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CONFLICTS OF INTEREST IN THE INSURER'S DUTY TO DEFEND IN ILLINOIS

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Liability insurance policies generally contain a standard clause requiring the insurer to defend all claims against the insured which fall within the policy coverage. The insurer has a duty to defend if the factual allegations in the injured party's complaint against the insured are within, or potentially within, the policy coverage.[1] If the insurer is thus under a duty to defend, it is also given the right to investigate, negotiate, settle and control the defense of any such claim.

A conflict of interest may arise, however, when a complaint alleges facts that the insurer believes are outside policy coverage or the insurer has other reason to believe it should not be required to defend. If the insurer refuses to defend the suit, it may have breached the insurance contract; if the claim is thereafter found to be within policy coverage, the insurer may be liable for the entire judgment plus the expense incurred by the insured in defending the suit. The insurer may thus be liable even though it did not in any way participate in the suit and even though the amount of the judgment may have been increased by the inexperience or inadequate selection of defense counsel by the insured.

This article will discuss the problems which can arise when a conflict exists as to whether the insurer is required to defend a claim under a policy. It will deal with the various situations where such conflicts can arise, and the options then available to

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1. La Rotunda v. Royal Globe Ins. Co., 87 Ill. App. 3d 446, 451, 408 N.E.2d 928, 933 (1980).

the insurer; it will point out why a declaratory judgment, if available, is the best of such options. The consequences of an insurer's refusal to defend, including estoppel and res judicata, and particularly the problem of conflict when the coverage issue is also the issue in the underlying tort claim, are also discussed.

SITUATIONS WHERE CONFLICT OF INTEREST ARISES

Although the interests of the insured and the insurer are usually the same—to defeat or minimize the claim against the insured—there are times when their interests will conflict. The most common instances of conflicting interests occur:

(1) When the damages sought exceed the policy limits;
(2) When there is a dispute as to whether the claim is covered by the policy; or,
(3) When the insurer has a defense to its liability under the policy.

Although liability insurance policies do not expressly require the insurer to settle claims, it is generally held that the insurer has a duty to make a good faith effort to settle within the policy limits when the claim exceeds the policy limits.[2] In such situations, it is usually in the best interests of the insured to settle the claim[3] so as to protect himself from any personal liability. On the other hand, if the proposed settlement is at or near the policy limit, the insurer may feel that it has little or nothing to lose by litigating, and that its interests are best served by trying to defeat or reduce the claim in court. Much has been written about the conflict of interest in this situation,[4] and this article will not discuss it further except to note that the conflict could be eliminated if a strict liability standard were adopted for excess liability cases.[5] Under that standard, an insurer which refused an offer to settle within the policy limits would do so at its own risk and would be held for the full amount of any subse-

2. Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967); Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 65 N.J. 474, 323 A.2d 495 (1974).

3. There are, however, cases where a settlement will affect the insured's ability to obtain coverage in the future, and the rates that will be charged; or where the insured's reputation or other nonfinancial interests are involved. *See, e.g.*, Ivy v. Pacific Auto. Ins. Co., 156 Cal. App. 2d 652, 320 P.2d 140 (1958); Pennix v. Winton, 61 Cal. App. 2d 761, 143 P.2d 940 (1943).

4. *See, e.g.*, Snow, *Excess Liability—Crisci and Lysick*, 36 INS. COUNSEL J. 51 (1969); Note, *Insurer's Liability for Refusal To Settle: Beyond Strict Liability*, 50 S. CAL. L. REV. 751 (1977).

5. *See* Johansen v. California State Auto. Ass'n. Inter-Ins. Bureau, 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975); Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 65 N.J. 474, 323 A.2d 495 (1974). *See generally*, Ingram, *Triangular Reciprocity in the Duty to Settle Insurance Claims*, 13 PAC. L.J. 859, 867-68 (1982).

quent judgment. There is much to be said for this approach.[6]

Secondly, there may be a question as to whether a claim against the insured is within the coverage of the policy. The general rule is that the insurer's duty to defend is determined by the allegations in the complaint against the insured. If the complaint alleges facts within, or potentially within, the coverage of the policy, then the insurer has a duty to defend.[7] There is also a duty to defend when the complaint includes several theories of recovery, some of which are covered while others are not.[8] These coverage questions typically arise when there is a dispute as to whether the claimant's injuries were caused negligently or intentionally by the insured; when the person seeking coverage as an insured is alleged to be a permissive user of a vehicle; when a claim under a professional liability policy is based on fraud or alternatively on negligence; or, when it is not clear whether the person seeking coverage was within the scope of his employment. In each of these situations, the insurer hopes to establish facts that will put the claim outside the coverage of the policy, while the insured's interest is directly opposed. The problems inherent in this conflict of interest will be discussed at length in this article.

