 362 Ill. App. 3d 220, 227, 841 N.E.2d 413, 418 (3d Dist. 2005) (insured’s guilty plea to reckless conduct during his trial for attempted murder did not have any preclusive effect in insurance coverage case regarding the application of the criminal act exclusion because it was not a plea to an intentional act); *Illinois State Medical Ins. Servs. v. Cichon*, 258 Ill. App. 3d 803, 809, 813, 629 N.E.2d 822, 827, 829 (3rd Dist. 1994) (criminal and sexual conduct exclusions precluded coverage for negligence actions because of insured’s guilty pleas in criminal cases). In any event, if an insurer is relying on a criminal conviction or plea to deny coverage despite allegations of negligence, it may be required to file a declaratory judgment action to avoid the punitive effects of Illinois’ estoppel doctrine. See *infra* p. 18-19.

IV. RESPONDING TO A TENDER OF DEFENSE

Once the defense of a suit has been effectively tendered to an insurer, the insurer has five options in responding to the tender: (1) accept the insured’s defense without interposing a reservation of rights; (2) accept the defense pursuant to a reservation of rights; (3) refuse to defend the insured and file a declaratory judgment action; (4) accept the tender under a reservation of rights and file a declaratory judgment action; or (5) deny defense and indemnity obligations for the suit outright. The option chosen significantly impacts the relationship between the insured and the insurer moving forward and also can affect the ability of the insurer to rely upon certain policy defenses. The ramifications of each option are discussed below.

A. ACCEPTING THE INSURED’S TENDER

The first option is to accept the insured’s defense without a reservation of rights. When the insurer assumes the defense of the insured without a reservation of rights, it is generally deemed to have waived any policy defenses *which it knew or should have known* existed at the time the defense was accepted. Where an insurer has no knowledge of or reason to know of the defense, it is not waived even if the policy defense was not reserved when the carrier began defending the insured. *American States Ins. Co. v. National Cycle*, 260 Ill. App. 3d 299, 307, 631 N.E.2d 1292, 1298 (Ill. App. Ct. 1st Dist. 1994) (“[A] party cannot assert a policy defense until it is aware of that defense, and as stated above, a party will not be found to have waived rights of which it was ignorant.”); Lumbermen’s Mut. Cas. Co. v. Sykes, 384 Ill. App. 3d 207, 223, 322 Ill. Dec. 167, 181, 890 N.E.2d 1086, 1100 (2008). However, an insurer must inform the insured of a coverage defense within a reasonable period of time after it has discovered or becomes aware of the defense, if it is defending. *Apex Mut. Ins. Co. v. Christner*, 99 Ill. App. 2d 153, 168, 240 N.E.2d 742, 750 (Ill. App. Ct. 1st Dist. 1968). Failure to do so will again result in a waiver. *Id.* at 168, 240 N.E.2d at 750. Accepting the defense without reserving known defenses is considered an act inconsistent with denying coverage (i.e., an implied waiver). *Id.* at 160, 240 N.E.2d at 747. When the insurer accepts the insured’s defense without reservation, it typically selects
counsel to represent the insured and controls all aspects of the insured’s defense, including settlement of the case.

1. Waiver and Estoppel In Pais

Many courts and commentators have confused the concepts of waiver and estoppel. Waiver is the voluntary relinquishment of a known right. (See, 16(b) Appelman, Insurance Law and Practice Section 9081 (1981); Anderson v. Holy See, 878 F. Supp. 2d 923, 933 (N.D. Ill. 2012); State Farm Mut. Auto Ins. Co. v. Easterling, 2014 IL App. (1st) 133225, at ¶23 (1st Dist. 2014) (“Waiver arises from an affirmative act, is consensual and consists of an intentional relinquishment of a known right.”).

Intentional or knowing waiver arises when an insurer simply does not demand strict compliance with the terms of the policy. Intentional or knowing waiver can occur when the insurer believes the breach by the insured is not significant enough to affect the handling of the claim, or the expense in denying coverage may prove more substantial than the cost of fully defending or settling the claim. In either event, an affirmative economic decision is made by the insurer whereby it simply relinquishes its right to demand strict conformance with the policy’s terms.

In some circumstances, courts have held that waiver need not be intentional or “knowing” but can be implied as a result of the mere passage of time. Under those circumstances, the doctrine of waiver imperceptibly merges into the doctrine of estoppel in pais. In a general sense, estoppel in pais arises as a result of the insured’s prejudicial or detrimental reliance on the insurer’s words or conduct. See, Farms & Merchants Bank v. Davis, 151 Ill. App. 3d 929, 937, 503 N.E.2d 565, 570-71 (2d Dist. 1987); Vaughn v. Speaker, 126 Ill. 2d 150, 164, 533 N.E.2d 885, 891 (1988). Therefore, estoppel in pais may arise where the insurer has assumed control of the insured’s defense without a reservation of rights. Courts reason that insurer has prejudiced the insured’s right to control its own defense by accepting the insured’s defense without reserving its rights. Am. Country Ins. Co. v. Williams, No. 1-01-3642, 2003 Ill. App. LEXIS 79, at *24-25 (1st Dist. Jan. 24, 2003); Preferred Am. Ins. v. Dulceak, 302 Ill. App. 3d 990, 995, 706 N.E.2d 529, 533 (2d Dist. 1999); Apex Mut. Ins. Co., 99 Ill. App. 2d 153, 160, 240 N.E.2d 742, 747 (1st Dist. 1968).

There are three elements necessary for estoppel in pais: (1) some knowledge on the part of the insurer of a particular policy defense either before or during the time that the defense of the insured is assumed; (2) an unreasonable delay in notifying the insured of the insurer’s position with regard to the policy defense; and (3) prejudice to the insured. Preferred Am. Ins. v. Dulceak, 302 Ill. App. 3d 990, 995, 706 N.E.2d 529, 533 (2d Dist. 1999); Cowan v. Insurance Co. of North America, 22 Ill. App. 3d 883, 888-91, 318 N.E.2d 315, 320-22 (1st Dist. 1974).

With respect to the knowledge requirement, some courts have held that actual knowledge by the insurer of a policy defense is not required before estoppel is applied. Rather, if the insurer, in the exercise of ordinary diligence, should have known of a policy defense and
failed to raise it, estoppel applies. See, Ford Motor Company v. Commissary, Inc., 286 F. Supp. 229, 233 (N.D. Ill. 1968). As discussed above, an insurer is not estopped from raising a policy defense, of which it did not have notice or was not available in the exercise of ordinary diligence. American States Ins. Co. v. National Cycle, 260 Ill. App. 3d 299, 307, 631 N.W.2d 1291, 1298 (1st Dist. 1994).

Once it has been determined that the insurer had knowledge of a potential policy defense, a court must then look to whether the insured was provided with timely notification of the defense. What constitutes timely notification depends on the facts of the case. Illinois courts have held that delays of anywhere from 35 days to 17 months sufficient to invoke estoppel in piai. See, Gibraltar Insurance Co. v. Varkalis, 46 Ill. 2d 481, 487-88, 263 N.E.2d 823, 827 (Ill. 1970); Equity General Ins. Co. v. Patis, 119 Ill. App. 3d 232, 237-38, 240 N.E.2d 348, 352 (1st Dist. 1983); Apex Mutual Ins. Co. v. Christener, 99 Ill. App. 2d 153, 240 N.E.2d 742 (1st Dist. 1968); Hawkeye-Security Ins. Co. v. Meyers, 210 F. 2d 890, 892 (7th Cir. 1954). Accordingly, a relatively short delay in notifying an insured of a particular policy defense may be sufficient to invoke estoppel principles. The question will turn on the reasonableness of the delay in light of the circumstances. How long was the delay? How close is the case to trial? These are factors which can impact this issue.

With respect to the third and final element of estoppel in piai, Illinois courts have held that prejudice to the insured must be shown before estoppel in piai will be applied. Some courts have held that the loss of the right to control its own defense is sufficient to establish prejudice. According to these courts, an insured’s right to control its own defense is a paramount right and that the lack of control of the defense over a period of time constitutes prejudice to the insured sufficient to support estoppel. Ford Motor Co. v. Commissary, Inc., 286 F. Supp. 229, 235-36 (N.D. Ill. 1968); Royal Globe Ins. Co. v. Tutt, 108 Ill. App. 3d 69, 71, 438 N.E.2d 943, 945 (4th Dist. 1982). On the other hand, some courts find that prejudice to the insured is not presumed by the mere entry of an appearance and assumption of the defense alone. See Western Casualty and Surety Company v. Brochu, 105 Ill.2d 486, 499-500, 475 N.E.2d 872, 879 (1985); Enter Leasing Co. v. Jenkins, 2014 IL App (1st) 130583-U, ¶ 17. Thus, prejudice is often a factual issue and is dependent upon the degree of hardship sustained.

**B. ACCEPTING THE DEFENSE PURSUANT TO A RESERVATION OF RIGHTS**

The second option available to the carrier is to accept the insured’s defense pursuant to a reservation of rights. Simply put, by sending a reservation of rights letter to its insured, an insurer may undertake the insured’s defense for a potentially covered claim, while at the same time preserving the policy defenses articulated in the reservation letter to deny an obligation to pay or indemnify the insured for the suit. The applicability and/or propriety of those coverage defenses can be litigated, if necessary, in a later filed declaratory judgment action. The insurer must, however, evaluate the policy defenses it is relying upon in its reservation of rights letter to determine whether its reservation of rights creates a conflict between its interests and those of the insured. If a conflict exists, the insurer must advise the insured of same and give the
insured the right to select independent counsel at the insurer’s expense. See, infra Section V.F., p. 23-25.


