

INSURANCE LAW UPDATES IN ILLINOIS

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V.

ETHICAL ISSUES

With litigation in the United States becoming more and more prevalent, individuals and companies are seeking to protect themselves by obtaining insurance policies which provide both a duty to defend and a duty to indemnify when a claim is made against the policyholder/insured. One of the key elements of such insurance coverage is the duty of the insurer to defend an insured, including providing, and paying for, an attorney to represent the insured, as well as managing the defense of an insured against whom a claim has been brought. In this context, multiple issues may arise relating to the relationship of the attorney to both the insured and the insurer. The materials set forth below will address the tripartite relationship that arises when an insurer issues an insurance policy that includes a duty to defend an insured, the obligations imposed on an attorney under the applicable rules of professional conduct when an attorney is representing an insured at the request of an insurer, the circumstances that can give rise to conflicts of interest in this context and, finally, the circumstances that can trigger an insured's entitlement to independent counsel.

A. The Tripartite Relationship

It has long been recognized that insureds and insurers share a special relationship because they are in privity of contract through the insurance policy. Preferred American Insurance v. Dulceak, 302 Ill. App. 3d 990, 706 N.E. 2d 529 (2nd Dist. 1999). One of the principal reasons why individuals and entities obtain insurance coverage is to minimize or eliminate the policyholder/insured's need to retain and pay an attorney to defend it if it is named as a defendant in a lawsuit. This duty to defend obligation is regularly found in many types of insurance policies, ranging from automobile insurance through professional liability policies. One of the fundamental characteristics of such insurance policies is that insurer will assign an attorney to represent a policyholder/insured against whom a claim has been brought and, after payment of any applicable deductible, the insurance carrier will pay the attorney and direct the defense of the insured.

When an insurance carrier retains/assigns an attorney to represent an insured in a claim, the attorney is deemed to represent both the insured as well as the insurer. Rogers v. Robson, Masters, Ryan, Brumend and Belom, 74 Ill. App. 3d 467, 392 N.E. 2d 1365 (3d Dist. 1979), cited and adopted by the Illinois Supreme Court in Waste Management, Inc. v. International Surplus Lines Insurance Company, 144 Ill. 2d 178, 579 N.E. 2d 322 (Ill. 1991).

The relationship between the insurer, the insured and the attorney retained by the insurer to represent the insured is commonly described as a "tripartite relationship". Thus although it is typically the insurance company that selects, assigns and pays the attorney, an attorney-client relationship exists between the insured and the attorney which imposes upon the attorney the same professional obligations that would exist had the attorney been personally retained by the

insured. See Rogers, *supra*. As a result of this tripartite relationship, it is customary for insurance defense attorneys to provide budgets, status reports and defense recommendations to both the insurer and the insured. The tripartite relationship arises from both the terms of the insurance contract between the insurer and the insured, as well as ethical obligations/requirements that are imposed upon attorneys under applicable rules of professional conduct and court decisions that have outlined the respective obligations of insurers, insureds and attorneys representing insureds.

Thus it is common for an insurance policy to specifically provide that the insurer will defend claims brought against an insured to the extent of the applicable policy limits after the exhaustion of a deductible. It is also common that insurance policies will contain a cooperation clause requiring the insured to cooperate with its insurance carrier and the attorney assigned for the insured's defense. Furthermore, insurance policies increasingly contain language which provides that the insurance carrier will not settle a claim without the written consent of the insured, which consent is not to be unreasonably withheld.

Ordinarily the interest of the insurer and the insured are aligned with the result that the attorney assigned to represent the insured is free to exercise independent judgment for both clients (the insurer and the insured). As will be discussed further below, it is when a conflict arises between the interests of the insurer and the insured that this tripartite relationship becomes strained and far more complicated for all three parties to the relationship, particularly the attorney who has been assigned to represent the insured.