The third major area of conflict occurs when the insured fails to comply with policy requirements which are conditions precedent to coverage, or is guilty of some other conduct which relieves the insurer of its duty to defend. Examples within this category include: the failure of the insured to give timely notice; failure of the insured to cooperate in the defense of the claim; collusion between the claimant and the insured; misrepresentation by the insured in the application for the insurance; and, the insured's failure to pay the premium when due. In each of these situations the insurer and insured are in conflict as to whether there is coverage and, therefore, a duty for the insurer to defend. This conflict of interest will also be discussed hereafter.

Options Available to the Insurer

When the insured tenders to the insurer the defense of an action which the insurer reasonably believes is either outside the coverage of the policy or susceptible to a coverage defense, the insurer has four options available. It can (1) deny liability and refuse to defend the claim against the insured; (2) defend the claim under a reservation of its rights under the policy;

6. Ingram, *supra* note 5, at 884-86.

7. Maryland Cas. Co. v. Peppers, 64 Ill. 2d 187, 193, 355 N.E.2d 24, 28 (1976).

8. *Id.* at 194, 355 N.E.2d at 28.

(3) defend the claim without a reservation of rights;[9] or, (4) seek a declaratory judgment, either prior to the third party's action or subsequent to the judgment therein. No matter which of these options the insurer elects, there is the potential for a conflict of interest.[10]

CAN THE INSURER HAVE A DECLARATORY JUDGMENT?

In most cases involving a conflict of interest because of a coverage question, the best option for the insurer is to seek a declaratory judgment before the claim against the insured is litigated.[11] In the declaratory judgment action, insured and insurer are separately represented and the issue as to coverage is directly presented. If the court rules in favor of the insured as to coverage, the insurer will be obligated to defend and will consequently have no conflict of interest in doing so.[12] A number of courts have held, however, that a declaratory judgment action at this stage is unnecessary[13] or premature,[14] or have rejected it because it is unfair to the insured or the insured claimant.[15]

Illinois courts have favored the insurer's right to obtain a declaratory judgment on the issue of policy coverage prior to the adjudication of the underlying tort claim.[16] In *Cowan v. Insurance Company of North America*,[17] the court stated that a declaratory judgment action should be filed, joining the insured and the injured party as defendants, as soon as the insurer becomes aware of a possible conflict of interest between insured

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9. By so doing, the insurer waives any policy defenses.

10. Comment, *Conflicts of Interest in the Liability Insurance Setting*, 13 GA. L. REV. 973, 975 (1979).

11. In some cases, however, the maximum amount which can be realized by a successful claimant is less than the cost to the insurer of a declaratory judgment action. Thus, as a practical matter, an insurer will not seek a declaratory judgment unless the claim is substantial. *Id.* at 980.

12. Morris, *Conflicts of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 13 UTAH L. REV. 457, 486-87 (1981).

13. Common facts and issues will be decided in the underlying litigation. All-Star Ins. Corp. v. Steel Bar, Inc., 324 F. Supp. 160 (N.D. Ind. 1971).

14. Allstate Ins. Co. v. Gleason, 50 Ill. App. 2d 207, 200 N.E.2d 383 (1964); Prashker v. United States Guar. Co., 1 N.Y.2d 584, 136 N.E.2d 871, 154 N.Y.S.2d 910 (1956).

15. Maryland Cas. Co. v. Peppers, 64 Ill. 2d 187, 355 N.E.2d 24 (1976); Brohawn v. Transamerica Ins. Co., 276 Md. 396, 347 A.2d 842 (1975).

16. Apex Mut. Ins. Co. v. Christner, 99 Ill. App. 2d 153, 163, 240 N.E.2d 742, 748. *Contra* State Farm Mut. Auto. Ins. Co. v. Morris, 29 Ill. App. 2d 451, 460, 173 N.E.2d 590, 599 (while the question of the insurer's duty to defend may pose "an awkward and difficult problem and dilemma," at the declaratory judgment point it is primarily "a business judgment policy problem"), *cert. denied*, 368 U.S. 878 (1961).