Defending under a reservation of rights can create a potential conflict in instances where the insurer’s and insured’s interests are not completely aligned on an issue in the case. In Illinois, both the insurer and its appointed defense counsel must disclose the potential conflict. If there is a conflict, unless it is disclosed and the insured knowingly consents, the insurer is not able to control the insured’s defense. See, infra at p. 23-25. A proper reservation of rights letter lets the insured intelligently decide whether it should hire its own counsel or accept the insurer’s appointed counsel.

An insurer, who fails to properly reserve a defense or properly identify a conflict, may be found to be estopped. State Farm Fire & Cas. Co. v. Martinez, 384 Ill. App. 3d 494, 498, 893 N.E.2d 975, 979 (1st Dist. 2008); Royal Insurance Co. v. Process Design Associates, Inc., 221 Ill. App. 3d 966, 973-74, 582 N.E.2d 1234, 1239 (1st Dist. 1991). Therefore, it is important to investigate coverage thoroughly and include all known grounds supporting the insurer’s coverage position. By doing so the insurer removes any potential for waiver or estoppel in pais.

1. Elements of a Reservation of Rights Letter

A typical reservation of rights letter contains five parts. First, the introduction of the reservation of rights letter should contain an acknowledgement of receipt of the tender or notice of the suit and set forth the location where the suit is pending. Although Illinois does not have a statutory mandate regarding the timing of an insurer’s acknowledgement for liability claims, courts require a “reasonably” prompt acknowledgment of the suit. Failure to do so can result in extra-contractual or bad faith liability. 215 ILCS 5/155 (LexisNexis, Lexis Advance through P.A. 99-904 of the 2016 Regular Legislative Session). The introduction should also indicate that the insurer has conducted a comparison of the complaint allegations and the terms of the policy. If the reservation of rights is based upon facts outside the scope of the pleading, the insured should be informed that the insurer has investigated the matters contained in the complaint. The introduction should then recite a clear but broad reservation of rights which indicates the coverages issued to the insured by policy name, number, effective date and limits. As set forth more fully below, the insurer is required to refer the insured to each policy provision relied upon by the insurer in reserving rights.
The preliminary statement containing the broad reservation of rights must also contain an unequivocal statement of intent to defend pursuant to a reservation of rights and the right to deny a duty to pay or indemnify for claims or damages that are not covered. Vague references to the existence of coverage issues or defenses are insufficient. Std. Mut. Ins. Co. v. Lay, 2013 IL 114617, ¶ 20 (“Bare notice of a reservation of rights is insufficient. The reservation of rights must specifically refer to the policy defense that may be asserted and to the potential conflict of interest”); See, Popvich v. Gonzales, 4 Ill. App. 3d 227, 229-230, 280 N.E.2d 757, 760 (1st Dist. 1972) (holding that a letter which only warns the insured of the possible consequences of his failure to cooperate with the attorneys in the defense of the suit did not constitute an express disclaimer of liability or an unequivocal reservation of rights).

A typical introductory paragraph in a reservation of rights letter might read as follows:

We acknowledge receipt of your request for a defense and indemnity in the above-referenced case which we received on January 1, 2015. You are hereby notified that ABC Insurance Company agrees to provide you a defense pursuant to a full reservation of rights described in detail below. In investigating the matters alleged in the aforesaid complaint or in defending the lawsuit filed against you, or in any other way acting or failing to act, ABC Insurance Company does not waive any of its rights or admit any obligations under the policy of liability insurance, bearing Policy No. 012345678, effective January 1, 2014 to January 1, 2015, with limits of $500,000 per occurrence and in the aggregate, nor shall ABC Insurance Company be estopped from raising any applicable coverage defenses to any judgment which might be rendered in the case.

The second part of a typical reservation of rights letter should state the facts known to the insurer, either through a brief discussion of the important allegations contained in the pleading itself, or outside of the pleading, which give rise to the possibility of non-coverage. For example, if the insurer believes it has a “late notice” defense, the reservation of rights letter should contain facts describing the length of time between knowledge by the insured of an “occurrence” or a potential claim or suit against it and the date upon which notice was received by the insurer. This section of the letter is particularly important because it provides support for the insurer’s coverage position and may become a pivotal document in any future coverage litigation between the insurer and the insured.

Third, a typical reservation of rights letter should contain quotations of the particular policy provisions relied upon to potentially deny or limit coverage. As detailed above, because one of the purposes of a reservation of rights letter is to enable the insured to make an informed decision, an insurer must set forth every reason of which it is aware, or should then be aware, why the insured might not ultimately be entitled to coverage. This is also important because an insurer may be estopped from asserting a policy defense if the defense was not
properly reserved. Although Illinois, like the majority of jurisdictions, requires some element of detrimental reliance by the insured, as a general rule of thumb, when drafting a denial or reservation of rights letter, it is best to include all known grounds supporting the insurer’s coverage position. By doing so the insurer should remove any potential for waiver or estoppel.

It should be noted that there are instances where an insurer may knowingly waive a policy defense. That can arise in circumstances where a reservation of rights might create a conflict of interest. For example, where a complaint contains allegations of negligence and intentional conduct, an insurer may intentionally elect not to reserve the “occurrence” or “expected or intended” exclusion. It might do so where it believes that its right to control the defense with its own selected counsel outweighs the benefit of asserting the right to rely on those policy defenses.

In addition to identifying the specific policy provisions and/or exclusions supporting the insurer’s coverage position, the reservation of rights letter should contain a broad statement informing the insured that the insurer reserves all rights under the policy including the right to raise additional coverage defenses that may exist or become evident as the facts develop. For instance, it is advisable to include a statement such as the following: “The enumeration of specific rights and coverage defenses herein should not be interpreted as a waiver of any other rights which the company may have or which become available,” or “the listing of various rights and coverage defenses in this letter does not constitute a waiver of any other rights and defenses.”

Fourth, a reservation of rights letter should contain a clear statement by the company that it will provide the insured with a defense subject to a reservation of rights. Where the reservation of rights does not create a conflict of interest, the letter identifies who has been retained as defense counsel for the insured. If the letter creates a conflict, the insurer must identify and explain any conflict of interest and advise the insured of their right to independent counsel, whose reasonable defense costs the insurer will pay.

Finally, the letter should invite the insured to submit any information it has that might have any bearing on the coverage issues. For first party property claims in Illinois, it is also necessary to advise the insured of its right to contact the Department of Insurance if it disagrees with the insurer’s position. See Ill. Admin. Code tit. 50, § 919.50(a)(1) (Lexis Advance through August 12, 2016). This requirement is not mandated for liability claims in Illinois.

The foregoing underscores the importance of preparing as comprehensive a reservation of rights letter as possible. Failure to reserve all potential coverage defenses may give rise to either waiver or estoppel in pais. Accordingly, a thorough analysis of all of the available facts and all policy provisions should be performed early in the case.
2. Reserving An Insurer’s Right To Obtain Reimbursement Of Defense Costs and/or Settlement Amounts

Under Illinois law, an insurer that defends its insured under a reservation of rights cannot later recoup defense costs paid even if a court later determines that it owed no duty to defend in the first instance – unless a provision allowing for the recovery of defense costs is contained in the insurance policy. See, General Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co., 215 Ill. 2d 146, 166, 828 N.E.2d 1092, 1104 (2005) (“As a matter of public policy, a reviewing court cannot condone an arrangement where an insurer can unilaterally modify its contract, through a reservation of rights, to allow for reimbursement of defense costs in the event a court later finds that the insurer owes no duty to defend.”). In response to this ruling insurers have begun to issue policies in Illinois to include provisions that expressly allow for the recovery of defense costs. If, however, an insurer files a declaratory judgment action and was ordered to pay defense costs during the pendency of an appeal because of an erroneous trial court ruling, the insured must make restitution and reimburse those fees after an appellate court’s reversal in favor of the insurer. See, Steadfast Insurance Company v. Caremark Rx, Inc., 373 Ill. App. 3d 895, 900, 869 N.E.2d 910, 914 (1st Dist. 2007).

While other jurisdictions may allow reimbursement of settlement amounts paid, whether an insurer can seek reimbursement of uncovered indemnity costs it paid from the insured is less clear. The Midwest Sporting Goods ruling, which disallowed reimbursement of defense costs paid under a reservation of rights, suggests that an insurer may be prohibited from unilaterally seeking reimbursement of settlement amounts paid on behalf of the insured absent a specific policy provision allowing for such recovery, even if a court subsequently determines that the claim was not covered. In other words, the Midwest Sporting Goods court’s holding may be extended beyond defense costs to settlement amounts paid by an insurer. Therefore, it is best to enter into a bilateral non-waiver agreement, supported by consideration, where the insured consents to the settlement and acknowledges and agrees that the insurer has a right to seek reimbursement.