B. Rules Of Professional Conduct

As noted previously, in the tripartite relationship the attorney has an attorney-client relationship with both the insurer and the insured. In this context, the rules of professional conduct which govern the attorney's behavior, are applicable both with respect to the insurer and the insured. Thus it has long been recognized that any attorney-client relationship includes the duty of the attorney to advise the client of progress in a case or controversy, and this duty is not altered by the presence of an insurance carrier which the lawyer also represents. Rogers, supra. While the code of professional responsibility governs the conduct of attorneys in Illinois, there are certain provisions of the code which are particularly relevant in the context of the tripartite relationship. Thus Rule 1.7(a) provides that:

A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:

- (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
- (2) each client consents after disclosure.

134 Ill. 2d Rule 1.7(a).

Along the same lines, Rule 1.7(b) of the Code of Professional Responsibility provides that:

A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest, unless:

- (1) the lawyer reasonably believes the representation will not be adversely affected, and
- (2) the client consents after disclosure.

134 Ill. 2d Rule 1.7(b).

Furthermore, pursuant to Rule 1.8(e):

A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients ... unless each client consents after disclosure, including disclosure of the existence in nature of all the claims or pleas involved and of the participation of each person in the settlement.

134 Ill. 2d Rule 1.8(e).

While not designed specifically to govern the tripartite relationship, the rules of professional conduct referenced above, have clear implications and application to an attorney representing an insured pursuant to an assignment from an insurance carrier. Given the fact that both the insurer and the insured constitute “clients” of the attorney, the provision of Rule 1.7(a) come into play if the interest of an insurer and its insured become adverse during the course of the attorney’s representation. Furthermore, the provisions of Rule 1.7(b) can be triggered in the tripartite relationship as well, in a situation in which the attorney feels constrained or materially limited in his ability to represent one of his clients (either the insurer or the insured) as a result of the lawyer’s responsibilities to his other client in the tripartite relationship. Consequently, in a situation where one course of action that the attorney takes may be favorable to the insurer but have a negative impact on the insured, Rule 1.7(a) would prohibit the attorney from maintaining the multiple client relationship unless the requirements of Rule 1.7(a)(1) and (2) are met. Thus in such a situation the lawyer must reasonably believe that the representation will not adversely affect his relationship with his other client in the tripartite relationship and the attorney must make a full disclosure and obtain consent from each of the clients to continue that representation.

The provision of Rule 1.8(e) also lends itself to issues involving the tripartite relationship. Pursuant to Rule 1.8(e) an attorney retained by an insurance carrier to represent an insured is not to participate in making a settlement of a claim unless both the insurer and insured consent to the settlement, after a full disclosure. While this may not appear to generally represent a concern,

given the fact that settlements will most often be funded by the insurance carrier, there are exceptions to that general rule. As will be discussed further in Section C below, it is not unusual in the context of a professional liability claim (against an attorney or physician), for the professional to express hesitation regarding settlement of a claim because of potential adverse affects on that professional's reputation, or because settlements of medial malpractice claims are reported to the Illinois Department of Professional Regulation. Additionally, situations have begun to arise with increasing frequency, where the size of a claim against an insured represents a potential excess exposure beyond the insured's policy limit thereby potentially requiring the insured to also participate in funding the settlement. See Ivy v. Illinois State Police, 263 Ill. App. 3d 12, 636 N.E. 2d 738 (1st Dist. 1994), Illinois Municipal League Risk Management Association v. Seibert, 223 Ill App. 3d 864, 585 N.E. 2d 1130 (4th Dist. 1992) and Illinois Masonic Medical Center v. Turegum Insurance Company, 522 N.E. 2d 611, 168 Ill. App. 3d 158 (1st Dist. 1988).

C. Conflicts of Interest

I.