17. 22 Ill. App. 3d 883, 318 N.E.2d 315 (1974).

and insurer.[18] However, *Maryland Casualty Co. v. Peppers*[19] and subsequent cases have limited the availability of a declaratory judgment prior to a determination of the underlying claim to those cases where there is no common fact or issue between the underlying claim and the question of insurance coverage.[20] When a common question exists, a declaratory judgment will be available, if at all, only after a judgment has been entered in the underlying tort case.[21] This rule is based on the courts' concern that, if a prior declaratory judgment is allowed, the interests of the insured[22] or the injured party may be prejudiced.[23]

Whenever the issues which determine policy coverage cannot be separated from the issues which determine the insured's tort liability, this problem arises. Of course, the doctrine of res judicata and collateral estoppel are not operative in the subsequent tort action if both the insured and the injured party were not parties to the declaratory judgment action. But in Illinois, injured claimants are proper and necessary parties to a declaratory judgment action,[24] and, if joined, the decision is normally binding upon them. Of course, if the issues are separable, *i.e.*, where there is no issue of fact in common between the insurer and the injured party, this problem will not arise.

Brohawn v. Transamerica Insurance Co.,[25] a case involving the same issues as *Peppers*, clarifies this premise. The same

18. *Id.* at 897, 318 N.E.2d at 326. The requirements for a declaratory judgment action under the Illinois declaratory judgment statute Code of Civil Procedure, § 2-701 (Supp. 1982) are as follows: (1) a plaintiff with a legal, tangible interest; (2) a defendant having an opposing interest; and (3) an actual controversy between the parties concerning such interests.

19. 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

20. These are the cases involving failure to comply with policy requirements, *e.g.*, Apex Mut. Ins. Co. v. Christner, 99 Ill. App. 2d 153, 240 N.E.2d 742 (1968) (breach of cooperation clause).

21. Maryland Cas. Co. v. Peppers, 64 Ill. 2d 187, 355 N.E.2d 24 (1976); Associated Indem. Co. v. Insurance Co. of N. Am., 68 Ill. App. 3d 807, 386 N.E.2d 529 (1979). *Accord* Murphy v. Urso, 88 Ill. 2d 444, 430 N.E.2d 1079 (1981); Thornton v. Paul, 74 Ill. 2d 132, 384 N.E.2d 335 (1978). In the latter two cases the court's statement is *dictum*, since a declaratory judgment was not sought.

22. Maryland Cas. Co. v. Peppers, 64 Ill. 2d 187, 355 N.E.2d 24 (1976) (insured may be exposed to punitive damages).

23. The injured party may be deprived of his choice of forum, the burden of proof may be altered, or the underlying tort suit may be unduly delayed. *See* Utah Farm Bureau Ins. Co. v. Chugg, 6 Utah 2d 399, 407, 315 P.2d 277, 282 (1957) (insured could use declaratory judgment as a "writ of prohibition" by taking "advantage of crowded court calendars, to be followed by an appeal, while the witnesses and evidence in the stalemated pending action disappear").

24. Williams v. Madison County Mut. Auto. Ins. Co., 40 Ill. 2d 404, 240 N.E.2d 602 (1968). The injured claimant was indeed a party in *Peppers*. *Peppers*, 64 Ill. 2d at 190, 355 N.E.2d at 26.

25. 276 Md. 396, 347 A.2d 842 (1975).

court had suggested in an earlier case[26] that when questions of policy coverage arise, a declaratory judgment action prior to the trial of the third party suit is desirable. In *Brohawn*, however, the court limited its earlier statements, saying that a declaratory judgment prior to the tort action is appropriate only if the questions of policy coverage are independent and separable from the claims asserted in the pending suit by an injured third party.[27]

It has been suggested that special interrogatories might be used to resolve a coverage question such as the intentional injury exclusion.[28] In *Cowan*, a declaratory judgment action after completion of the tort suit, the insured claimed that, though the insurer had defended the suit against the insured under a reservation of right, it was the duty of the insurer to protect and adjudicate the issue of whether there was an intentional injury. The insured claimed that the insurer had breached its duty by failing to submit a special interrogatory on intent in the tort suit to clarify the issue. The court, however, said that the breach of duty would have been in the act of *submission* to the jury, *not* the omission.[29] The complaint against the insured alleged that he violently assaulted the injured third party and that the assault was willful and malicious. Therefore, it was possible that, if the interrogatory had been submitted, the jury might have answered the interrogatory in the affirmative resulting in a higher degree of culpability attributable to the insured (*i.e.*, exemplary damages).[30] The same argument would apply to the use of separate verdicts for each count.[31] Though they are provided for by section 68 of the Code of Civil Procedure,[32] a separate verdict might have the same effect as a special interrogatory, *i.e.*, increased culpability of the insured.

