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TABLE OF CONTENTS

I.	INTRODUCTION	1-3
A.	Conflicts	1
B.	Identifying the Conflict.....	1
C.	<i>Cumis</i>	1-2
D.	“ <i>Cumis</i> ” in Illinois: “ <i>Peppers</i> ”	2-3
E.	The Consequence of Ignoring a Conflict.....	3
F.	Types of Potential Conflicts	3
II.	MOST CITED ILLINOIS CONFLICT CASES.....	3-4
III.	CONFLICT COUNSEL.....	4-8
A.	Multiple Insureds – Same Policy	4
B.	Multiple-Count Complaints	5
C.	Excess of Policy Limits	5
D.	Misconduct	5
E.	Who Selects Independent Counsel	5-7
1.	Multistate	5-6
2.	Illinois	6-7
F.	Additional Tenets of Law	7-8
IV.	ESTOPPEL	8-11

I.

INTRODUCTION

A. Conflicts

In general, conflicts arise as a result of the insurance contract providing for the insurer to have exclusive control of the defense of its insured and under the same policy questioning the coverage and/or representing multiple parties under the same policy.

B. Identifying the Conflict

A rule of thumb in identifying a conflict:

1. Will the defense of the insured lead to information to defeat coverage or indemnity under the policy? I.e., will a liability report to the insurer give the insurer facts and evidence to take the claim outside of coverage?

2. Are my actions in any way potentially lessening in quality or quantity the available insurance to my insured?

3. Is the same adjuster and counsel being asked to defend multiple defendants with different interests covered under the same policy?

If the answer to any one question is “yes,” the probability is a conflict.

C. Cumis

One of the country’s most famous cases concerning the insured’s right to conflict counsel is San Diego Navy Federal Credit Union v. Cumis Insurance Society, 162 Cal. App.3d 358, 208 Cal. Rptr. 494. Although since overruled by statute, (Cumis has been superseded by California Civil Code section 2860) it remains a synonym for “conflict counsel.” The concept holds:

- A coverage dispute between insurer and insured creates a conflict of interest.

- A conflict arises once the insurer takes the view that a coverage issue is present.
- A serious conflict of interest occurs when insurer's retained counsel obtains information bearing directly on the issue of coverage during the course of preparation of the underlying suit.
- In actions in which the insurer and insured have conflicting interests, the insurer may not compel the insured to surrender control of the litigation. If the insurer must pay for the cost of defense and, when a conflict exists, the insured may have control of the defense if he wishes, it follows the insurer must pay for such defense conducted by independent counsel.

D. "Cumis" in Illinois: "Peppers"

In Illinois, the synonym for conflict counsel is "Peppers." In Maryland Casualty Co. v. Peppers (64 Ill.2d 187, 355 N.E.2d 24), the court described the conflict of interest which arose in that case:

"In the personal injury action if [the insured] is held responsible, it would be to his interest to be found negligent, which, under the policy of his insurance, would place the financial loss on [the insurer]. On the other hand it would be to [the insurer's] interest to have a determination that [the insured] intentionally injured Mims, which, by the terms of the policy, would relieve [the insurer] of the obligation to pay the judgment."

Maryland Casualty Co. v. Peppers, 64 Ill.2d at 197.

According to the Peppers court, such a conflict created "serious ethical questions" which would prohibit an attorney from representing both the insurer's and the insured's interests. Maryland Casualty Co. v. Peppers, 64 Ill.2d at 198. The court in Peppers, however, noted that the insured in that case retained his own counsel and was, at all times, represented by his own attorney.

Maryland Casualty Co. v. Peppers, 64 Ill.2d at 196.

As to conflict estoppel, the insurer is in a much stronger scenario when the insured has its own counsel where the insurer would be benefited by a finding of an exclusion, while such a finding would have subjected the insured to noncoverage.

Defending under a reservation and filing a declaratory may cure a conflict. In Fidelity & Casualty Co. v. Envirodyne Engineers, Inc., 122 Ill.App.3d 301, 461 N.E.2d 471 (1983), the insurer exercised its options to defend under a reservation of rights and to file a declaratory judgment action.