How Conflicts Arise

In the ordinary course of the tripartite relationship the interest of the insurer and the insured are the same with a common goal of the claim against the insured being successfully defended and no indemnity payment being made on the insured's behalf. However, this harmonious relationship between insurer and insured can often deteriorate and result in a situation where the insured's interests do not align with the insurer's interests. This conflict of interest most frequently arises when a claim is made against an insured which involves aspects of

the claim which are clearly entitled to insurance coverage and other aspects which arguably are not entitled to insurance coverage. Thus where a claim is brought against an insured and alleges intentional conduct, fraud, willful and wanton conduct and/or seeks an award of punitive damages, an insurance carrier may often issue a reservation of rights letter informing the insured that coverage may not be applicable for one or more of the claims that have been made against the insured. See for example Williams v. American Country Insurance Company, 359 Ill. App. 3d 128, 833 N.E. 2d 971, (1st Dist. 2005), Mobil Oil Corporation v. Maryland Casualty Company, 288 Ill. App. 3d 743, 681 N.E. 2d 552 (1st Dist. 1997), Nandorf, Inc. v. CNA Insurance Companies, 134 Ill. App. 3d 134, 479 N.E. 2d 988 (1st Dist. 1985) and Murphy v. Urso, 88 Ill. 2d 444, 430 N.E. 2d 1079 (Ill. 1981).

For purposes of determining whether a conflict of interest exists, Illinois courts have considered whether, in comparing the allegations of the complaint at issue to the insurance policy terms, the interest of the insurer would be furthered by providing a less than vigorous defense to certain allegations contained in a complaint brought against an insured. Nandorf, supra. Where a complaint against an insured contains claims for compensatory and punitive damages, a conflict of interest has been argued, and in some cases found to exist, because the insurance carrier purportedly has "... an interest in providing a less than vigorous defense to allegations in the ... complaint which, if proved, would have supported an imposition of punitive damages". Nandorf, supra. In such a situation the argument is made that the insurer's failure to vigorously defend allegations which are not potentially covered by the policy has the affect of subjecting the insured to a greater liability exposure.

Additional scenarios where conflicts of interest may exist between an insurer and its insured, include situations where there are multiple plaintiffs and the total damage exposure

clearly exceeds the available policy limits; where a claim has been brought against an insured and the insurer believes that there may not have been proper and complete disclosure in a policy application for insurance coverage thereby creating a potential for recession of the insurance policy applicable to the claim involved; and situations where the insurer and insured disagree over the direction/strategy for the defense and potential settlement of a case. The existence of a conflict of interest between an insurer and insured creates significant additional issues regarding the continuing activities of the assigned defense attorney and the ability of the insurance carrier to direct the defense of the case.

It has previously been held in Illinois that a conflict arises "... when the divergent interest of the insurer and insured are apparent and the attorney representing the insured can no longer represent both clients' interests without prejudice to either client". American Family Mutual Insurance Co. v. W. H. McNaughton Builders, Inc., 843 N.E. 2d 492 (2nd Dist. 2006). In such a setting, an attorney retained by the insurance carrier to represent the insured must make a complete disclosure of the conflict between the insurer and insured, and cannot continue with the insured's representation unless the insured consents to such representation with full knowledge of the divergent interest of the insurer.

II.

Discoverability Of Otherwise Privileged Communications

Although not significantly litigated, the principle has evolved that when a dispute arises between an insurer and insured regarding the availability of insurance coverage and the insured retains counsel to represent its interest in an underlying suit/matter, communications between the insured and the attorney(s) it has retained are subject to discovery by the insurance carrier,

notwithstanding an otherwise effective attorney-client privilege and the work product doctrine. See Waste Management, Inc. v. International Surplus Lines Insurance Company, 144 Ill. 2d 178, 579 N.E. 2d 322 (Ill. 1991), Allianz Insurance Company v. Guidant Corporation, 869 N.E. 2d 1042 (2nd Dist. 2007) and Western States Insurance Company v. O'Hara, 357 Ill. App. 3d 509, 828 N.E. 2d 842 (4th Dist. 2005).