One other device which has been suggested for early resolution of a coverage dispute is to allow, or perhaps require, the insurer to intervene as a named party in the underlying tort suit. The jury would be instructed to return a special verdict which would be binding on all parties—insurer, insured, and injured

26. Glens Falls Ins. Co. v. American Oil Co., 254 Md. 120, 254 A.2d 658 (1969).

27. *E.g.*, lack of notice, failure to cooperate, nonpayment of premiums.

28. Cowan v. Insurance Co. of Am., 22 Ill. App. 3d 883, 318 N.E.2d 315 (1974).

29. *Id.* at 897, 318 N.E.2d at 326.

30. *Id.*

31. Use of a special verdict was ordered in Utica Mut. Ins. Co. v. Cherry, 45 A.D.2d 350, 354, 358 N.Y.S.2d 519, 524 (1974), *aff'd* 38 N.Y.2d 735, 343 N.E.2d 758, 381 N.Y.S.2d 40 (1975).

32. ILL. REV. STAT. ch. 110, § 2-1201(c) (Supp. 1982).

party.[33] Similarly, some courts have allowed insurers to be brought in through third party complaints or by consolidating the underlying action with the declaratory judgment action.[34] There are numerous disadvantages to these devices, however, besides those previously mentioned in connection with special verdicts, including higher jury verdicts,[35] complexity, procedural problems, and increased time and expense.[36]

CONSEQUENCES OF INSURER'S REFUSAL TO DEFEND

Under the doctrine of collateral estoppel, it is generally held that a determination of the factual issues between litigating parties is conclusive and precludes the relitigation of the same issues in a subsequent suit between the parties on a different cause of action.[37] When a factual issue has been litigated by a party, and determined adversely to him, he has had his "day in court" and is not denied due process of law if he is denied relitigation of the issue in a subsequent suit.[38] On the other hand, one who was not a party to a judgment is generally not bound by any issues determined in that litigation because he has not had his "day in court".[39] The major exception to this rule is based on the concept of privity. If the interests of a non-party are represented by a litigating party to such a degree that due process requirements are satisfied, the non-party will be bound by determinations in the prior litigation.[40]

A relationship of privity usually exists between a liability insurer and an insured because they are in the positions of indemnitor and indemnitee. When an insured notifies his insurer of a claim against him that is covered by the policy,[41] the insurer normally takes control of the defense of the action and the insurer is bound by determinations in the ensuing litigation. If, however, the insurer refuses to defend the action against its insured, the insurer may be bound to the same extent as if it had participated because it had the opportunity to take control of the

33. Note, *The Effect of Collateral Estoppel on the Assertion of Coverage Defenses*, 69 COLUM. L. REV. 1459, 1473-74 (1969).

34. *See* Morris, *supra* note 12, at 488-87 and cases cited therein.

35. The jury will be aware that the defendant is insured. However, most juries probably assume that the defendant is insured anyway. *Effect of Collateral Estoppel on the Assertion of Coverage Defenses*, *supra* note 33, at 1474.

36. *See* Morris, *supra* note 12, at 489, and footnotes cited therein.

37. *See* RESTATEMENT OF JUDGMENTS §§ 17, 27 (1982).

38. *See id.* § 27, comment c.

39. *See id.* § 34(c).

40. *See id.* § 41.