3. Reserving An Insurer’s Right To Withdraw From the Insured’s Defense And/Or File A Declaratory Judgment Action

Where the insurer intends to file a declaratory judgment action immediately and believes that it will receive a favorable ruling during the pendency of the underlying action, it is advisable to specifically notify the insured that the insurer intends to seek a judicial determination and that it will withdraw from the defense upon notice to the insured. This makes the ramifications of the coverage defenses clear to the insured and gives the insured an opportunity to have counsel of their choice at their own expense involved, facilitating a subsequent withdrawal. Some courts have held that a reservation of rights letter must expressly reserve the right to withdraw from the defense so that the insured can fully understand the meaning and import of the reservation. See, Royal Ins. Co. v. Process Design Assocs., 221 Ill. App. 3d 966, 973-75, 582 N.E.2d 1234, 1238-40 (1st Dist. 1991). Thus, it is best
to indicate intent to withdraw or file a declaratory action, if that is what the insurer intends to do.

C. DENYING COVERAGE AND PURSUING A DECLARATORY JUDGMENT ACTION

The third option for an insurer in responding to a tender of defense is to deny coverage and promptly pursue a declaratory judgment action seeking a judicial ruling as to its rights and obligations under the policy. Promptly litigating a declaratory judgment action after denying coverage is the favored, safest option in Illinois and is generally sufficient to avoid application of Illinois’ onerous equitable estoppel penalty.

1. Timing of the Declaratory Judgment Action

Illinois courts do not contemplate a race to the courthouse to file a declaratory judgment action. An insured cannot invoke equitable estoppel merely by filing a declaratory judgment action before the insurer. See, Korte Construction Company v. American States Ins. Co., 322 Ill. App. 3d 451, 458, 750 N.E.2d 764, 769-70 (5th Dist. 2001); Sears, Roebuck and Company v. Seneca Ins. Co., 254 Ill. App. 3d 686, 693-94, 627 N.E.2d 173, 178 (1st Dist. 1993). All that is required is that the insurer not sit on the sidelines. It must actively seek to adjudicate the issue of coverage through discovery, dispositive motion or trial. An insurer cannot avoid estoppel, however, by actively litigating coverage if the insurer did not act to do so within a reasonable time of an insured’s demand for coverage. See, Uhlich Children’s Advantage Network v. Nat’l Union Fire. Co., PA, 398 Ill. App. 3d 710, 721, 929 N.E.2d 531, 541-42 (1st Dist. 2010) (even if insurer actively participated in the declaratory judgment action once it was filed, forcing an insured to file declaratory judgment action two years after the denial was unreasonable and estoppel applied); Korte Construction Company v. American States Ins. Co., 322 Ill. App. 3d 451, 456-58, 750 N.E.2d 768-69 (5th Dist. 2001) (insurer’s affirmative defense setting forth its coverage defense insufficient to avoid estoppel where insured was forced to file a declaratory judgment action approximately a year after its tender). Timely filing a declaratory judgment alone is insufficient to avoid estoppel. Rather, an insurer must timely pursue a declaratory judgment action seeking a ruling on the issue of coverage in order to avoid estoppel.

Illinois courts have generally applied one of three tests to determine whether a declaratory judgment action was timely. Some cases find that the declaratory judgment action is timely filed as long as it was filed before the underlying suit ends. Employers Ins. of Wausau v. Ehlo Liquidating Trust, 186 Ill. 2d 127, 157, 708 N.E.2d 1122, 1138 (1999); Farmers Auto Ins. Ass’n v. Country Mut. Ins., 309 Ill. App. 3d 694, 700-01, 722 N.E.2d 1228, 1234 (4th Dist. 2000); see also Gould & Ratner v. Vigilant Ins. Co., 336 Ill. App. 3d 401, 411, 782 N.E.2d 749, 758 (1st Dist. 2002) (the timeliness of a declaratory judgment filing only applies if there is a duty to defend).. Other cases look to see whether the insurer waited until trial or settlement was “imminent.” Aetna Cas. & Sure. Co. v. O’Rourke Bros., 333 Ill. App. 3d 871, 880, 776 N.E.2d 588, 596 (3d Dist. 2002); Westchester Fire Insurance Co. v. G. Heileman Brewing Co., 321 Ill. App. 3d 622, 634, 747 N.E.2d 955, 965 (1st Dist. 2001). However, if the declaratory judgment action was filed within a reasonable amount of time after tender was received, an insurer should not be
estopped even if the underlying case settles quickly. See, Fed. Ins. Co. v. Arthur Andersen LLP, 522 F.3d 740, 744 (7th Cir. 2008) (noting but not deciding that estoppel should not apply if declaratory judgment filed in a reasonable amount of time even though the underlying case was settled soon after tender); State Farm Fire & Casualty Co. v. Martin, 186 Ill. 2d 367, 374, 710 N.E.2d 1228, 1232 (Ill. 1999)(cautioning against rigid rule fixated on resolution of the underlying case because this would give the insured and tort plaintiff an incentive to resolve the suit quickly before a declaratory judgment action to try to invoke estoppel). Illinois courts have also discussed a “reasonable time” test looking to see whether the insurer filed and pursued the declaratory judgment action within a reasonable time. L.A. Connection v. Penn-America Insurance Co., 363 Ill. App.3d 259, 266, 843 N.E.2d 427, 433 (3d Dist. 2006); Employers Reinsurance Corp. v. E. Miller Insurance Agency, Inc., 332 Ill. App. 3d 326, 341-42, 773 N.E.2d 707, 719 (1st Dist. 2002); West American Insurance Co. v. J.R. Construction Co., 334 Ill. App. 3d 75, 87, 777 N.E.2d 610, 620 (1st Dist. 2002Ill. App. 3d); see also Santa’s Best Craft, LLC v. St. Paul Fire & Marine Ins. Co., 611 F.3d 339, 350 (7th Cir. 2010). This test appears to be the recent trend and probably the best expression of the state of Illinois law.

Under the reasonable time test, Illinois courts generally have found that a few months between an insured’s tender and the filing of a declaratory judgment action is reasonable whereas longer delays are unreasonable. Compare, L.A. Connection v. Penn-America Insurance Co., 363 Ill. App.3d 259, 266, 843 N.E.2d 427, 433 (3rd Dist. 2006) (a two to six month period is a reasonable delay); State Automobile Mutual Insurance Co. v. Kingsport Development, LLC, 364 Ill. App.3d 946, 961, 846 N.E.2d 974, 988 (2d Dist. 2006) (a seven month period is a reasonable delay); Fed. Ins. Co. v. Arthur Andersen LLP, 522 F.3d 740, 744 (7th Cir. 2008) (suggested that seven or eight months after notice of underlying suit was reasonable); with FCCI Ins. Co. v. Westfield Ins. Co., 2014 IL App (1st) 131598-U, at ¶68 (unpublished) (10 month delay after notice of underlying suit was reasonable); Central Mut. Ins. Co. v. Kammerling, 212 Ill. App. 3d 744, 749-50, 571 N.E.2d 806, 810 (1st Dist. 1991) (court found that 10 month delay after notice, six month delay after issuing a reservation of rights letter and months after notice of a possible settlement was unreasonable); and West American Insurance Co. v. J.R. Construction Co., 334 Ill. App. 3d 75, 87, 777 N.E.2d 610, 620 (1st Dist. 2002) (a 21 month period is an unreasonable delay).

The longer an insurer waits to file or actively participate in an existing declaratory judgment action, the more likely an insurer will be facing an estoppel issue. It is good practice for an insurer to file a declaratory judgment action at or near the time that it receives notice and denies coverage in Illinois. In addition, if an insured files a declaratory judgment action first, an insurer cannot just sit idly by, it must actively pursue resolution of its coverage defenses in its pleadings, discovery, motion practice and trial.

2. Waiver of Policy Defenses in Denial Letter

App. 3d 692, 696, 574 N.E.2d 160, 162 (1st Dist. 1991); Ladd Construction Co. v. Ins. Co. of N. Am., 73 Ill. App. 3d 43, 49-50, 391 N.E.2d 568, 573 (Ill. App. 3d Dist. 1979). It must, however, set forth those defenses of which it has knowledge and which may also adversely affect the insured’s position if they are not disclosed. For instance, notice is typically a defense that should be known to an insurer and raised in the insurer’s letter. Mathis v. Lumbermen’s Mut., 354 Ill. App. 3d 854, 858, 822 N.E.2d 543, 547-48 (5th Dist. 2004); Jones v. Universal Casualty Co., 257 Ill. App. 3d 842, 851-52, 630 N.E.2d 94, 101 (1st Dist. 1994). If the insured can show they relied to their detriment on the failure to assert a particular defense in a denial letter, the insurer is estopped from asserting that defense. Mathis, 354 Ill. App. 3d at 858; 822 N.E.2d 543 at 547-48; Jones, 257 Ill. App. 3d at 851-52, 630 N.E.2d at 101; but see Pekin Ins. Co. v. Skender Constr., 2013 IL App (1st) 123532-U, ¶ 42 (unreported; noting that estoppels and waiver “are separate doctrines with separate requirements”). Thus, it is a best practice to assert all known coverage defenses even in the denial letter to avoid the potential for waiver or estoppel.

