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Conflicts and the Use of Independent Counsel
By Scott O. Reed

When regularly advising or representing clients on litigation-related matters, one is likely to encounter the situation in which the client and its insurer are in a conflict of interest. The general rule is that the insurer is not entitled to control the defense and must appoint independent counsel, also known as *Peppers* counsel,**[1]** at its own expense to defend the insured.**[2]** The existence of a conflict or *Peppers* situation may raise questions for the attorney and client about the client's rights, and particularly what it is entitled to expect from the insurer and from the defense counsel it chooses. Should the insurer's coverage position be challenged? Should the defense provided by the insurer be accepted, and if not, what is the alternative? What happens if the insurer's defense is accepted, but there is concern over the manner in which the defense is being handled?

The published cases in Illinois provide some instruction on the duties of the insurer and the duties of its defense counsel when the insurer's interests conflict with the insured. They may not answer all the questions which the attorney or client may have in the conflict situation, but this survey of those authorities is designed to give practitioners a start in identifying the sources to consult to begin to find the answers.

What Conflicts of Interest Require the Offer of Independent Counsel?

The reporters have many cases discussing the subject of an insurer's conflict of interest with its insured. Putting them into a consistent framework to be able to answer whether a conflict exists in any particular situation, however, is somewhat more difficult. Recently, Judge Leinenweber of the Northern District of Illinois considered the different lines of authority on this question in *Nautilus Insurance Co. v. Dubin & Associates, Inc.***[3]**

Judge Leinenweber noted that some Illinois states and federal court cases adopt the most restrictive test for a conflict between the insurer and insured – one which he described as the "either/or" test. Under this view, the only time an insurer's interests conflict with the insured's are when there are two mutually exclusive outcomes, either of which benefits the insurer. The classic example of this type of conflict is where the complaint against the insured alleges negligence and intentional battery. In that situation, the insurer benefits either if the insured successfully defends the case or loses it on the grounds of intentional battery, which is not covered.**[4]**

The other test mentioned in *Dubin* does not require an "either/or" situation for a conflict, but states that a conflict exists if the insurer lacks the incentive to defend a claim or part of the case which is not covered under its policy.**[5]** Judge Leinenweber concluded that this more expansive view of what constitutes a conflict between insurer and insured is the view followed by more recent Illinois cases.**[6]** Another way to describe this test is not that the insurer is engaging in conflict harmful to the insured, but rather that their "interests are divergent, which creates a potential for such harm."**[7]** Just because an insurer may have (1) equal interest in negating coverage for all counts of the complaint or (2) a shared interest with the insured in defeating the underlying claim will not be dispositive of the existence of a conflict.**[8]**

Examples of Conflicts of Interest

What do these tests mean in practice? What conflicts are deemed "serious conflicts" which require the insurer to provide independent or conflicts counsel to defend the insured at the insurer's expense? It is important to have a general sense of what constitutes a conflict, because while insurers do generally recognize conflicts and apprise their insureds of them, it cannot be assumed that this will always be the case.

Intentional/negligent acts. The most common situation in which a *Peppers* conflict is found to exist is where the insured is charged with injuring the plaintiff both by negligent conduct, or, alternatively, by acting with the intent to injure.**[9]** These types of conflicts often arise in claims arising out of batteries and shootings, but they can arise in other contexts as well. For example, where a defamation claim included allegations that the defamation was made by the insured with knowledge of the statements' falsity, a conflict existed precluding the insurer from controlling the defense.**[10]**

Damage outside policy period. Another potential conflict arises where the complaint alleges property damage, bodily injury or advertising or personal injury occurring outside the policy period.**[11]** These types of cases can include long-term exposure cases such as asbestos or pollution claims, or professional liability claims arising from a continuous series of wrongful acts (including those taking place while the professional is affiliated with different institutions or professional firms).