41. Thus entitling the insured to indemnity if a judgment is rendered against him.

litigation and have its interests represented.[42]

For many years there has been well-reasoned authority in some jurisdictions that, where an insurer refused to defend, it was not bound as to its claim of noncoverage by findings in the underlying tort suit. These cases held that the insurer cannot be estopped by the acts of parties in an action "in which it has no concern and over which it has no control."[43] To apply estoppel in this situation would deprive the insurer of its "day in court" and put it at the mercy of a claimant who alleges a claim within the policy coverage and establishes it because the insurer cannot show the true facts.[44]

The Illinois appellate court, however, had held that, if the insurer refused to defend a claim alleging facts within the policy coverage, it would be estopped from later raising the coverage question.[45] This rule was reaffirmed in *McFadyen v. North River Insurance Co.*[46] which attempted to put to rest the uncertainty caused by the unclear holding in *Gould v. Country Mutual Casualty Co.*[47] In *Gould*, the court had said that the judgment in the underlying tort suit was "conclusive on the insurer as to all questions determined therein which are material to a recovery against it in an action on the policy."[48] The court further noted that the judgment would not be conclusive "as to matters which were not tried or determined in the former action, such as the question whether the loss was within the coverage of the policy."[49] It was not clear from the opinion whether the court held that the insurer was bound by the tort judgment because it had refused to defend, or that the insurer could contest the coverage question in the subsequent action, but had produced no admissible evidence of noncoverage. The *McFadyen* court stated that, if the claim alleged facts within the policy coverage, a judgment therein would be conclusive against the insurer whether it de-

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42. RESTATEMENT (SECOND) OF JUDGMENTS § 58. *See also Effect of Collateral Estoppel on the Assertion of Coverage Defenses*, *supra* note 33, at 1460-62.

43. *E.g.*, Farm Bureau Mut. Auto Ins. Co. v. Hammer, 177 F.2d 793, 799-800 (4th Cir. 1949).

44. *Id.* at 800. *See also* Vaksman v. Zurich Gen. Acc. & Liab. Ins. Co., 172 Pa. Super. 588, 94 A.2d 186, 189 (1953) (showing that the damage was intentionally done by insured was not a defense to the tort action against the insured, so insurer had no opportunity to present its defense on noncoverage).

45. Sims v. Illinois Nat'l Cas. Co., 43 Ill. App. 2d 184, 197, 193 N.E.2d 123, 129 (1963).

46. 62 Ill. App. 2d 164, 209 N.E.2d 833 (1965).

47. 37 Ill. App. 2d 265, 185 N.E.2d 603 (1962), *overruled on other grounds*, Smith v. Andrews, 54 Ill. App. 2d 51, 61, 203 N.E.2d 160, 165 (1964).

48. 37 Ill. App. 2d at 283, 185 N.E.2d at 611.

49. *Id.*

fended or not.[50] The court pointed out that this was not unfair to the insurer because, if there was doubt about coverage, the insurer could either seek a declaratory judgment or defend under a reservation of rights.[51]

This rule[52] was followed in two subsequent appellate court cases.[53] In all of these cases there was a coverage question involved which created a conflict of interest between the insurer and the insured and which the insurer could not effectively assert in the tort litigation without prejudicing the insured's interests.[54] Because the courts believed that the coverage question could be resolved in a declaratory judgment action prior to trial of the tort action, however, they held that the insurer had a duty to defend.

A change in Illinois law was indicated, however, in *Maryland Casualty Co. v. Peppers*,[55] which held that a declaratory judgment prior to trial of the tort suit was improper.[56] The court also held that, because of the conflict of interest, the insurer must pay for an attorney of the insured's choice who would control the litigation.[57] Since the insurer now had no way to resolve the conflict before the tort trial, and could not effectively raise the coverage question in that litigation, the court said that the insurer would "not be barred from subsequently raising the defense of noncoverage in a suit on the policy."[58]

Whereas the insurer in *Peppers* had taken the previously approved course of seeking a declaratory judgment, in *Thornton v. Paul*[59] the insurer simply refused to defend, asserting that there was no coverage because the injury was caused intentionally by the insured.[60] The tort action ultimately resulted in a

50. 62 Ill. App. 2d at 171, 209 N.E.2d at 836.

51. *Id.* at 172, 209 N.E.2d at 837 *quoting* Sims v. Illinois Nat'l Cas. Co., 43 Ill. App. 2d 184, 199, 193 N.E.2d 123, 130 (1963).

52. *See* text accompanying note 45.

53. Aetna Cas. & Sur. Co. v. Coronet Ins. Co., 44 Ill. App. 3d 744, 358 N.E.2d 914 (1976); Elas v. State Farm Mut. Auto. Ins. Co., 39 Ill. App. 3d 944, 352 N.E.2d 60 (1976).