3. Payment of Underlying Defense Costs

In addition to avoiding estoppel, another benefit of denying coverage and pursuing a declaratory judgment action is that an insurer is not paying defense costs for its insured during the pendency of the case which can be significant in certain situations. See, Allstate Ins. Co. v. Amato, 372 Ill. App. 3d 139, 147, 865 N.E.2d 516, 524 (1st Dist. 2007) (rejected insured’s argument that insurer was required to reimburse an insured for defense costs until a court rules that an insurer had no duty to defend). If an insurer prevails in the declaratory judgment action, it has no liability for defense costs incurred by an insured, but if it loses the declaratory judgment action, it must pay the insured’s reasonable defense costs. Certain Underwriters v. Professional Underwriters, 364 Ill. App. 3d 975, 981, 848 N.E.2d 597, 602-03 (2d Dist. 2006); General Star Indemnity Co. v. Lake Bluff School District No. 65, 354 Ill. App. 3d 118, 128, 819 N.E.2d 784, 794 (2d Dist. 2004). It may also be liable for prejudgment interest on those costs. Caterpillar, Inc. v. Century Indem. Co., No. 1-01-3642, 2011 Ill. App. Unpub. LEXIS 48, at *35-36, 2011 WL 488935 (3d Dist. 2011); Conway v. Country Cas. Ins. Co., 92 Ill. 2d 388, 399, 442 N.E.2d 245, 250 (Ill. 1982). Of course, if an insurer chooses this route, it gives up the opportunity to control the insured’s defense as well as any potential to choose defense counsel during the time it denied coverage.

4. Ripeness of a Declaratory Judgment Action

There are instances where a declaratory judgment action is premature. First, because the duty to defend is broader than the duty to indemnify, if there is no duty to defend, there is no duty to indemnify. Crum & Forster Managers Corp. v. Resolution Trust Corp., 156 Ill. 2d 384, 398, 620 N.E.2d 1073, 1081 (1993). Thus, it is proper for an insurer to seek a ruling in a declaratory judgment case as to both its defense and indemnity obligation before the putative insured’s liability has been determined in the underlying suit. The obligation to defend is the potential that an insurer must pay or indemnify the insured for the loss. If there is no potential to pay, then there can be no actual duty to pay and thus the issue can be disposed of in the insurer’s favor before resolution of the underlying suit. The converse is not true. When a
putative insured seeks a determination of an insurer’s indemnity obligation before underlying liability has been determined such a request is premature. In that scenario, even if there is the potential for coverage, i.e., a duty to defend exists, the determination of whether there is actual coverage depends on the outcome of the underlying suit. Therefore, Illinois courts hold that an insured’s request for indemnity must await the resolution of the underlying suit. Traveler’s Ins. Co. v. Eljer Mfg., 197 Ill. 2d 278, 298, 757 N.E.2d 481, 491-92 (2001); First Mercury Ins. Co. v. Nationwide Sec. Services, Inc., 2016 IL App (1st) 143924, ¶ 25, 54 N.E.3d 323, 330, appeal denied, 60 N.E.3d 872 (Ill. 2016).

Second, a declaratory judgment action against an excess or umbrella carrier may also be premature because an excess policy is not potentially implicated until the underlying insurance is exhausted. Fox v. Am. Alternative Ins. Corp., 757 F.3d 680, 684 (7th Cir. 2014)(excess carrier has no duty to defend until underlying limits are exhausted); Hartford Accident & Indem. Co. v. International Envtl. Corp., 1994 U.S. Dist. LEXIS 2824 **23-24 (N.D. Ill. Mar. 8, 1994)(dismissing complaint against excess insurer because insured’s claim was not ripe).

One case suggests, but did not decide, that estoppel could be applied to an umbrella carrier under the “drop down” provision. Sinclair Oil Corp. v. Allianz Underwriters Ins. Co., 2015 IL App (5th) 140069, ¶ 37, 39 N.E.3d 570, 580, appeal denied, 48 N.E.3d 677 (Ill. 2016). In Sinclair Oil, the court held that an umbrella carrier breached its duty to defend after it had actual notice that the primary policy was exhausted with respect to property damage claims. Id. at ¶55. The Sinclair court explained that “actual notice” is more than the insured’s allegation of exhaustion but some evidence of actual payments, whether provided by an underlying insurer or the insured. Id. The Sinclair court found that the insurer had actual notice that the underlying insurance for property claims was exhausted, however, it did not address whether the umbrella carrier was estopped because the trial court did not rule on the issue. Id. at ¶ 33 fn. 15. Nevertheless, there is language in the decision which suggests that an umbrella carrier may be estopped and the decision also cites to certain Illinois estoppel cases. See, Id. at ¶51 (“once the umbrella carrier is in possession of such evidence of payments made, the burden is on the insurer regarding exhaustion. [...] if the umbrella carrier wishes to litigate the issue of underlying exhaustion or assert any other defense to coverage, it must defend the insured under a reservation of rights or seek a declaratory judgment.”). Therefore, if an umbrella insurer wishes to contest the insured’s evidence of exhaustion and avoid estoppel, it is best for the insurer to file a declaratory judgment action.

Finally, where pursuing a declaratory action would involve a determination of one of the ultimate issues in the underlying litigation against the insured, an insurer might not be allowed to deny a defense and litigate that issue before the underlying case is resolved. Maryland Casualty Company v. Peppers, 64 Ill. 2d 187, 196-97, 355 N.E.2d 24, 30 (1976); Country Mut. Ins. Co. v. Dahms, 2016 IL App (1st) 141392, ¶ 46, 58 N.E.3d 118, 127, reh’g denied (June 21, 2016), appeal denied, 60 N.E.3d 872 (Ill. 2016). If a declaratory judgment is filed before the resolution of the underlying case which would decide an ultimate fact in that case, Illinois courts may order the insurer to defend the insured and either stay the declaratory judgment action until the underlying lawsuit is resolved or outright dismiss the coverage action. See, e.g.,
Clarendon Am. Ins. Co. v. B.G.K. Sec. Servs., 387 Ill. App. 3d 697, 704-05, 900 N.E.2d 385, 393-94 (1st Dist. 2008)(insurer had duty to defend and cannot use extrinsic evidence to deny coverage because it will determine an ultimate fact in the underlying case); State Farm Fire & Cas. Co. v. Leverton, 289 Ill. App. 3d 855, 857-89, 683 N.E.2d 476, 478-79 (4th Dist. 1997)(found duty to defend where trial court’s finding that insured’s act fell within intentional acts exclusion improperly decided an ultimate issue of fact in the underlying case); State Farm Fire & Casualty Co. v. Shelton, 176 Ill. App. 3d 858, 865-67, 531 N.E.2d 913 (1st Dist. 1989)(insurer had duty to defend because whether the insured expected or intended injuries is an issue of ultimate fact to be decided in the underlying case); Grinnell Mut. Reinsurance Co. v. Ferando, 2011 U.S. Dist. LEXIS 88110 **14-16, 2011 WL 3489782 (S.D. Ill. Aug. 9, 2011)(stayed declaratory judgment action and ordered the insured to defend the insured because consideration of whether insured’s conduct was criminal was premature); but see, Lexington Ins. Co. v. Bd. of Educ., 2012 U.S. Dist. LEXIS 2702, at *4-5, 2012 WL 74778 (N.D. Ill. Jan. 10, 2012)(stayed declaratory judgment action because it would decide an ultimate issue of fact in the underlying case but did not order the insurer to defend the action); TIG Ins. Co. v. Canel, 389 Ill. App. 3d 366, 375, 906 N.E.2d 621, 630 (1st Dist. 2009)(stayed declaratory judgment proceedings on insurer’s duty to defend when premature resolution could interfere with underlying action without addressing insured’s argument that an insurer cannot suspend its duty to defend and was required to pay defense costs).

D. RESERVING RIGHTS AND FILING A DECLARATORY JUDGMENT ACTION

Another option available to the insurer is to provide the insured with a defense subject to a reservation of rights while simultaneously filing a declaratory judgment action. In some circumstances, the insurer may choose this course of action as opposed to a denial so as to avoid having to deal with a default judgment and assignment where the insured is unlikely to defend the lawsuit. Also, in some circumstances, the coverage defenses, while reasonable, may involve a matter of first interpretation, and accordingly, the success of those defenses is less certain. In such a case, the insurer may want to control the defense and select defense counsel to manage costs, substantive defenses and the pace of the case against the insured in the event that the court rules against it in the coverage case. By undertaking the insured’s defense, the carrier can protect the insured and itself from adverse rulings against the insured as well as costs until the declaratory action is resolved.

E. DENIAL OF COVERAGE AND EQUITABLE ESTOPPEL

The final option available to the insurer in responding to a tender of defense is to simply deny coverage. In Illinois, this option can be risky for insurers. From a practical perspective, an outright denial would seem appropriate when the allegations of the complaint, on their face, are clearly outside of coverage and the financial stakes of being estopped from relying on coverage defenses to avoid an indemnity obligation are relatively slight. This is because, under Illinois law, if an insurer incorrectly refuses to defend a suit against its insured which a court later determines should have been defended, the insurer will generally be estopped from
relying on any policy defenses to avoid an indemnity obligation for a settlement or judgment in that case. See, e.g., State Farm Fire & Cas. Co. v. Martin, 186 Ill. 2d 367, 371, 710 N.E.2d 1228, 1231 (Ill. 1999); Employers Insurance of Wausau v. Ehco Liquidating Trust, 186 Ill. 2d 127, 151, 708 N.E.2d 1122, 1135 (Ill. 1999); Sinclair Oil Corp. v. Allianz Underwriters Ins. Co., 2015 IL App (5th) 140069, ¶49, 39 N.E.3d 570, 584, appeal denied, 48 N.E.3d 677 (Ill. 2016) . This type of estoppel is known in Illinois as “equitable estoppel.” Illinois courts justify equitable estoppel holding that the insurer has no right to insist that the insured be bound by the provisions of the insurance contract inuring to the insurer’s benefits (i.e., exclusions, conditions and other limiting provisions) when the insurer has already breached the contract by violating the provisions inuring to the benefit of the insured (i.e., the defense obligation). Mt. Hawley Ins. Co. v. Certain Underwriters at Lloyd’s, 2014 IL App (1st) 133931, at ¶40-41 (1st Dist. Sep. 9, 2014). Estoppel can apply against an insurer which refuses to defend, even if another carrier undertakes the insured’s defense. See, Northbrook Property and Casualty Ins. Co. v. United States Fidelity and Guarantee Company, 150 Ill. App. 3d 479, 484-85, 501 N.E.2d 817, 820-21 (1st Dist. 1986).