Agent acting outside scope of authority. Defending multiple insureds with differing interests can present a conflict of interest for the insurer. This situation often arises in the principal-agent relationship. In *Murphy v. Urso*,**[12]** a preschool van driver was involved in an accident while using the van for personal purposes after work. In the claimant's suit against the preschool and the van driver, the Illinois Supreme Court held that the insurer operated under a conflict of interest which prevented it from defending both defendants because the insurer's interests would be served by a finding that the driver was acting outside the scope of his authority for the preschool and therefore was not covered under the preschool's policy. As the Supreme Court explained, the insurer had to pick a defense strategy – was the driver acting within or outside his authority? – which it could not do without harming one of the two defendants.**[13]**

Exclusionary language. In a similar situation to the principal/agent scenario, the presence of an exclusion for bodily injury to employees created a conflict of interest requiring independent counsel where the insured contended that the injured worker was not an employee but was a "leased worker," a category expressly excepted from the exclusion.**[14]** Other exclusionary language is likely to give rise to a conflict of interest where the facts on which the application of the exclusion would rest will be presented in the underlying action, where defense counsel can develop them to benefit either the insurer or the insured. One example is a general liability insurer's assertion of a professional liability exclusion in a claim against an insured engineering firm.**[15]**

Punitive damages. The existence of a punitive damage claim may or may not give rise to a conflict. The mere fact that punitive damages are sought – or may potentially be sought in the future – does not alone give rise to a conflict requiring the appointment of separate counsel.**[16]** However, under the "peculiar facts" of *Nandorf, Inc. v. CNA Ins. Cos.***[17]** where the claim for punitive damages was "greatly

counsel.[16] However, under the "peculiar facts" of *Nandorf, Inc. v. CNA Ins. Cos.*[17] where the claim for punitive damages was "greatly disproportionate" to the amount of compensatory damages sought, a conflict of interest requiring appointment of independent counsel existed.[18] There is some question whether cases such as *Nandorf* will have much going-forward effect, given that it is highly unusual for a party to plead a specific amount of punitive damages requested, and if such a pleaded amount is disproportionate to the requested compensatory damages, there may be a question of the constitutionality of the punitive damages request. Additionally, if the insurer expressly disclaims in its policy the duty to defend punitive damages claims (an unusual arrangement), the presence of such a claim does not create a conflict of interest requiring appointment of independent counsel to defend the compensatory damages claim.[19]

Construction Defects. In *Stoneridge Development Co. v. Essex Ins. Co.*,[20] the insured contended that the insurer had a conflict of interest in defending against a homeowner's construction defect claim which, while pleaded as breach of contract, could also raise the breach of the implied warranty of habitability. The insured argued that the insurer's reference to damages sought as "contractual" and therefore not an "occurrence" suggested that the insurer would not cover any implied warranty claim. The Appellate Court disagreed, pointing out that the insurer's coverage position was based on the construction defects not being an "occurrence," and the possibility that there was no damage to "other property", not on any dichotomy between contractual and implied warranty theories. In other construction defect cases, issues of damage outside the property period (discussed above) can create a conflict of interest.[21]

The Insurer Must Give Adequate Notice and An Explanation of the Conflict

The first duty of the insurer faced with a conflict in defending its insured is to give the insured notice of the existence of the conflict and a sufficiently detailed explanation of the basis for the conflict so that the insured can make an informed decision as to whether to accept the defense counsel proposed by the insurer. A group of Illinois cases states exactly what is required of an insurer to meet this standard.

In *Allstate Insurance Co. v. Carioto*,[22] an insured was sued for stabbing a robbery victim when the insured was intoxicated. The victim alleged that the insured acted either negligently or intentionally. Defense counsel advised the insured that a conflict of interest arose because it was in the insurer's interest to have a determination that the insured intentionally injured the victim. The insured signed defense counsel's letter and accepted the defense it offered. The Appellate Court held that this letter was inadequate, because it neither told the insured that defense counsel was regularly retained by the insurer, nor did it explain exactly how the intentional/negligent act issue created a conflict for counsel. The *Carioto* court "strongly discouraged" defense counsel's practices as referenced in the letter, even though it decided the case on grounds other than an estoppel created by an insufficient conflicts letter. The court said that it would be more likely to find the insurer's declaratory action premature if the insurer had attempted to use statements made by defense counsel in the pleadings to support a request for a declaration.