Although the decision of the Illinois Supreme Court in Waste Management, *supra* has been roundly criticized by courts outside of Illinois, it remains the law in this state. The Illinois Supreme Court has stated that the attorney client privilege does not bar the production of documents exchanged between an insured and its attorney, when requested by an insurer, both because of the contractual obligations (such as the cooperation clause) contained in an insurance policy, and the “common interest” doctrine. The Illinois Supreme Court held in Waste Management, *supra* that pursuant to insurance policy terms the insurer was entitled to receive from the insured, “... any communication they had with defense counsel representing them on a claim for which the insurers had the ultimate duty to satisfy”. Waste Management, at 192. The Court reasoned that the duty of cooperation in an insurance policy is generally without limitation or qualification and that a “fair reading” of the insurance policies involved in Waste Management, *supra* left any expectation of attorney-client privilege as unreasonable. Waste Management at 192 through 193.

Additionally, with respect to the “common interest” doctrine the Illinois Supreme Court has stated that this doctrine provides that “... when an attorney acts for two different parties who each have a common interest, communications by either party to the attorney are not necessarily privileged in a subsequent controversy between the two parties”. Waste Management at 193. The Illinois Supreme Court deemed the common interest doctrine to be applicable even where an

attorney was retained by an insured and was not in direct communication with the insurer, where the attorneys' actions are for the mutual benefit of both the insured and the insurer. Thus where an insured retains an attorney to defend it in litigation for which an insurer has reserved rights or declined to assume the defense of the insured, that attorney is providing "in a limited sense" representation to the insurer since the insurer and the insured have a "common interest" in either defeating or settling for a minimal sum the underlying litigation. Waste Management at 194 through 195.

The work product doctrine has also been held to not bar an insurer from seeking production of documents from an insured in a declaratory judgment action where the requested materials were not prepared in anticipation of the declaratory judgment action between the insured and insurer, but were prepared in connection with a claim being brought against the insured by a third party which gave rise to the declaratory judgment suit. Waste Management, *supra* and Allianz Insurance Company v. Guidant Corporation, *supra*.

Additionally, the work product doctrine will not shield documents sought by an insurance carrier from the insured as a result of the "at issue" exception to the work product doctrine. The Illinois Supreme Court has held that the "at issue" exception "... permits discovery of work product where the sought after material is either the basis of the lawsuit or the defense thereof". Waste Management at 199 through 200. Furthermore, in the situation outlined above, where an insured retains counsel to defend it and a declaratory judgment action arises, the work product doctrine will not be available to bar discovery by the insured or insurer. Waste Management at 200 and Allianz Insurance Company v. Guidant Corporation, *supra*.

In summary, when a conflict of interest exists between an insurer and insured which results in the insured retaining counsel to defend it in connection with a claim, and a declaratory

judgment action is filed between the insurer and insured, the insurer will have the right to seek production of communications between the insured and its attorney, and those materials will be subject to production notwithstanding otherwise applicable attorney client privilege and work product doctrine arguments.

D. Entitlement To Independent Counsel

The Illinois Supreme Court has held that there are two principal categories of cases in which an insured is entitled to independent counsel paid for by the insurer. The first situation is one in which an insurer is obligated to provide a defense for two or more insureds who have adverse interests. See for example Murphy v. Urso, *supra*, where a passenger in an automobile sued both the driver and owner of the vehicle for injuries that arose as a result of an accident. Where the driver's interests conflicted with those of the owner each was entitled to separate counsel paid for by the insurance company, as opposed to one attorney representing both insureds. See also Williams v. American Country Insurance Company, 355 Ill. App. 3d 128, 833 N.E. 2d 971 (1st Dist. 2005).

The second situation, in which an insured is generally entitled to independent counsel arises when proof of certain facts would eliminate all or part of the insurance coverage thereby shifting the indemnity obligation from the insurer to the insured. See for example Maryland Casualty v. Peppers, 64 Ill. 2d 187, 355 N.E. 2d 24, (Ill. 1976). See also Illinois Municipal League Risk Management Association v. Seibert, *supra*. In this second scenario a complaint brought against an insured may contain allegations of negligence which are covered by the policy and allegations of intentional conduct, or conduct giving rise to punitive damages, which are arguably not covered by the insurance policy. See Nandorf, *supra*. The fact that an insured

may be exposed to significant punitive damages which are not covered by an insurance policy has been held to constitute a basis for independent counsel. See Illinois Municipal League v. Seibert, *supra*.