Where an insurer is found to be equitably estopped from raising policy defenses, the scope of its indemnity obligation is expanded beyond the terms of the actual coverages. Due to the incorrect refusal to defend, the insurer becomes liable for all damages that flow from the breach even if the insurer has a proper policy defense which could otherwise be relied upon to avoid paying indemnity. These damages include the judgment and/or settlement of the underlying case and any defense costs, but these damages are not restricted to these amounts and can sometimes include sums in excess of the policy limits if they flow from the failure to defend the suit. See, Conway v. Country Casualty Ins. Co., 92 Ill.2d 388, 397-98, 442 N.E.2d 245, 249 (Ill. 1982) (“Damages for a breach of the duty to defend are not inexorably imprisoned within the policy limits, but are measured by the consequences proximately caused by the breach.”); Delatorre v. Safeway Ins. Co., 2013 IL App (1st) 120852, ¶¶33-35, 989 N.E.2d 268, 276 (1st Dist. 2013)(insurer is liable for default judgment, even though it exceeded the policy limits, because those damages directly flow from the insurer’s breach of contract). The insurer can be held liable for these sums even absent a bad faith finding. Illinois courts hold that the insured should be placed in the same position it would have been had the insurer not breached the contract.

Because of the potentially harsh consequences of equitable estoppel, it is utmost importance for insurers to properly evaluate their options when they receive a tender of defense. If a policy defense is not absolutely clear from the four corners of the complaint, an insurer should either file a declaratory judgment action and/or defend the suit under a reservation of rights. From a practical perspective, cases where the costs of non-compliance with the duty to defend may expose the carrier significantly, like business/competitor disputes or significant injury or damages cases, should dictate additional caution. It may be cheaper in the long run to litigate a straightforward defense obligation than defend a coverage action with
a substantial settlement or a judgment against the insured clouded by accusations of improper denial of a defense, estoppel and perhaps bad faith.

V.  EQUITABLE ESTOPPEL LIMITATIONS

Although the estoppel doctrine can be problematic for insurers, it is not without limits. First, as detailed above, equitable estoppel is only potentially applicable if an insurer actually breaches its duty to defend. Employers Insurance of Wausau v. Ehco Liquidating Trust, 186 Ill. 2d 127, 151, 708 N.E.2d 1122, 1135 (Ill. 1999); FHP Tectonics Corp. v. Am. Home Assur. Co., 2016 IL App (1st) 130291, ¶ 41, 57 N.E.3d 575, 583. In other words, equitable estoppel does not apply if there is no duty to defend and only potentially applies if an insurer incorrectly denies coverage. Nevertheless, as explained below, equitable estoppel should not exist even if the insurer is wrong in denying coverage in all instances.

A. Whether a Policy Exists

Estoppel should not apply if there is no insurance policy in existence. Id. Therefore, if a policy is cancelled or rescinded, estoppel should generally not apply. See, Hunt v. State Farm Mut. Auto. Ins. Co., 2013 IL App (1st) 120561, at ¶30, 994 N.E.2d 561, 569 (1st Dist. 2013) (estoppel did not apply because policy was properly cancelled for non-payment of premium at the time of the accident); State Farm Ins. Co. v. Am. Serv. Ins. Co., 332 Ill. App. 3d 31, 37-38, 773 N.E.2d 666, 671-72 (1st Dist. 2002) (estoppel only bars an insurer’s policy defenses and is inapplicable to rescission claim). There are, however, some Illinois cases which have estopped an insurer that raised cancellation as a defense where there was a dispute as to whether the cancellation was effective. See, e.g., Johnson v. State Farm Fire & Cas. Co., 2011 Ill. App. Unpub. LEXIS 1777, at *32-34, 2011 IL App (2d) 100586-U, at ¶38 (2d Dist. 2011 ) (insurer estopped from asserting that the policy was no longer in effect from cancellation for non-payment of premium because there was a dispute as to whether it was properly cancelled); Am. Std. Ins. Co. v. Gnojewski, 319 Ill. App. 3d 970, 978, 747 N.E.2d 367, 374-75 (1st Dist. 2001) (insurer estopped from arguing policy cancelled because there was the potential for coverage since insurer failed to notify the lien holder of the cancellation and the cancellation may have been ineffective); compare with Hunt v. State Farm Mut. Auto. Ins. Co., 2013 IL App (1st) 120561, ¶¶ 30, 46, 994 N.E.2d 561, 569 (insurer has no duty to defend if there was no insurance policy at time of incident and insurer properly cancelled policy). Because of this divergent case law, it is still safest to file a declaratory judgment rather than deny outright.

B. Who Is An Insured Under a Policy

531, 541 (1st Dist. 2010); and United Stationers Supply Co. v. Zurich American Insurance Co., 386 Ill. App. 3d 88, 105-06, 896 N.E.2d 425, 439-40 (1st Dist. 2008). Thus, estoppel should not be applied to the issue of whether a person or entity is actually an insured under the policy. See, Knezovich, 2012 IL App (1st) 111677, at ¶15, 975 N.E.2d at 1170; Ulrich Children’s Advantage Network, 398 Ill. App. 3d at 720, 929 N.E.2d at 541; United Stationers Supply Co., 386 Ill. App. 3d at 105-06, 896 N.E.2d at 439-40. However, if the allegations in the underlying suit allege the potential that the person is an insured, an insurer must file a declaratory judgment action to avoid estoppel particularly where it is relying on extrinsic evidence to the complaint in denying coverage. See, Clemmons v. Travelers Ins. Co., 88 Ill. 2d 469, 475-76, 430 N.E.2d 1104, 1107-08 (Ill. 1981) (insurer estopped from asserting that driver was not a permissive user of a vehicle, i.e., not an insured, based on an accident report when it did not file a declaratory judgment action and the allegations of the complaint alleged the possibility that the driver was driving his employer’s vehicle with permission even though the complaint did not specifically state that the driver had permission).

C. Insuring Agreement Defenses

A vexing issue in Illinois for insurers is whether an insurer can be estopped from contesting that the claim does not fall within the grant of coverage if the insurer did not defend the insured. There are many cases which can hold that estoppel cannot create coverage. See, e.g., Schuster v. Occidental Fire & Cas. Co., 2015 IL App (1st) 140718, at ¶29 (1st Dist. 2015). Illinois courts have not explicitly considered whether an insurer can raise the defense that the claim does not actually fall within an insuring agreement to avoid estoppel. In other words, whether there is a difference between a non-coverage defense and a policy defense based on a condition, limitation or exclusion in the policy.

There is some case law which suggests that there is a difference in employing estoppel between the insuring agreement (scope or grant of coverage), defenses and the limitations, exclusions or conditions of coverage. See, e.g., Employers Mut. Companies/Illinois Emcasco Ins. Co. v. Country Cos., 211 Ill. App. 3d 586, 592, 570 N.E.2d 528, 532 (1st Dist. 1991) (although finding no duty to defend, court in dicta stated an insurer “could not be estopped from asserting these defects [no action against an insured and suit falls outside the insuring agreement which states that the accident must result from the ownership, maintenance or use of either an ‘insured vehicle’ or a ‘non-owned vehicle’] because they relate to the scope of coverage afforded by the definitions contained in the policy, rather than exclusions”); Graman v. Continental Casualty Co., 87 Ill. App. 3d 896, 901-02, 409 N.E.2d 387, 392 (5th Dist. 1980) (although court found there was no duty to defend, court rejected insured’s argument that insurer estopped from raising the claims made and reported requirement in the insuring agreement because the provision controls the grant of coverage, which is different than an exclusion). It is important to note that neither of these cases considered whether this was true if an insurer actually breached a duty to defend. See, Clemmons, 88 Ill.2d 469, 478, 430 N.E.2d 1104, 1108 (Ill. 1982) (rejected argument that Graman supports the position that inclusions of coverage are treated differently than exclusions because there was no duty to defend in
Graman since the complaint did not allege the claims were not reported to the insurer within the required time in the policy).

On the other hand, there are other cases which suggest that an insurer can be estopped from asserting defenses regarding the scope of coverage. See, Mt. Hawley Ins. Co. v. Certain Underwriters at Lloyd’s, 2014 IL App (1st) 133931, at ¶40, 19 N.E.3d 106, 114 (1st Dist. 2014) (insurer estopped from denying indemnity because insurer refused to defend on the basis that entity was not an insured because its liability did not arise from the named insured’s acts as required by an additional insured endorsement); West Am. Ins. Co. v. J.R. Construction Co., 334 Ill. App. 3d 75, 87, 777 N.E.2d 610, 620 (1st Dist. 2002) (insurer estopped from raising excess provision in additional insured endorsement when it failed to file a declaratory judgment action against putative additional insured); see also, Ehlco, 186 Ill.2d at 153-54; 708 NE.2d at 1136 (“where a complaint alleges facts potentially within the policy's coverage, an insurer taking the position that a claim is not covered cannot simply refuse to defend the suit”).