The insurer's reservation letter was deemed insufficient in *Utica Mut'l. Ins. Co. v. David Agency Insurance, Inc.*,[23] where the underlying suit was a business tort action containing a count that the insured defamed the plaintiff by making statements which it knew to be false. The insurer raised the coverage issues relating to willful and intentional conduct, but did not explain how this created a conflict for the defense counsel it retained. Moreover, it compounded the error by advising that the insured could, at its own expense, hire a personal attorney to protect against uncovered losses. The District Court noted that there was no Illinois authority requiring that the insurer specifically say that it will pay for conflicts counsel, but it certainly cannot suggest otherwise.[24]

In *Royal Insurance Co. v. Process Design Associates, Inc.*[25] the general liability insurer referred to its policy's professional liability exclusion in a reservation of rights for a claim against its insured, an engineering firm. But the letter was indefinite on that point, and stated that if an amended complaint or third-party complaint were to be filed alleging professional negligence, then the insurer may not continue funding the defense and the insured's professional liability insurer may become involved. The Appellate Court found that the letter did not unequivocally and clearly inform the insured that the insurer intended to rely on that defense under all circumstances, not just under the possibility of future pleadings. One important point from this case is that a conflict is tested by reviewing the insurer's reservations of rights – whether or not the underlying complaint against the insured makes allegations which support those stated reservations.[26]

In *Williams v. American Country Insurance Co.*,[27] the insurer raised an intentional acts defense to a cab driver insured under its policy, based on the fact that the underlying claim included allegations of battery. However, not only did it not explain that this created conflict for its retained defense counsel, it refused the insured's request for independent counsel. The Appellate Court found that these acts not only created an estoppel to deny coverage but also warranted an award of fees for the declaratory action and penalties under the Illinois Insurance Code for the insurer's "vexatious and unreasonable" conduct.[28]

By contrast, the Appellate Court deemed the conflicts letter in *Standard Mutual Insurance Co. v. Lay*[29] to be sufficient. That letter explained all of the several potential conflicts areas the insurer's reservation of rights raised in a telephone-fax claim, including the intentional/negligent acts conflict and the fact that the statutory damages sought by the class of plaintiffs were in the nature of excluded penalties. Illinois law does not require an insurer to state all of its reservations of rights or risk waiving them forever.[30] But if the coverage defenses are of such a nature as would create a conflict requiring the appointment of independent counsel, they must be raised by the insurer and the conflict explained, or the insurer risks an estoppel.[31]

Consequences for failure to raise or explain the conflict are severe for the insurer. The Appellate Court explained the rationale for those consequences in *Cowan v. Insurance Co. of North America*,[32]

it is important that the insurer adequately inform the insured of the rights which it intends to reserve; for it is only when the insured is adequately informed of the potential policy defense that he can intelligently choose between retaining his own counsel or accepting the tender of defense counsel from the insurer. Accordingly, bare notice of a reservation of rights is insufficient unless it makes specific reference to the policy defense which may ultimately be asserted and to the potential conflict of interest. If the insurer has adequately informed the insured of its position, and the insured accepts the tender of defense counsel, the insurer has not breached its duty of loyalty and is not equitably estopped from denying its obligation to indemnify.

Illinois courts have found waiver of a wide variety of coverage defenses, including many of those discussed above as examples of defenses which create a conflict, when the insurer failed to give the insured adequate explanation of the conflict.

Duties of the Insurer and its Defense Counsel Where a Conflict Exists

If the insurer's offer of a defense is accepted by the insured, notwithstanding the existence of a conflict, there are still duties and obligations to the insured which the insurer and its defense counsel must take care to honor. The insurer "remains bound, however, both ethically and legally, to protect the interests of the insured in the defense of the tort claim. The latter obligation is separate and distinct from the insurer's duty to inform the insured of its position, and is not waived ... by mere acquiescence to the conduct of the insurer."[33] The defense counsel retained by the insurer has ethical obligations both to the insurer and insured, whether or not there is a conflict of interests.[34]

An insurer cannot take any steps to alter the complaint against the insured so as to prejudice its interests in its insurance coverage. This rule, which is applicable both when there is a conflict and when there is not a conflict, was explained in *Lockwood Int'l. v. Volm Bag Co.*,