Distinguishing other fact situations, the Envirodyne court stated:

“A related but different situation may arise when the insurer defends its insured in the underlying action but does not either defend under a reservation of rights or file a declaratory judgment proceeding. If the insurer later contests the issue of coverage, it may be estopped from denying its own liability under the policy. (See Apex Mutual Insurance Co. v. Christner, 99 Ill.App.2d 153, 240 N.E.2d 742.)”

Fidelity & Casualty Co. v. Envirodyne Engineers, Inc., 122 Ill.App. 3d at 306 n.1.

E. The Consequence of Ignoring a Conflict

The consequence of failing to ignore the conflict is estoppel: the inability to deny coverage, indemnity or defense under the policy irrespective of the insurance agreement.

F. Types of Potential Conflicts

1. When issues or facts to be decided or developed in the litigation may affect the coverage question. Maryland Casualty Co. v. Peppers, 64 Ill.2d 187, 355 N.E.2d 24 (1976).

2. When it may be advantageous for the insurer if defense counsel provides a less than vigorous defense. Nandorf, Inc. v. CNA Insurance Cos., 134 Ill.App.3d 134, 479 N.E.2d 988 (1st Dist. 1985).

3. When the insurer represents multiple parties as insured relative to the same occurrence.

II.

MOST CITED ILLINOIS CONFLICT CASES

Maryland Casualty Co. v. Peppers, 64 Ill.2d 187, 355 N.E.2d 24 (1976);

Thornton v. Paul, 74 Ill.2d 132, 23 Ill.Dec. 541, 384 N.E.2d 335 (1978);

Murphy v. Urso, 88 Ill.2d 444, 58 Ill.Dec. 828, 430 N.E.2d 1079 (1981);

Aetna Casualty & Surety Co. v. Dichtl, 78 Ill.App.3d 970, 34 Ill.Dec. 759, 398 NE.2d 582 (2nd Dist. 1979);

Home Ins. Co. v. Lorelei Restaurant Co., 83 Ill.App.3d 1083, 39 Ill.Dec. 304, 404 N.E.2d 895 (1st Dist. 1980); and

Pekin Ins. Co. v. Home Ins. Co., 134 Ill.App.3d 31, 89 Ill.Dec. 72, 479 N.E.2d 1078 (1st Dist. 1985).

III.

CONFLICT COUNSEL

A. Multiple Insureds – Same Policy

In general, if coverage under the same policy is triggered by multiple insureds or additional insureds and those parties have a right to contribution, indemnity, subrogation or set-off (contract or common law), then there is a conflict in the same counsel representing all parties.

Generally liability insurance policies allow the insurer exclusive control over litigation against the insured. The insurer must defend the insured in all actions against it covered by the policy even though the suit may be groundless, false or fraudulent. With regard to this duty to defend, an insurance company may face an irreconcilable conflict of interests when it undertakes to represent several insured defendants who have antagonistic interests. The insurer must provide independent counsel for each insured in order to avoid the conflict. Moreover, an insurer has been required to pay for an insured's independent counsel where a conflict of interest arises because the insurer offered to defend only under a reservation of its rights under the policy, which offer was refused by the insured.

B. Multiple-Count Complaints

Another conflict is the tender of a lawsuit which contains both covered and non-covered allegations. The most common example is a complaint alleging both negligence and willful and wanton conduct.

Many conflict of interests cases arise in the situation where the complaint filed against the insured contains allegations which are potentially both within and outside policy coverage. Often in such a situation the insurer will seek to defend only on the grounds that remove the insured from coverage, whereas the insured will seek a defense on any grounds. The courts have almost uniformly concluded that the existence of such a conflict obligates the insurer to assume the cost of retaining independent counsel for the insured.

C. Excess of Policy Limits

Another situation in which a conflict of interest between the insured and the insurer may arise is where the complaint seeks damages in excess of the policy limits.

The typical situation is a death case on a \$50,000 policy and the insurer refusing to tender the limits and continuing in the defense.

D. Misconduct

Yet another situation in which a conflict of interests between an insured and an insurer may arise is where the insured alleges misconduct by the insurer in managing the defense.

E. Who Selects Independent Counsel

1. Multistate

At times, courts in those jurisdictions which impose a duty on the insurer to provide independent counsel are also called upon to determine whether the insurer or the insured has the right to select independent counsel. Most courts appear to allow the insured to select independent counsel when a conflict of interests arises. However, one court has held that the insurer may select

the independent counsel where the conflict arises because the insurer undertakes to represent several insured with antagonistic positions in the same action. Several jurisdictions have allowed an insurer to retain the right of reasonable participation in the selection of independent counsel. Finally, one court has indicated that an insurer has the option of either providing independent counsel or allowing the insured to choose.