In addition, Graman was criticized in Uhlich Children’s Advantage Network v. Nat’l Union Fire Co., PA, 398 Ill. App. 3d 710, 929 N.E.2d 531 (1st Dist. 2010). In Uhlich, the insurer argued that it had no duty to defend because a claim was first made during the first policy period but was not reported until the second policy period. Id. at 714; 929 N.E.2d at 536. The Uhlich court found that the insurer was estopped from contesting coverage even though the insured received notice of a claim (EEOC charge) during the first policy period but did not give the insurer notice until the second policy period when the lawsuit was filed during the second policy period. Id. at 720; 929 N.E.2d at 541-42. The Uhlich court rejected the insurer’s reliance on Graman for the proposition that failure to notify the insurer is a condition precedent such that estoppel does not apply. Id. at 719-20; 929 N.E.2d at 541. Although the Uhlich case should properly be seen as a late notice case, some language appears to conflate late notice with the reporting requirement in the insuring agreement of a claims made and reported policy.¹

Given the unsettled nature of the law on this issue, it is best for an insurer to file a declaratory judgment action even when relying on insuring agreement defenses. Insurees often argue that restrictions contained in the grant of coverage which limit the coverage afforded, should be treated like any other limiting language in the policy. In other words, insureds argue that simply because a limitation on coverage is contained in a definition, that limitation is functionally no different than an exclusion. There is some case law which supports this view. Caution is recommended in this area, particularly when there is a significant claim being made against the insured.

D. Public Policy Defenses

Even if an insurer is estopped from asserting its policy defenses to avoid indemnity, that does not mean an insurer cannot raise public policy or equitable defenses. See, e.g., Platinum

¹ One recent unpublished case affirmed that Uhlich was a late notice case and it and estoppel did not apply where the claim was made before the policy was even in effect. BNSF Ry. Co. v. Lexington Ins. Co., 2015 IL App (1st) 140415-U (1st Dist. Jan. 20, 2015).
Tech, Inc. v. Fed. Ins. Co., 282 F.3d 927, 931 (7th Cir. 2002) (even if an insurer is estopped from asserting policy defenses, insurer can still raise certain extra-contractual and public policy defenses); Great W. Cas. Co. v. Rogers Cartage Co., 00 C 6221, 2001 U.S. Dist. LEXIS 20486, at **12-14, 28, 2001 WL 1607608 (N.D. Ill. Dec. 26, 2001) (estoppel cannot create coverage for punitive damages). Therefore, when an insurer is faced with the possibility that it may be estopped from asserting its policy defenses, it is important for an insurer to evaluate its other non-policy defenses, including all public policy defenses in thwarting an estoppel claim.

E. Settlement in the Underlying Suit

Even if an insurer is estopped from asserting its coverage defenses, that insurer does not automatically pay an entire settlement under Illinois law.2 The settlement is only binding and payable by an insurer if the insured proves that the settlement is reasonable because a settlement where the insured has no real liability raises concerns about collusion. See, e.g., Guillen v. Potomac Ins. Co., 203 Ill. 2d 141, 158, 162-64, 785 N.E.2d 1, 11-12, 14-15 (2003); Central Mutual Insurance Company v. Tracy’s Treasures, Inc., 2014 IL App (1st) 123339, at ¶56, 19 N.E.3d 1100, 1113-14 (1st Dist. Sep. 30, 2014); Pietras v. Sentry Ins. Co., 513 F. Supp. 2d 983, 985-86 (N.D. Ill. 2007). An insurer also retains the right to rebut any preliminary showing of reasonableness. Guillen, 203 Ill. 2d at 163-64, 785 N.E.2d at 14-15; Central Mut. Ins. Co., 2014 IL App (1st) 123339, at ¶56, 19 N.E.3d at 1113-14; Pietras, 513 F. Supp. 2d at 985-86.

The Illinois Supreme Court has held that courts must consider whether “the insured’s decision conformed to the standard of the prudent uninsured” and whether the amount of the settlement “is what a reasonably prudent person in the position of the [insured] would have settled for on the merits of plaintiff’s claim.” Guillen, 203 Ill. 2d at 163 (emphasis in original). Thus, the facts bearing on liability and damages of the claim against the insured are relevant to the circumstances of the settlement. See, Id. The prudent uninsured test presumes that the insured is not “on the brink of bankruptcy” and has the ability to actually pay a substantial judgment. Tracy’s Treasures, Inc., 2014 IL App (1st) 123339 at ¶64. Moreover, a settlement can be unreasonable if there is evidence of bad faith, collusion or fraud. See, Id. at ¶¶78-81 (listing factors to evaluate bad faith, collusion or fraud such as misrepresentation, concealment, secretiveness, lack of serious negotiations, attempts to affect the insurance coverage, profit to the insured, and harming an insurer’s interest).

When an insurer is faced with the possibility that it may be estopped from asserting its policy defenses and the underlying case has settled, it is important for the insurer to evaluate whether the settlement is reasonable. When the underlying suit has settled, an insurer should obtain information concerning the liability and damages in the underlying suit, the financial wherewithal of the insured, along with the circumstances of the settlement. The circumstances

2 Although beyond the scope of this article, insurers should be aware that they may have an additional recourse when faced with a consent judgment against an insured. An insurer may be able to intervene and seek to vacate the underlying judgment. G.M. Sign, Inc. v. Schane, 2013 IL App (2d) 120434 ¶35(insurer had standing to challenge a consent judgment against an insured where only the insurer was required to pay under a settlement/consent judgment).
may tend to show collusion and an unreasonable settlement. These are often factual issues which may require extensive litigation, including a trial.

F. Conflict of Interest

Where the insurer’s control of the insured’s defense creates a conflict of interest between the insurer and the insured, an insurer’s failure to assume the defense of its insured will not create estoppel. Ehlico, 186 Ill. 2d at 156, 708 N.E.2d at 1137; Murphy v. Urso, 88 Ill. 2d 444, 451-52, 430 N.E.2d 1079, 1082-83 (Ill. 1981); Maryland Casualty Company v. Peppers, 64 Ill. 2d 187, 198-99, 355 N.E.2d 24, 31 (Ill. 1976). When such a conflict exists, and is not waived, the insurer is not obligated, or even permitted, to participate in the defense of the underlying liability case against its insured. Id. Importantly, however, the insurer cannot simply refuse to defend and do nothing. When a conflict exists, the insurer’s duty to defend is satisfied by reimbursing the insured for the reasonable costs of the defense. Murphy, 88 Ill. 2d at 451-52, 430 N.E.2d at 1082-83; Utica Mut. Ins. Co. v. David Agency Ins., Inc., 327 F. Supp. 2d 922, 929 (N.D. Ill. 2004) (“If a conflict of interest exists, the insurer ordinarily must pay the costs of independent counsel instead of participating in the defense itself.”). The insurer cannot wait until the underlying case is resolved to pay defense costs, it must reimburse the insured for defense costs as they are incurred to avoid estoppel. Am. Serv. Ins. Co. v. China Ocean Shipping Co. (Americas) Inc., 402 Ill. App. 3d 513, 530, 932 N.E.2d 8, 24 (1st Dist. 2010); Insurance Co. of Pennsylvania v. Protective Ins. Co., 227 Ill. App. 3d 360, 368-69, 592 N.E.2d 117, 123 (1st Dist. 1992); Gibraltar Casualty Co. v. Sargent & Lundy, 214 Ill. App. 3d 768, 785, 574 N.E.2d 664, 674 (1st Dist. 1991).


There are three basic types of conflicts of interest which have been identified by Illinois courts. The first type arises where the same evidence and/or facts are germane to liability and coverage issues. For example, if a complaint against the insured alleges both negligent conduct (which is covered) and intentional conduct (which is not covered), a conflict exists. Under those circumstances the insurer may have an interest in proving or shaping a set of facts in the case against the insured which would, in effect, subject the insured to greater liability on uncovered

Secondly, a conflict of interest occurs where the insurer potentially affords coverage to two defendants with divergent interests. In Murphy v. Urso, 88 Ill. 2d 444, 449-58, 430 N.E.2d 1079, 1081-86 (1981), the claimant sued the operator and owner of a vehicle for injuries sustained in a collision. The underlying complaint alleged that the vehicle operator was the agent of the vehicle owner. The insurer accepted the defense of the owner but declined coverage to the operator maintaining that the operator did not have permission to drive the vehicle and therefore was not covered by the owner’s policy. The Illinois Supreme Court found that the insurer owed the operator a defense based upon the allegations of the complaint but also found a conflict of interest between the operator, the owner and the insurer (i.e., the owner/insurer would benefit by establishing that the operator was not the owner’s agent while it was in the operator’s best interest to be found an agent so as to obtain coverage under the policy). Because a conflict of interest existed, the insurer could not control the operator’s defense and had to reimburse the reasonable costs of his defense.