[35] 273 F.3d 741 (7th Cir. 2001), a case decided under Wisconsin law. In *Volm Bag*, the Seventh Circuit held that an insurer cannot settle with a claimant by resolving covered claims only and then insisting that the claimant re-plead the remaining covered claims as non-covered claims. This conduct was held to be bad faith under Wisconsin law. The Seventh Circuit noted that if the covered claims drop out of the case by settlement or otherwise, the insurer's duty to defend the insured stops. The insured, however, cannot:

prevent the insurer from settling covered claims for an amount that protects the insured from having to pay anything on those claims out of his own pocket, merely because the settlement, by giving the insured all that he contracted for, will terminate the insurer's duty to defend the entire suit. ... But [the insurer] did not merely settle covered claims; as part of the settlement it paid [the claimant] to convert some of the covered claims to uncovered claims. That was not dealing in good faith with its insured.**[36]**

The court posed an example of a suit involving two covered claims, of which the insurer could settle one for $1 million and both for $2 million, which is more than it wants to pay. Hypothetically, the insurer:

> says to the plaintiff, "I'll give you $1.5 million to settle the first claim if you'll agree to redraft the second so that it's an uncovered claim, which you can of course continue to press against my insured." The only purpose of such a deal would be to spare the insurance company the expense of defending against the second claim, even though it was a covered claim when filed and would have continued to be a covered claim had it not been for the insurer's bribe of the plaintiff.**[37]**
>
> *Volm Bag* makes plain that the insurer's only obligations are to defend and settle covered allegations, as long as they remain in the case. If the insurer does not re-cast covered claims as non-covered claims, it may settle only covered allegations, leaving the insured to defend the non-covered claims at its own expense without committing any form of bad faith or breach of contract.

On the other hand, the insured's counsel does not do anything wrong by encouraging the plaintiff's counsel to plead into coverage, or even in giving some more precise guidance to do so. There appears to be no published Illinois law on this issue. However, a trial level decision from Maine, *Messier v. Commercial Union Insurance Co.*,**[38]** held that an insured's defense counsel did not breach the insured's cooperation clause when, as agent for the insured, he told the plaintiff to amend a complaint originally alleging only intentional acts to include allegations of negligence. One Illinois circuit court has considered *Messier* to be persuasive in dismissing breach of cooperation allegations against an insured for similar conduct.**[39]**

The duty not to impair the insured's coverage extends to the insurer's retained defense counsel. The attorney-client relationship is a fiduciary one.**[40]** While that status would appear to imply that defense counsel must take appropriate actions to maximize and preserve the client's insurance coverage, in Illinois, that duty has been made even more explicit by an ethical opinion. The Illinois State Bar Association issued Advisory Opinion on Professional Conduct, No. 92-2, which addressed the situation of counsel's reporting to the insurer on facts which could potentially affect the client's coverage. The Advisory Opinion concluded that:

The attorney retained by an insurance company to defend its insured owes a duty to the insured not to disclose facts to the insurer which might prejudice the insured's rights in a potential coverage dispute with the insurer; the insured may thus require that counsel's reports be edited to delete this information. Disagreement between the insured and retained counsel regarding the contents of such reports may ultimately require withdrawal.**[41]**

Nothing in this Advisory Opinion differentiates between retained counsel where a conflict exists and retained counsel where no conflict exists. Thus, the counsel retained by the insurer has a duty to the insured not to gather facts which can then be used by the insurer to support a denial of coverage.

These obligations of defense counsel – whether retained by the insurer or by the insured – are all part of counsel's general obligations to maximize the insured's available insurance coverage. While there does not appear to be published Illinois case law on this subject, cases from other jurisdictions suggest that in some circumstances litigation counsel has a duty to investigate and pursue any insurance coverage which may be available to provide a defense or indemnity for the litigation in which counsel is retained.**[42]**

Conclusion

Knowing what circumstances have been held by Illinois courts to constitute a conflict will assist in determining whether your client has the right to insist on independent counsel at the insurer's expense. Also, knowing the insurer's obligations to give notice of the conflict may inform negotiations with the insurer over choice of counsel issues. Finally, if your client does accept the defense provided by the insurer, notwithstanding the existence of a conflict, that counsel has an obligation not to take any actions to impair your client's insurance coverage position, and in fact has a positive duty to take reasonable measures to preserve that coverage.

[1] Named after *Maryland Cas. Co. v. Peppers*, 64 Ill.2d 187, 355 N.E.2d 24 (1976).