54. In *Aetna*, the insured may have been driving the car without permission; in *Elas*, the car driven by insured may have been excluded because it was available for his frequent or regular use; in *McFadyen*, the premises may have been used for a business purpose, which was excluded; in *Sims*, the injured passenger may have been an employee of insured engaged in his employment and, therefore, excluded; in *Gould*, the injury may have been caused intentionally by the insured.

55. 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

56. 64 Ill. 2d at 197, 355 N.E.2d at 30.

57. 64 Ill. 2d at 198-99, 355 N.E.2d at 31.

58. 64 Ill. 2d at 199, 355 N.E.2d at 31.

59. 74 Ill. 2d 132, 384 N.E.2d 335 (1978).

60. The insured had been convicted of battery as a result of the incident.

default judgment against the insured and the injured party then brought a garnishment proceeding against the insurer. The court, relying on *Peppers*,[61] held that the insurer must reimburse the insured for the cost of defense because it had a contractual obligation to provide a defense where the allegations of the complaint were within the policy coverage. However, because of the conflict of interest as to whether the injury was caused intentionally or negligently, the insurer could not properly have controlled the defense of the tort action and was therefore not estopped from asserting noncoverage in the garnishment proceeding. Thus, *Thornton* and subsequent cases[62] make it clear that, where the coverage question involves a conflict of interest between insurer and insured, the insurer is neither obligated nor permitted to conduct the defense, must reimburse the insured for the cost of the defense, and cannot have a declaratory judgment or intervene in the tort action. Further, the insurer is not estopped or otherwise barred from asserting noncoverage in any subsequent proceeding. However, where the insurer's assertion of noncoverage does not create any conflict of interest in the underlying tort suit,[63] the normal rules as to duty to defend and estoppel will apply. The insurer should defend under a reservation of rights,[64] and may seek a declara-

61. The court also cited and relied on Burd v. Sussex Mut. Ins. Co., 56 N.J. 383, 267 A.2d 7 (1970); Glens Falls Ins. Co. v. American Oil Co., 254 Md. 120, 254 A.2d 68 (1969); Ferguson v. Birmingham Fire Ins. Co., 254 Or. 496, 460 P.2d 342 (1969); Williams v. Farmers Mut. of Encumclaw, 254 Or. 557, 423 P.2d 518 (1967). It is interesting to note that neither the *Thornton* court nor those in previous Illinois cases cited Karas v. Snell, 11 Ill. 2d 233, 142 N.E.2d 46 (1957). *Karas* involved essentially the same problem as *Thorton*. A statute provided that the city would indemnify a police officer for liability for any judgment recovered against him resulting from personal injury or property damage caused by the policeman, except injuries caused by willful misconduct. A policeman shot a person in a tavern and the city refused to defend the policeman. The city asserted that he was not performing police duties and that the shooting was willful misconduct. Judgment was entered based only on a negligence count, the dramshop and willful counts having been dismissed prior to judgment. The court concluded that the city was not bound by the tort judgment because the issues of willful misconduct and performance of duty were not presented or decided in that action.

62. Murphy v. Urso, 88 Ill. 2d 444, 430 N.E.2d 1079 (1981); Home Ins. Co. v. Lorelei Restaurant Co., 83 Ill. App. 3d 1083, 404 N.E.2d 895 (1980); Aetna Cas. & Sur. Co. v. Dichtl, 78 Ill. App. 3d 970, 398 N.E.2d 582 (1980); Associated Indem. Co. v. Insurance Co. of N. Am., 68 Ill. App. 3d 807, 386 N.E.2d 529 (1979).

63. *E.g.*, where the assertion of noncoverage involves lack of cooperation, failure to give timely notice, or nonpayment of premium.

64. The attorney who defends the insured in the tort action should not participate in any way in any subsequent proceedings involving coverage questions, as it is likely that he would have a conflict of interest. *See infra* text accompanying notes 74-79 (explaining the problem which arises when an insured selects the attorney).

tory judgment if it wishes to do so.[65] If the insurer refuses to defend, it will be estopped from asserting noncoverage later.[66]

COVERAGE QUESTION ALSO INVOLVED IN TORT SUIT

Maryland Casualty v. Peppers[67] established the rule that, where the insurer asserts a defense to coverage involving a question also at issue in the underlying tort litigation, the insured has the right to be defended by "an attorney of his own choice who shall have the right to control the conduct of the case,"[68] and the insurer must reimburse the insured "for the reasonable cost of defending the action."[69] This rule has been followed by the Illinois courts in all subsequent cases.[70] Unfortunately, application of this rule has not eliminated the conflict of interest between the insurer and the insured. It has merely adopted the view that, where such a conflict exists, the interest of the insured must be preferred over the interest of the insurer.