A third conflict of interest arises where the economic incentives of the insurer may cause it to provide a less than vigorous defense to the insured. In Nandorf, Inc. v. CNA Ins. Cos., 134 Ill. App. 3d 134, 138-40, 479 N.E.2d 988, 992-94 (1st Dist. 1985), the plaintiff sought a small amount in compensatory damages and a large punitive award. The insurer disclaimed coverage for any punitive damage award. The appellate court concluded that a conflict of interest existed because the insurer retained control over the litigation in which the vast majority of potential liability involved punitive damages, for which it had denied coverage. The court reasoned that the insurer’s interest would be served by an award of minimal compensatory damages (covered) and significant punitive damages (not covered), and therefore a conflict of interest existed. 3

Where an insurer is faced with a conflict of interest, it has the following three potential courses of action: (1) the insurer may waive its policy defense thereby curing the conflict; (2) the insurer may fully disclose the conflict, seek a waiver from the insured and then defend with the insurer’s choice of counsel if the insured consents; 4 or (3) the insurer may fully disclose the

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3 Not all cases involving a claim for punitive or uncovered damages give rise to a conflict of interest. The conflict only arises where the source of uncovered damages presents a substantial/disproportionate portion of the potential liability in the underlying suit.

4 In this scenario, appointed defense counsel must also disclose the potential conflict of interest and obtain a waiver. Peppers, 64 Ill.2d at 198-99, 355 N.E.2d at 30-31 (noting that attorney’s professional obligation satisfied when defense attorney discloses conflict of interest and insured accepts the insurer’s defense); Preferred Am. Ins. v. Dulceak, 302 Ill. App. 3d 990, 995-96, 706 N.E.2d 529, 533 (2d Dist. 1999)(defense attorney is ethically prohibited from representing both insured and insurer when there is a conflict absent full disclosure of the conflict and consent); Illinois Municipal League Risk Management Ass’n v. Seibert, 223 Ill. App. 3d 864, 871, 585 N.E.2d 1130, 1135 (4th Dist. 1992)(absent consent, ethical obligations prevent defense attorney from representing both the insurer and insured). Depending on the severity of the conflict, there could be situations whereby defense counsel does not believe he can represent the insured while reporting to an insurer. If defense counsel does not fully disclose the conflict and the insured does not waive the conflict, the insurer will be estopped. Id.; Allstate Ins.
conflict and offer to provide independent counsel of the insured’s own choosing, at the insurer’s expense. Murphy, 88 Ill. 2d at 451-52, 430 N.E.2d at 1082-83; Peppers, 64 Ill. 2d at 198-99, 355 N.E.2d at 30-31; Protective Ins. Co., 227 Ill. App. 2d at 369; 592 N.E.2d at 123. Failure by an insurer to follow one of the above three options when presented with a conflict of interest will result in the insurer being estopped from relying upon coverage defenses. Id. 5

G. Reasonableness of the Insured’s Defense Attorney’s Fees

Even if an insurer is estopped, an insurer is not estopped from contesting the reasonableness of an insured’s expenses or fees in the defense of the underlying suit. See, Knoll Pharm. Co. v. Auto. Ins. Co., 210 F. Supp. 2d 1017, 1024-25 (N.D Ill. 2002) (insurer was estopped from raising policy defenses to indemnity but was only required to pay reasonable expenses for the defense of the underlying action). However, insurers have no duty to pay for the insured’s prosecution of their own counterclaim for affirmative relief against the claimant. International Ins. Co. v. Rollpoint Packaging Prods., 312 Ill. App. 3d 998, 1014, 728 N.E.2d 680, 695 (1st Dist. 2000)(no duty to pay for insured to prosecute its counterclaim). However, the court has suggested that an insurer may be required to pay for a defensive counterclaim which is needed to limit or defeat liability, such as a contribution action. Id. at 1015, 728 N.E.2d at 694.

Generally, the burden of showing that a claim for attorney’s fees is reasonable falls upon the party seeking reimbursement of those fees. First, if the insured has paid the attorney’s fees, there is a rebuttable presumption that the attorney’s fees are reasonable. See, American Serv. Ins. Co. v. China Ocean Shipping Co., 2014 Ill App 1st App 121896 ¶26, 7 N.E.3d 161, 172-73 (1st Dist. 2014)(insured’s attorney’s fees are prima facie reasonable if they have been paid but that an insurer may provide evidence to overcome the presumption). The party seeking reimbursement must provide proof of the attorneys involved, their hourly rate, the time spent and the work done. Harris Trust & Sav. Bank v. American Nat'l Bank & Trust Co., 230 Ill. App. 3d 591, 595, 594 N.E.2d 1308, 1312 (1st Dist. 1992). Insureds are generally required to provide its defense counsel’s entire file to the insurer in such circumstances. See, Waste Management, Inc. v. International Surplus Lines Ins. Co., 144 Ill. 2d 178, 199-203, 579 N.E.2d 322, 331-32 (Ill. 1991).

Courts consider several factors to determine whether the requested fees are reasonable such as the attorneys’ skills, the nature of the case, the novelty and difficulty of the legal issues involved, the usual or customary charge for similar services within the community, and whether there is a reasonable connection between the fees charged and the underlying litigation. Id. While trial courts have broad discretion in reviewing claims for reimbursement of attorney’s

Co. v. Carioto, 194 Ill. App. 3d 767, 551 N.E.2d 382 (1st Dist. 1990). Thus, it’s important to make sure defense counsel obtains a waiver. 5

5Illinois courts no longer recognize an exception to the estoppel doctrine based upon an insured’s breach of contract. Previously, courts had held that when an insured breached its obligation under the policy to give prompt notice of a suit or occurrence to the insurer, the insurer was absolved of any further obligations under the policy, including any obligation to defend the insured. These decisions were overruled in Employers Ins. v. Ehlco Liquidating Trust, 186 Ill. 2d 127, 153, 708 N.E.2d 1122, 1136 (1999).
fees, those courts have found that duplicative staffing and partner-heavy billing constitute unreasonable fees. See, e.g., Abrams v. Van Kampen Funds, Inc., No. 01 C 7538, 2006 U.S. Dist. LEXIS 2129, at *15, Abrams v. Van Kampen Funds, Inc., 01 C 7538, 2006 WL 163023, at *8 (N.D. Ill. Jan. 18, 2006). (generally travel expenses for more than two attorneys to a court hearing are not allowed and top-heavy billing practices unreasonable). Findings of unreasonableness are often difficult to prove and remain within the discretion of the trial court. Such findings are strongly grounded in the particular facts and circumstances of each underlying dispute.

VI. TERMINATION OF THE DUTY TO DEFEND

An insurer’s duty to defend under a policy may be terminated in certain circumstances.

A. An Insured’s Withdrawal of Its Tender

In Illinois, if an insured withdraws its tender, even if the insurer has notice of a covered case, there is no duty to defend and an insurer need not pursue for a declaratory judgment. In order for a court to maintain jurisdiction over a declaratory judgment action, there must be an “actual controversy” for the court to adjudicate. Selective Ins. Co. v. Phusion Projects, Inc., 836 F. Supp. 2d 731, 732 (N.D. Ill. 2011). When an insured withdraws tender, the insurer is considered “deactivated,” thereby relieving it of any present obligation to the insured. Id. at 734; Legion Ins. Co. v. Empire Fire & Marine Ins. Co., 354 Ill. App. 3d 699, 705, 822 N.E.2d 1, 6 (1st Dist. 2004) (insured’s letter deactivated its tender in a letter which relieved that insurer of its duty to defend). Accordingly, Illinois courts will respect the choice of an insured to forgo coverage by withdrawing its tender. In fact, any attempt by an insurer to pursue a declaratory action under these circumstances will likely be dismissed as moot or premature because there is no current case of controversy.

B. Duty to Appeal

An insurer’s continued duty to defend after an adverse verdict against the insured is governed by the policy terms. Illinois courts have held that the typical insuring agreement, requiring an insurer to defend a suit against the insured, does not explicitly obligate the insurer to pursue an appeal. Lincoln Park Arms Bldg. Corp. v. United States Fidelity & Guaranty Co., 287 Ill. App. 520, 537, 5 N.E.2d 773, 780 (1st Dist. 1936)(an agreement to defend does not necessarily include an obligation to appeal but noting the insurer must act in good faith). If insurer pays its policy limits, the insurer generally does not have a duty to appeal the verdict. See, General Casualty Company of Wisconsin v. Whipple, 328 F.2d 353, 357 (7th Cir. 1964)(no bad faith for failure to appeal when insurer decided to pay limits instead of pursuing an appeal of the verdict); Moore v. Columbia Casualty Company, 174 F.Supp. 566, 573 (S.D. Ill. 1959)(not required to pursue an appeal after insurer paid its policy limits even though verdict was in excess of policy limits although noting that the policy did require payment of premium for appeal bond). If “reasonable grounds” exist for an appeal and the insurer has a duty to defend, it can be compelled to prosecute one. See Illinois Founders Ins. Co. v. Guidish, 248 Ill. App. 3d 116, 122, 618 N.E.2d 436, 441 (1st Dist. 1993); see Fox v. Admiral Ins. Co., 12 CV 8740, 2016 WL
3520145, at *5 (N.D. Ill. June 28, 2016). Importantly, if an insurer does not have a duty to defend, it does not have any duty to appeal. Id. at 122, 618 N.E.2d at 441.

This does not mean that an insurer may never become liable for failing to prosecute an appeal on behalf of the insured. If an insurer squanders the ability of the insured to perfect an appeal and later disclaims coverage or allows the insured to become liable for uncovered sums, then the insurer may itself become liable for the entire judgment. See Lincoln Park Arms Building Corp., 287 Ill. App. at 537-39, 5 N.E.2d at 780-81.