[2] *See also, Murphy v. Urso*, 88 Ill.2d 444, 451-52, 430 N.E.2d 1079 (1981).

[3] 2012 U.S. Dist. LEXIS 89066 (N.D. Ill., June 27, 2012) (Leinenweber, J.).

[4] This was the situation in *Thornton v. Paul*, 74 Ill. 2d 132, 384 N.E.2d 355 (1978). The "either/or" test was also followed by the Seventh Circuit in *Maneikis v. St. Paul Ins. Co.*, 615 F.2d 818 (7th Cir. 1981).

[5]*Littlefield v. McGuffey*, 979 F.2d 101, 106 (7th Cir. 1992*), citing, Nandorf, Inc. v. CNA Ins. Cos.*, 134 Ill. App. 3d 134, 479 N.E.2d 988, 992 (1st Dist. 1985).

[6] In *American Family Mut'l. Ins. Co. v. Westfield Ins. Co.*, 2011 IL App (4th) 110088, 962 N.E.2d 993 (4th Dist. 2011), the court stated that a conflict may exist if "the interest of the insurer would be furthered by providing a less than vigorous defense to those allegations," but a conflict does not exist simply because an insurer has an interest in negating policy coverage. 962 N.E.2d at 999, *citing, Royal Ins. Co. v. Process Design Assocs., Inc.*, 221 Ill. App. 3d 966, 582 N.E.2d 1234 (1st Dist. 1991).

[7] *R. G. Wegman Constr. Co. v. Admiral Ins. Co.*, 629 F.3d 724, 730 (7th Cir. 2011) (Posner, J.).

[8] *National Cas. Co. v. Forge Indus. Staffing, Inc.*, 567 F.2d 871 (7th Cir. 2009).

[9] *Maryland Cas. Co. v. Peppers*, 64 Ill.2d 187, 355 N.E.2d 24 (1976); *Country Mut'l. Ins. Co. v. Olsak*, 391 Ill. App. 3d 295, 901 N.E.2d 1091 (1st Dist. 2009); *Illinois Farmers Ins. Co. v. Puccinelli*, 276 Ill. App. 3d 293, 657 N.E.2d 1062 (1st Dist. 1995).

[10] *Utica Mut'l. Ins. Co. v. David Agency Ins., Inc.*, 327 F. Supp. 2d 922 (N.D. Ill. 2004).

[11] *Santa's Best Craft, L.L.C. v. Zurich American Ins. Co.*, 408 Ill. App. 3d 173, 941 N.E.2d 291 (1st Dist. 2010); *Illinois Masonic Med. Center v. Turegum Ins. Co.*, 168 Ill. App. 3d 158, 522 N.E.2d 611 (1st Dist. 1988) (alleged medical malpractice involving multiple hospitalizations one of which was outside the insurer's coverage period).

[12] *Murphy v. Urso,* 88 Ill.2d 444, 430 N.E.2d 1079 (1981).

[13] *See also, Williams v. Yellow Cab Co.,* 359 Ill. App. 3d 128, 833 N.E.2d 971 (1st Dist. 1995) (because of agency questions, conflict existed between defense of cab driver and cab company in suit alleging that cab driver committed battery by driving away with plaintiff leaning inside the cab).

[14] *Great West Cas. Co. v. Dekeyser Exp., Inc.,* 475 F. Supp. 2d 772 (C.D. Ill. 2006).

[15] *Royal Ins. Co. v. Process Design Assocs., Inc.,* 221 Ill. App. 3d 966, 582 N.E.2d 1234 (1st Dist. 1991).

[16] *National Cas. Co. v. Forge Indus. Staffing, Inc.,* 567 F.2d 871 (7th Cir. 2009) (punitive damage claim was speculative based on EEOC complaint, where no punitive damages are allowed, and there was no certainty that such a claim would be made if the claimant ultimately filed suit).

[17] 134 Ill. App. 3d 134, 479 N.E.2d 988 (1st Dist. 1985).

[18] *See also, Illinois Mun. League Risk Mgmt. Grp. v. Siebert,* 223 Ill. App. 3d 864, 585 N.E.2d 1130 (4th Dist. 1992) (punitive damage claim gave rise to requirement to appoint conflicts counsel); *Utica Mut'l. Ins. Co. v. David Agency Ins., Inc.,* 327 F. Supp. 2d 922 (N.D. Ill. 2004) (in addition to intentional conduct issue, claims for $500,000 in punitive damages and $500,000 in compensatory damages created conflict in defamation case).