Several serious problems are created by the *Peppers* rule. First is the question of the competence of an attorney selected by the insured. It is quite possible that the insured will not know any lawyer, let alone an experienced trial lawyer. He may obtain a referral from a friend or select an attorney from the Yellow Pages,[71] but it is most unlikely that he will find as competent

65. Clemmons v. Travelers, 88 Ill. 2d 469, 430 N.E.2d 1104 (1981); Mol v. Holt, 86 Ill. App. 3d 838, 409 N.E.2d 20 (1980); Apex Mut. Ins. Co. v. Christner, 99 Ill. App. 2d 153, 240 N.E.2d 742 (1968).

66. *See supra* note 65. A federal court applying Illinois law recently held that the conflict must be "serious enough to merit the application of the *Thornton* exception" and that there must be an "either/or situation" involving "mutually exclusive theories of recovery." Maneikis v. St. Paul Ins. Co. of Ill., 655 F.2d 818, 825 (7th Cir. 1981).

67. 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

68. *Id.* at 199, 355 N.E.2d at 31.

69. *Id.* A number of other jurisdictions have shown support for this approach. *See*, American Home Assur. Co. v. Sand, 253 F. Supp. 942 (D. Ariz. 1965); Executive Aviation, Inc. v. National Ins. Underwriters, 16 Cal. App. 3d 799, 94 Cal. Rptr. 347 (1971); Brohawn v. Transamerica Ins. Co., 276 Md. 396, 347 A.2d 842 (1975); Prahm v. Rupp Const. Co., 277 N.W.2d 389 (Minn. 1979); Burd v. Sussex Mut. Ins. Co., 56 N.J. 383, 267 A.2d 7 (1970); Satterwhite v. Stols, 79 N.M. 320, 442 P.2d 810 (1968) (applying Texas law); Jaeger v. Travelers Ins. Co., 53 A.D. 637, 384 N.Y.S.2d 848 (1976); Employers' Fire Ins. Co. v. Beals, 103 R.I. 623, 240 A.2d 397 (1968); Steel Erection Co. v. Travelers Indem. Co., 392 S.W.2d 713 (Tex. Civ. App. 1965).

70. *See, e.g.*, Thornton v. Paul, 74 Ill. 2d 132, 384 N.E.2d 335 (1978); Aetna Cas. & Sur. Co. v. Dichtl, 78 Ill. App. 3d 970, 398 N.E.2d 582 (1980); Associated Indem. Co. v. Insurance Co. of N. Am., 68 Ill. App. 3d 807, 386 N.E.2d 529 (1979).

71. Which do not list specialties.

a trial attorney as the insurer would have selected.[72] Thus, what the insured may gain in undivided loyalty may be more than offset by having control of the defense in the hands of an attorney who is not experienced in tort litigation. Also, a less competent defense will almost surely result in higher settlements and judgments and will probably result in higher fees than the insurer's regular attorneys would have charged.[73]

A second major problem lies in the fact that the insured-selected attorney will do everything possible to resolve the issues in favor of the insured.[74] It is clearly in the best interest of the insured to present the defense in a way that will establish coverage under the insurance policy.[75] The insurer is helpless to protect itself against this because, while the *Peppers* rule allows the insurer to have an attorney of its own choosing participate in the defense of the tort case, the insurer's attorney will have no opportunity to bring in evidence which will establish noncoverage.[76] The insured and the injured party will frame the issues in such a way that evidence relating to noncoverage will be irrelevant and therefore inadmissible.[77] In fact, there is a very real danger that the insured will simply default and allow entry of a judgment based only on a covered claim.[78] While it could be argued that this is a breach of the insurance policy's cooperation clause,[79] such a defense is very difficult to establish.

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72. *See* Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend: A Postscript*, 24 CLEV. ST. L. REV. 18, 26-27 (1975).