When the underlying judgment is partially covered or not covered, some issue exists as to an obligation to appeal. If the entire judgment is not covered, there should be no duty to appeal as an insurer’s duty to defend ends when only uncovered claims remain. See Valley Forge Ins. Co. v. Swiderski Elecs., Inc., 359 Ill. App. 3d 872, 891 (2d Dist. 2005) aff’d, 223 Ill.2d 352 (2006); Phila. Indem. Ins. Co. v. Chi. Title Ins. Co., 771 F.3d 391, 402 (7th Cir. 2014). If, however, the judgment is only partially covered as there are both covered and uncovered claims, there could be some danger if the insurer does not appeal the underlying judgment. In those instances, it is best to evaluate whether there are reasonable grounds to appeal.

C. An Insurer’s Withdrawal of Defense

Termination of an insurer’s duty to defend can also occur when the insurer withdraws from the defense pursuant to a policy defense. For example, an insurer is obligated to defend its insured if only one count of a multi-count complaint sets forth allegations potentially within coverage. If the plaintiff dismisses the only potentially covered count, then the insurer no longer has a duty to defend its insured and can withdraw from the defense. See, Phila. Indem. Ins. Co. v. Chi. Title Ins. Co., 771 F.3d 391, 402 (7th Cir. 2014) (refiling the only potentially covered claim that was dismissed with prejudice to preserve issue for appeal insufficient to continue insurer’s duty to defend); Edward T. Joyce & Assoc., P.C. v. Prof'l Direct Ins. Co., 13 CV 2475, 2014 U.S. Dist. LEXIS 138908 *25 (N.D. Ill. Sept. 30, 2014) (duty to defend ends when all the covered claims fall outside of the case).

Also, if an insurer discovers the applicability of a policy defense which precludes coverage during litigation of the suit against the insured which was not known nor could it have been reasonably discovered by the insurer at the outset, the insurer can, in the proper circumstances, withdraw from the defense of its insured. See Apex Mutual Ins. Co. v. Christener, 99 Ill. App. 2d 153, 168, 240 N.E.2d 742, 750 (1st Dist. 1968).

Whether the insurer can settle the covered counts and then withdraw its defense of the case because only non-covered claims remain is unclear. One case from the Seventh Circuit, applying Wisconsin law, may be instructive. The Seventh Circuit held that an insurer’s duty to defend ends if the “covered claims fall out of the case through settlement or otherwise” acknowledging that an insured cannot prevent an insurer for settling covered claims even though the settlement will terminate the insurer’s duty to defend. Lockwood Int'l, B.V. v. Volm Bag Co., 273 F.3d 741, 744-45 (7th Cir. 2001). However, the Lockwood court found that the insurer did not merely settle the covered claims but paid the underlying plaintiff to convert
some claims into non-covered claims without the insured’s consent. Id. Not only did the court find that this was in bad faith, the Lockwood court found that the underlying suit still alleged facts that could describe a covered claim and therefore, the insurer had a duty to defend even though it paid its policy’s limit through the settlement. Lockwood instructs that any settlement of covered claims must be in good faith.

Given the dearth of case law, insureds will likely challenge an insurer’s withdrawal for settlement of covered claims. The insured may argue it is prejudiced particularly if the settlement and withdrawal is close to trial or it is against public policy to allow a settlement. Further, if an insurer is considering settling covered claims, it is best to obtain its own counsel to do so. Having assigned defense counsel conduct these negotiations would put that lawyer in a conflict of interest and expose the lawyer and the insurer to liability. Rogers v. Robson, Masters, Ryan, Brumund & Belom, 74 Ill. App. 3d 467, 473-75, 392 N.E.2d 1365, 1370-72 (3d Dist. 1979), aff’d, 81 Ill.2d 201, 407 N.E.2d 47 (Ill. 1980); Dulceak, 203 Ill. App. 3d at 995-96, 706 N.E.2d at 533. Because of the potential estoppel and bad faith implications of the wrongful withdrawal of a defense, it would be best to pursue a declaratory judgment action if an insurer seeks to withdraw its defense after settling the covered claims.

An insurer can also withdraw from the defense of its insured when the insurer has been fraudulently induced by the insured to undertake its defense. See London Guar. & Accident Co. v. Am. Cereal Co., 159 Ill. App. 537, 540 (1st Dist. 1911) (insurer has right to withdraw defense upon discovering fraud), reversed on other grounds, 251 Ill. 123, 95 N.E. 1064 (1911).

While prejudice to the insured can be presumed when the insurer assumes control of the defense of the insured without interposing a reservation of rights, prejudice is not presumed when the insurer provides the defense as an “accommodation.” In other words, if the insurer appears for the insured after advising the insured of its coverage position and does so to avoid or prevent a default judgment from being entered against the insured, then a prompt withdrawal is proper and no estoppel principles will apply. See Greater Chicago Auction, Inc. v. Abram, 25 Ill. App. 3d 667, 670, 323 N.E.2d 818, 821 (1st Dist. 1975).

Importantly, if an insurer improperly withdraws a defense, it may be estopped from asserting its coverage defenses. If an insurer incorrectly withdraws from the defense of the insured, insurer is generally in the same position as it would have been in had it wrongfully refused to defend the suit from the beginning. In other words, the insurer will be estopped from asserting a defense of non-coverage to an indemnity obligation. See, Commercial Union Ins. Co. v. Continental Ins. Co., No. 92 C 3426, 1993 U.S. Dist. LEXIS 14381, at *8 (N.D. Ill. Oct. 13, 1993); 14 Couch On Insurance 2d, Section 51:97 (1982).

D. Exhaustion of Limits

The termination of an insurer’s duty to defend can also occur where the policy limits are exhausted. The typical insuring agreement contains the following limitation clause:
This company shall not be obligated to pay any claim or judgment or defend any suit after the applicable limit of this company’s liability had been exhausted by payment of judgments or settlements on behalf of the insured.

Illinois courts have construed the above language to mean that after the limits of liability are exhausted by payment of judgments or settlements on behalf of the insured, an insurer is not obligated to defend any new actions which might fall within the scope of the policy or to continue to defend actions pending against the insured which have been previously accepted for defense by the insurer. See Zurich Insurance Company v. Raymark Industries, Inc., 118 Ill. 2d 23, 54-56, 514 N.E.2d 150, 164-65 (1987); Conway v. Country Casualty Insurance Company, 92 Ill. 2d 388, 395-96, 442 N.E.2d 245, 248 (1982); Am. Serv. Ins. Co. v. China Ocean Shipping Co., 402 Ill. App. 3d 513, 527, 932 N.E.2d 8, 21-22 (1st Dist. 2010); Douglas v. Allied Am. Ins., 312 Ill. App. 3d 535, 541-43, 727 N.E.2d 376, 381-83 (5th Dist. 2000). Moreover, if an insurer has exhausted its limits of liability by payment of judgment or settlements, an insurer’s duty to defend ends and therefore, it should not have to prosecute an appeal of an underlying judgment. Cf., Illinois Founders Ins. Co. v. Guidish, 248 Ill. App. 3d 116, 121-22, 618 N.E.2d 436, 440-41 (1st Dist. 1993) (if there is no duty to defend the insured, there is no duty to appeal of a judgment against him).

There are two limitations put on an exhaustion defense by Illinois courts. First, payment of the policy limits by the insurer must be pursuant to a judgment or a settlement of the claim against the insured. An insurer’s voluntary payment of policy limits to a claimant which does not terminate the litigation against the insured cannot discharge or terminate an insurer’s duty to defend. See Conway v. Country Cas. Ins. Co., 92 Ill. 2d 388, 395-96, 442 N.E.2d 245, 248 (1982). In other words, an insurer cannot voluntarily tender its limits (i.e., no settlement or judgment) to discharge its duty to defend. Douglas v. Allied Am. Ins., 312 Ill. App. 3d 535, 542, 727 N.E.2d 376, 382 (5th Dist. 2000). Second, an insurer cannot exhaust its policy limits by payment of other claims pursuant to settlements when the insurer has been issued a garnishment summons with regard to a particular claim. See Sampson v. Cape Industries, Ltd., 185 Ill. App. 3d 83, 86-88, 540 N.E.2d 1143, 1145-47 (4th Dist. 1989). In such a case, the insurer must, as a garnishee, hold any “non-exempt indebtedness” in the garnishee’s control belonging to the debtor. The insurer cannot squander the rights of a garnishor by payment of other claims. Illinois courts require the insurer to continue to defend the garnishment action and ultimately to pay the judgment even if it has to pay sums in excess of its limit.

VII. CONCLUSION

In sum, because of Illinois’ onerous estoppel doctrine, insurers must carefully evaluate how to respond to a tender of the insured’s defense. While the estoppel doctrine is not without limits, it is a thorny issue and insurers should be vigilant in protecting their policy defenses. If an insurer incorrectly denies coverage or does not properly reserve its rights, an insurer may be estopped from raising policy defenses to contest indemnity in Illinois. To avoid this harsh result, an insurer denying coverage should carefully evaluate whether it needs to file a declaratory
judgment action to adjudicate the coverage issues. Even when not required, an insurer may still want to file a declaratory judgment action if the issue is close, the law is unsettled or it wants to proceed in the most conservative manner.

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