2. Illinois

The law in Illinois is quite “complicated” because prejudice must be shown to the insured and prejudice is a question of fact. *See Maryland Casualty Co. v. Peppers*, 64 Ill.2d 187, 195, 355 N.E.2d 24 (1976).

In Illinois, several questions exist:

1. Is the insured already represented by its own counsel?
2. Is the insured sophisticated?
3. Did the conflict occur prior to retaining counsel; or during the pending of the defense?
4. Is the insured being defended under a reservation of rights?

In light of Peppers and the prejudice and fact standards, there are no clear cases laying out a matrix. For instance, the complaint alleges willful and negligence. The insurer defends under a reservation of rights (ROR) and selects counsel. The insured does not object. Unless something happens midstream. . . no conflict.

Another situation: An insured is denied coverage since the allegations are willful. He has personal counsel defend. The complaint is amended to add negligence and tendered. Tender is accepted under an ROR . Probably a bad idea to select and substitute counsel. In general, the insured’s initial acceptance and defense under a ROR is not challenged. Prejudice may become an

insurmountable burden for the insured.

Often it is only when an insurer offers to defend under a reservation of rights that the conflict of interest between the insured and the insurer becomes apparent. An insurer may be able to avoid the conflict if the insured accepts a defense under a reservation.

F. Additional Tenets of Law

An insurer taking the position that a complaint potentially alleging coverage is not covered by a policy which provides that the insurer has the right and duty to defend any claims brought against the insured cannot simply refuse to defend the insured. It must defend the suit under a reservation of rights or seek a declaratory judgment that there is no coverage. If the insurer fails to do this, it is estopped from later raising policy defenses to coverage and is liable for the award against the insured and the costs of the suit, because the duty to defend is broader than the duty to pay. Sims v. Illinois National Casualty Co., 43 Ill.App.2d 184, 199 (1963). An insurer must decline to defend where there is a conflict of interest between it and the insured. Thornton v. Paul, 74 Ill.2d 132, 152 (1978); Maryland Casualty Co. v. Peppers, 64 Ill.2d 187, 198-99 (1976). Instead of participating in the defense itself, the insurer must pay the costs of independent counsel for the insured. 74 Ill.2d 132, 162; 64 Ill.2d 187, 199.

The insurer facing a conflict of interest with its insured in the conduct of the insured's defense is not obligated or permitted to participate in the defense. Thornton v. Paul, 74 Ill.2d 132, 152 (1978); Maryland Casualty Co. v. Peppers, 64 Ill.2d 187, 198 (1976). It makes no difference whether the conflict is with a putative insured instead of directly with the named insured. An argument over exclusion from policy coverage is, for these purposes, really no different from an argument over inclusion. The particulars of the conflict of interest do not matter, only the fact that there is a conflict at all. The insured has the right to be defended by counsel of his own choosing.

The court will not require an insured to be defended by what amounts to his enemy in the litigation.

Failure to assert a defense of noncoverage, however, must result in some prejudice to the insured.

IV.

ESTOPPEL

In general, estoppel will not apply if the insured accepts counsel under the ROR; or, pays the insured's counsel.

The estoppel doctrine provides that an insurer which contends that a complaint potentially alleging coverage is not covered under a policy which includes a duty to defend may not simply refuse to defend the insured. Such insurer must defend the suit under a reservation of rights or seek a declaratory judgment that there is no coverage. If the insurer fails to do this, and is subsequently found to have wrongfully denied coverage, it is estopped from later raising policy defenses to coverage. Waste Management, Inc. v. International Surplus Lines Insurance Co., 144 Ill.2d 178, 207-08, 579 N.E.2d 322, 161 Ill.Dec. 774 (1991); Maryland Casualty v. Peppers, 64 Ill.2d 187, 355 N.E.2d 24 (1976). This principle is based upon the general principle of contract law that a party who has breached the terms of its contract may not rely on the terms of the same contract to avoid its obligations. M/A Com, Inc. v. Perricone, 187 Ill.App.3d 358, 543 N.E.2d 228, 134 Ill.Dec. 945 (1989), citing Kinnan v. Charles B. Hurst Co., 317 Ill.251, 148 N.E.12 (1925).