73. The insured-selected attorney will have less incentive to charge a lower fee, because he does not have a continuing relationship with the insurer. Due to lack of experience, he is also likely to take more time than an experienced attorney. *See*, Browne, *supra* note 72, at 25-26; Morris, *supra* note 12, at 477.

74. Indeed, he has an ethical duty to do so.

75. *See* Browne, *supra* note 72, at 24-25.

76. *See e.g.*, Burish v. Dignon, 416 Pa. 486, 206 A.2d 497 (1965). An insurer-selected attorney defended an action by an injured third party. The insured retained another attorney to handle the counterclaim against a third party. On appeal, the insurer unsuccessfully argued that it was error for the trial court to refuse to allow the insurer's attorney to make a closing argument to the jury in addition to the closing argument of the insured's attorney. The insurer's attorney was going to argue that both parties were negligent and neither should recover. While this would have been a successful defense to the claim against the insured, it would also have defeated his counterclaim.

77. For example, if only negligence is pleaded in the tort action, the insurer will be unable to introduce evidence that the injury was caused intentionally by the insured; it would surely be a breach of duty to do so in any event.

78. *See, e.g.*, Thornton v. Paul, 74 Ill. 2d 132, 384 N.E.2d 335 (1978).

79. "The insured shall cooperate with the company . . . in the conduct of suits . . . with respect to which insurance is afforded under this policy." R. KEETON, BASIC TEXT ON INSURANCE LAW, App. H at 664 (1971).

POSSIBLE SOLUTIONS

It has been suggested that liability insurance policies could provide[80] that, in cases involving conflicts of interest resulting from coverage questions, the insured will be represented by an attorney selected by the insured from a list of attorneys provided to him by the insurer.[81] Presumably, the insurer would include on this list only attorneys who are known to be skilled and experienced in tort litigation. However, there is a serious question as to whether an attorney so employed could avoid at least the appearance of failing to give his entire fidelity to his client, the insured, as required by the codes of ethics.[82]

Another proposed solution would be to provide in the policy[83] that the insurer will defend *all* claims against the insured, but to also include an express non-waiver agreement reserving the insurer's right to contest coverage later. Such an agreement would defeat the collateral estoppel effect of issues which have been litigated and determined in the tort action, not only as to the insured (who entered into the agreement with the insurer), but also as to the injured third-party.[84] Here again, however, it would be very difficult for an attorney to avoid at least the appearance of divided loyalty between insurer and insured.[85]

CONCLUSION

The provision for defense of the insured is a vital and valuable part of a liability insurance policy. Its value to the insured, however, depends heavily on his assurance that the attorney who conducts the defense will give his undivided loyalty to the insured. Such loyalty is clearly mandated both by professional

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80. The insurer should anticipate a possible conflict of interest and set forth the provisions as to its duty to defend in clear and distinct language. Employers' Fire Ins. Co. v. Beals, 103 R.I. 623, 634, 240 A.2d 397, 404 (1968).

81. *See generally* Morris, *supra* note 12, at 487-88.

82. MODEL CODE OF PROFESSIONAL RESPONSIBILITY, Canon 5 (1980); Illinois Code of Professional Responsibility, Rules 5-105, 5-107.

83. *See supra* note 80.

84. Centennial Ins. Co. v. Miller, 264 F. Supp. 431 (E.D. Cal. 1967); Great Am. Ins. Co. v. Ratliff, 242 F. Supp. 983 (E.D. Ark. 1965); Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966).

Several Illinois cases have indicated that an insurer which refuses to defend is also not estopped from subsequently asserting noncoverage. *See e.g.*, Murphy v. Urso, 88 Ill. 2d 444, 430 N.E.2d 1079 (1981); Thornton v. Paul, 74 Ill. 2d 132, 384 N.E.2d 335 (1978). However, an insurer which refuses to defend runs the risk that a court will subsequently find that the conflict of interest was not so "complete" as to merit application of the *Thornton* exception and the insurer may find itself estopped from asserting its policy defenses. *See* Maneikis v. St. Paul Ins. Co. of Ill., 655 F.2d 818, 825-26 (7th Cir. 1981) and note 66 *supra*.

85. *See supra* note 82.

ethics and by the insurance policy itself. Hopefully, we will find it possible to give the insured the best possible legal representation while also fully protecting the insurer's legitimate interest in controlling the defense.