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ILLINOIS LAW MANUAL
CHAPTER XI
INSURANCE COVERAGE AND DEFENSES

H. CONFLICTS OF INTEREST

Generally, the insurer's duty to defend includes the right to assume control of the litigation. The purpose of such a right is to allow insurers to protect their financial interest in the outcome of litigation and to minimize unwarranted liability claims. Giving the insurer exclusive control over litigation against the insured safeguards the orderly and proper disbursement of large sums of money involved in the insurance business.

7C Appleman, Insurance Law & Practice, sec. 4681, at 2-5 (1979).

The attorney that the insurer hires for the insured has a fiduciary duty to both the insured and the insurer. However, courts have determined that in certain instances the attorney that the insurer hires may have a greater allegiance to the insurer than to the insured. In those circumstances, a conflict of interest arises and the insurer is precluded from controlling the defense of the insured. See Maryland Cas. Co. v. Peppers, 64 Ill. 2d 187 (1976).

Conflict situations which require the insurer to give up control of the defense of the case by offering the insured the right to retain counsel of his choosing at the company's expense are difficult to recognize. The best rule of thumb for practical guidance on this issue is to ask whether the outcome or factual determinations made in the underlying tort case being defended under a reservation of rights will determine the outcome of the coverage dispute. If the answer is

affirmative, then the insurer should divest itself of control of the defense of the underlying claim. Likewise, if the insurer would benefit from a less-than-vigorous defense of a claim or a part of a claim (e.g., where substantial punitive damages are sought) then the insurer should consider giving up control of the defense.

Typical fact patterns where conflicts have been recognized by Illinois courts are:

(a) Defense of multiple claims or theories where one claim or theory results in coverage and others do not (e.g., intentional act/negligence); and

(b) Defense of cases where the potential for payment of compensatory damages is small when compared to the probable exposure for punitive damages.

In the case of Nandorf, Inc. v. CNA Insurance Cos., 134 Ill. App. 3d 134 (1985), a victim sued Nandorf for false imprisonment, seeking both compensatory and punitive damages. Id. at 135. The court characterized the damages as "a large amount of punitive damages and a relatively small amount of compensatory damages." Id. at 138. The insurer disclaimed indemnification of any punitive damage award on the basis that it was against Illinois public policy to insure for punitive damages. Id. at 135. The insured brought a declaratory action against the insurer. Id. at 135. The insurer brought a motion to dismiss which the trial court granted. In the interim, the insurer settled the underlying action. Id. at 136.

On appeal, the court reversed the decision of the trial court and found that a conflict of interest existed between the insurer and insured. It stated:

> The insurer and the insured shared a common interest in a finding of no liability. However, if [insured] was found liable, their interests diverged. [Insurer's] interests would have been just as well served by an award of nominal compensatory damages and substantial punitive damages. Such an award is not inconceivable. As a result of its reservation of rights, [insurer] has an interest in providing a less-than-vigorous defense to allegations in the [underlying] complaint which, if proved, would have supported an imposition of punitive damages. [Citations omitted] [Insurer's] failure to vigorously defend those allegations would have had the effect of subjecting its insured to greater liability. Clearly, the insurer's fidelity to its insured was hampered by its own interest in this case.

Id. at 138.

In Illinois Municipal League Risk Management Association v. Seibert, 223 Ill. App. 3d 864 (1992), the underlying action was a claimed violation of civil rights. The punitive damage risk was significant as the federal statute allowed for treble damages, attorney's fees, and costs to plaintiff, if successful.

Although the claimed punitive damages were only one-half of the claimed compensatory damages, the court expanded upon the Nandorf "balancing test" and stated that the "proportionality between potential compensation and punitive damages should not be the guiding factor" as to whether a conflict of interest exists. Id. at 875. The remainder of the opinion seems to indicate that, wherever there is a claim of punitive damages in an underlying complaint, a conflict of interest arises between insurer and insured. See Id. at 873-878.