[19] In *Village of Lombard v. Intergovernmental Mgmt. Agency (IRMA),* 288 Ill. App. 3d 1003, 681 N.E.2d 88 (2d Dist. 1997), the insurer (risk pool) correctly retained counsel to defend the covered compensatory count it agreed to defend, but the insured needed to retain its own counsel to defend the non-covered punitive damages count which did not impose a defense duty on the insurer.

[20] 382 Ill. App. 3d 731, 742, 888 N.E.2d 632 (2d Dist. 2008).

[21] *American Family Mut'l. Ins. Co. v. W.H. McNaughton Builders, Inc.,* 363 Ill. App. 3d 505, 843 N.E.2d 492 (2d Dist. 2006).

[22] 194 Ill. App. 3d 767, 551 N.E.2d 382 (1st Dist. 1990).

[23] 327 F. Supp. 2d 922 (N.D. Ill. 2004).

[24] The absence of such a misrepresentation, in part, saved the insurer's reservation of rights from creating an estoppel in *Nautilus Ins. Co. v. Dubin & Assocs., Inc.* 2012 U.S. Dist. LEXIS 89066 (N.D. Ill., June 27, 2012). Also, the insurer's inadequate explanation of the nature of the conflict due to intentional acts allegations was not fatal in that case because it did not relate to the employee exclusion, which was the provision on which the insurer ultimately denied coverage.

[25] 221 Ill. App. 3d 966, 582 N.E.2d 1234 (1st Dist. 1991).

[26] To the same effect is *Stoneridge Development Co. v. Essex Ins. Co.,* 382 Ill. App. 3d 731, 888 N.E.2d 632 (2d Dist. 2008).

[27] 359 Ill. App. 3d 128, 833 N.E.2d 971 (1st Dist. 1995).

[28] 215 ILCS 5/155.

[29] 2012 IL App (4th) 110527, 975 N.E.2d 1099 (4th Dist. 2012).

[30] *Tobi Eng'g., Inc. v. Nationwide Mut'l. Ins. Co.,* 214 Ill. App. 3d 692, 574 N.E.2d 160 (1st Dist. 1991).

[31] *Universal Fire & Cas. Ins. Co. v. Jabin,* 16 F.3d 1465, 1471 n. 4 (7th Cir. 1994).

[32] 22 Ill. App. 3d 883, 893, 318 N.E.2d 315, 326 (1st Dist. 1974) (citation omitted).

[33] *Id.*

[34] *Stoneridge Development Co. v. Essex Ins. Co.,* 382 Ill. App. 3d 731, 742, 888 N.E.2d 632 (2d Dist. 2008).

[35] *Lockwood Int'l. v. Volm Bag Co.,* 273 F.3d 741 (7th Cir. 2001).

[36] 273 F.3d at 744 (citations omitted).
[37] *Id.*

[38] 1987 Me. Super. LEXIS 188 (Civil Action Docket No. CV-84-482, Super. Ct., Cumberland Co., July 1, 1987).

[39] *United Fire & Cas. Co. v. Civil Constructors, Inc., et al.,* No. 2011-MR-40 (Cir. Ct., Whiteside Co., Ill., Mar. 7, 2013, Hauptman, J.). No written opinion was issued.

[40] *Timothy Whelan Law Assocs., Ltd. v. Kruppe,* 409 Ill. App. 3d 359, 371, 947 N.E.2d 366 (2d Dist. 2011) ("an attorney-client relationship is fiduciary'").

[41] ISBA Adv. Op. No. 92-2, Digest.

[42] *Shaya B. Pacific, LLC v. Wilson Elser Moskowitz Edelman & Dicker, LLP,* 38 App. Div. 3d 34, 827 N.Y.S.2d 231 (2006) (finding question of fact as to whether defense counsel retained by primary insurer had duty to locate and notify insured's excess insurer); *O'Shea v. Brennan,* 2004 WL 583766 (S.D.N.Y., Mar. 23, 2004) (expert testimony needed to establish that failure to pursue insurance coverage was breach of lawyer's duty of care).

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