Seventh Circuit Expands on Illinois Law Regarding Insurer’s Duty to Provide Independent Counsel Due to Conflict of Interest

By William K. McVisk

When insurers defend their insureds in liability actions, they have long had to be careful to protect the interests of the insured while still protecting their own interests. Illinois courts have addressed two scenarios where the conflicting interests of the insured and the insurer are particularly difficult to reconcile: (1) where the insurer’s coverage defenses create an incentive for the insurer to defend the case in a way that would maximize the insurer’s potential to prevail on its coverage defenses, even though that might create more exposure to the insured; and (2) where the verdict potential of the case substantially exceeds the insurer’s policy limit, so that the insurer might be inclined to try the case rather than settle it within its limit in the hope that it will obtain a defense verdict and therefore pay nothing rather than paying all or most of its limit to settle the claim. Illinois courts have adopted two different approaches to reconciling these potential conflicts. For the first situation, Illinois courts have ruled that when the insurer’s coverage defenses create a conflict of interest with the insured, the insurer must give the insured the right to retain counsel of its own choosing, to be paid for by the insurer. E.g., Maryland Cas. Co. v. Peppers, 64 Ill.2d 187, 193, 355 N.E.2d 24, 28 (1976); Illinois Masonic Medical Center v. Turegum Ins. Co., 168 Ill.App.3d 158, 163, 522 N.E.2d 611, 613 (1st Dist. 1988). In the case where the verdict potential exceeds the policy limits, insurers generally maintain control over the defense of the case, but if the insurer acts in bad faith by unreasonably failing to settle the claim within its limit, the insurer will be liable for the full amount of the verdict or judgment entered against the insured, even though it exceeds the policy limits. E.g., Haddick v. Valor Insurance, 198 Ill.2d 409, 763 N.E.2d 299 (2001); O’Neill v. Gallant Ins. Co., 329 Ill. App. 3d 1166, 769 N.E.2d 100 (5th Dist. 2002).

Despite the clear demarcation between these two lines of cases, the Seventh Circuit Court of Appeals recently ruled that under Illinois law, an insured is entitled to independent counsel whenever there is a substantial likelihood that the verdict in the case will exceed the insurer’s policy limit. R.G. Wegman Constr. Co. v. Admiral Ins. Co., 2011 U.S. App. LEXIS 679 (7th Cir. Jan. 14, 2011). In Wegman, Admiral issued a policy to Wegman with limits of $1 million. A worker at one of Wegman’s construction sites was injured on the job, and sued Wegman. Admiral defended the case through trial and a judgment was entered against Wegman for $2 million, $1 million in excess of Admiral’s limits. The court acknowledged that when the case was first assigned to defense counsel, neither Admiral nor Wegman had any reason to believe the case would exceed the policy limit. However, according to the court, when the plaintiff was deposed and revealed the extent of his injuries, Admiral learned that a judgment or settlement could well exceed its $1 million limit. The court stated that this “likelihood created a conflict of interest by throwing the interests of Admiral and Wegman out of alignment.” The court went on to state that when such a conflict of interest exists, the insurer’s duty of good faith requires that it notify the insured. The court acknowledged that this usually occurs when the insurer denies coverage, but considered the principle to be the same when the conflict arises from the relationship between the policy limit and the insured’s potential liability.

The court carried this further by concluding that once notified of the conflict, the insured has the option to hire a new lawyer, whose loyalty will be exclusively to the insured, to be paid for by the insurer. According to the court, the new lawyer “would have tried to negotiate a settlement with [the plaintiff] that would not exceed the policy limit; and if the settlement was reasonable given the risk of an excess judgment, Admiral would be obligated to pay.”

Much of the court’s opinion seems to have been supported by the fact that the insurer not only failed to notify the insured of a conflict of interest, but failed to notify the insured that the judgment was likely to exceed the policy limits. As a result, the insured did not notify its excess carrier, so the excess verdict was not covered by excess coverage. Nevertheless, the import of the court’s decision cannot be overemphasized. If followed by Illinois state courts, it creates a right of independent counsel whenever there is a substantial likelihood of an excess verdict. Moreover, the court’s ruling that the independent counsel can negotiate a settlement, apparently without the insurer’s consent, which the insurer will have to pay if reasonable, takes control of the insurer’s funds and right to settle away from the insurer and gives it to the insured, in violation of the terms of the policy which give the power to settle to the insurer.

The decision in Wegman raises the question of why the court considered it necessary to mix up the concept of conflict of interest created by coverage defenses with the problems created by the potential for an excess verdict. Illinois insureds have long had a remedy for an insurer which gambles with the insured’s money in the face of a potential excess verdict: an action against the insurer for bad faith failure to settle. This protection has adequately protected the insured’s rights by ensuring that the insurer will consider the insured’s interests in avoiding an excess verdict at least equal with its own rights. However, the conflict of interest standard does not fit this situation. In
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a case presenting excess exposure, both the insured and the insurer have an interest in a strong defense that will result in a verdict of non-liability or a low settlement. There is no need for independent counsel. Nor is there any need to take away the insurer’s control of settlement, when the insurer’s obligations to the insured mandate that it consider the insured’s interests at least equally with its own when faced with a potential excess verdict.

No previous Illinois state court case has gone as far as the court did in Wegman. However, as long as Wegman stands without being challenged by an Illinois appellate court, insurers must be aware of the risk they face if they fail to appoint independent counsel when there is a substantial risk of an excess judgment. At the same time, insureds concerned about excess judgments should seek to have the insurer appoint an independent counsel to represent them and potentially settle the claim. Insureds must be cautious though, since a decision to settle without the agreement of the insurer could backfire if future courts do not follow Wegman. ♦