It is important to note that in those circumstances when an insured is entitled to independent counsel, it is not simply enough for an insurance carrier to allow the insured to select its attorney, as the insurer must relinquish control of the insured's defense to the insured but continue to pay the costs of defense.

The foregoing principals regarding the entitlement to independent counsel are well established in Illinois and can be traced back to Maryland Casualty v. Peppers, *supra* and Thornton v. Paul, 74 Ill. 2d 132, 384 N.E. 2d 335 (Ill. 1978). However the more recent decision of the Village of Lombard v. Inter Governmental Risk Management Agency, 288 Ill. App. 3d 1003, 681 N.E. 2d 88 (2d Dist. 1997) raises an issue as to whether insurance carriers can, by modifying policy language, reduce the likelihood of there being a conflict of interest and an obligation to pay for independent counsel.

In Village of Lombard the insurance policy contained a "No Coverage-No Defense" exclusion which provided that the insurer would not provide a defense or pay attorney's fees or defense costs "... for any loss, claim proceeding, suit or any other legal or administrative action or part thereof to which this coverage document does not apply and/or for which there is no coverage or indemnification afforded except at the sole discretion of [the insurer]." Additionally, the insurance policy in the Village of Lombard also contained a "Punitive Damages Exclusion" which stated that "it is agreed that this coverage does not apply to punitive or exemplary damages. In addition we will not pay defense costs nor shall we be obligated to

provide a defense for claims or legal actions in any way requesting punitive or exemplary damages, except at our discretion”.

Village of Lombard, *supra* involved an eight count complaint seeking both compensatory and punitive damages filed by a former Lombard police officer. The Village of Lombard tendered the defense of the case to its insurance carrier. While the insurer accepted the defense of the compensatory damage claims, it rejected the defense of the punitive claims on the grounds that they were not covered by the insurance policy. The court in Village of Lombard distinguished the holdings in Nandorf, *supra* and Illinois Municipal League v. Seibert, *supra*, finding that no conflict of interest existed and that the Village of Lombard was not entitled to independent counsel and was also not entitled to direct the defense of the case in its entirety. On the contrary, the appellate court stated that the plain language of the insurance policy provided that the insurer had no obligation to either defend or indemnify claims seeking punitive damages and, therefore, no duty was imposed upon the carrier to defend or indemnify those portions of the eight count complaint filed against the Village of Lombard. The court in Village of Lombard, *supra* reasoned that an insurer may properly seek through the policy’s language to contractually limit the scope of its duty to defend and that given the policy language, no conflict of interest existed which prevented the insurer’s appointed attorney from defending the Village of Lombard and its employees with respect to the covered compensatory damage claims. Because the insurer was not obligated to defend both covered and uncovered claims against the Village of Lombard, no conflict of interest existed and it was reasonable for the Village of Lombard to retain its own counsel to provide a defense with respect to the punitive damage claims.

Based upon the reasoning of the court in Village of Lombard v. Inter Governmental Risk Management Agency, *supra* it is apparent that in those situations in which an insurer undertakes

to defend both covered and uncovered claims, a conflict of interest may be argued to exist entitling the insured to independent counsel and a relinquishment of the direction of the defense by the insurer. However, where an insurance carrier specifically excludes coverage for certain of the claims at issue, there is now precedent for the insurer to argue that no conflict of interest exists and that two attorneys will defend the insured: one attorney retained and paid for by the insurance company for the covered claims and a second attorney retained and paid for by the insured to defend those claims which are not covered by insurance. In such a situation, it appears incumbent upon the insured to take the appropriate steps to coordinate its defense by both attorneys acting on its behalf.

The discussion contained herein was not intended to be all encompassing on the topic of Ethical Issues in the insurance context. Should you have any questions regarding the points discussed in this presentation, or a point that was not addressed herein, please feel free to contact Howard L. Lieber at FISHER KANARIS, P.C.