The conflict of interest and possible prejudice problems are avoided because under Maryland Casualty Co. v. Peppers, 64 Ill.2d 187, 198-99, 355 N.E.2d 24 (1976), the insured would be represented by its own attorney and because plaintiff could raise noncoverage in a subsequent suit on the policy.

Maryland held that absent the acceptance of the defense by the insured after full disclosure by the attorney of the conflicting interests arising because of the insurer's interest in a finding that the insured intentionally injured plaintiff, which was one of the ultimate facts upon which recovery was predicated, and absent the insurer's waiver of the defense of noncoverage, the insured has the right to be defended by an attorney of his own choice who will have the right to control the conduct of the case. Maryland, 64 Ill.2d at 198-99. The court also held that the insurer had to reimburse the insured for the reasonable cost of defense and that the insurer was not barred from subsequently raising the defense of noncoverage in a suit on the policy because the issue of coverage could not have been determined in the declaratory judgment action prior to the resolution of the third party's suit against the insured. Maryland, 64 Ill.2d at 199. Thornton v. Paul, 74 Ill.2d 132, 155, 159, 384 N.E.2d 335 (1978), also held that in the case of the insurer's conflict of interest, the insurer's obligation to provide a defense should be satisfied by reimbursing the insured for the defense costs.

Neither Maryland nor Thornton adopted the holding of Burd v. Sussex Mutual Insurance Co., 56 N.J. 383, 267 A.2d 7 (1970), that the insurer could reimburse the insured for costs of defense later, after an adjudication that the claim was one within the covenant to pay. But neither of these cases nor the cases of Pepper Construction Co. v. Casualty Insurance Co., 145 Ill.App.3d 516, 495 N.E.2d 1183 (1986); or Illinois Masonic Medical Center v. Turegum Insurance Co., 168 Ill.App.3d 158, 522 N.E.2d 611 (1988), clearly state that reimbursement is to occur before the resolution of the third party's suit against the insured.

Village Management, Inc. v. Hartford Accident & Indemnity Co., 662 F.Supp. 1366, 1374 (N.D. Ill. 1987), which held that when the insured has to hire its own counsel because of the insurer's conflict of interest, the insurer has the duty to reimburse the defense costs as they are incurred. Village reasons that the insured could not be provided an effective defense if it was reimbursed only at the end of the case. (662 F.Supp. at 1374). Village found that the suggestion in Burd that the insurer could reimburse the insured after policy defenses were resolved was hard to reconcile with the concept that the duty to defend was not coextensive with policy coverage. 662 F.Supp. at 1374 n. 13.

However, when there is a conflict of interest between the insurer and the insured, the insurer should not be obligated or permitted to participate in the defense of the case. Thornton, 74 Ill.2d 132, 152; Associated Indemnity Co. v. Insurance Co. of North America, 68 Ill.App.3d 807, 821, 386 N.E.2d 529, appeal denied, 75 Ill.2d 589 (1979). Their obligation to provide a defense should be satisfied by reimbursing the insured for costs of the defense. Thornton, 74 Ill.2d 132, 152). Otherwise, to require the insurer to defend "would put the insurer and the insured in the untenable position of attempting to cooperate in the conduct of the litigation where their interests were, in fact, adverse." Thornton, 74 Ill.2d 132, 154, 83 Ill.App.3d 1083, 404 N.E.2d 95 (1980).

Whether an insured is prejudiced by an insurer's conduct in assuming the defense of an action is a question of fact. Peppers, 64 Ill.2d at 196. Where the insurer's assumption of the defense has induced the insured to surrender his right to control his or her own defense, he or she has suffered a prejudice which will support a finding that the insurer is estopped to deny policy coverage. Peppers, 64 Ill.2d at 996. A party claiming the benefit of estoppel must prove reasonable reliance upon the acts or representations of the party sought to be estopped, without the knowledge of or convenient means of learning the true facts. National Ben Franklin Insurance Co. v. Davidovitch, 123

Ill.App.3d 88, 93, 462 N.E.2d 696, 78 Ill.Dec. 577 (1984).

Conflict "Cumis" Counsel 5-1-07 Seminar (00545209.DOC)