wiley

NEWSLETTER

No Duty to Defend in Illinois Pending Conclusion of Recission Action

June 2006

An Illinois appellate court has held that when an insurer has a pending claim for rescission of an insurance contract, its duty to defend the underlying action is stayed pending the conclusion of the rescission action. *Those Certain Underwriters At Lloyd's v. Prof'l Underwriters Agency*, 2006 WL 1195622 (Ill. App. Ct. May 3, 2006).

The insurer issued a duty-to-defend E&O policy to an insurance agency. The insurer subsequently filed a complaint against the agency and two of its principals, seeking to rescind the policy based on material misrepresentations in the application process.

After the insurer had filed the declaratory judgment action, a third party filed a lawsuit against the agency, which the agency then tendered to the insurer. The insurer refused to defend, relying on the pending rescission action. The insurer then amended its complaint to add counts seeking a declaratory judgment that it owed no duty to defend the suit by the third party. The seventh count of the amended complaint alleged that the insurer had no duty to defend the complaint by the third party because the insurer had rescinded the policy. The trial court granted a motion by the agency to stay the litigation as to the first six counts pending resolution of the underlying litigation, but granted the insurer's motion for partial summary judgment as to the seventh count. This appeal ensued.

The appellate court explained that the Illinois Supreme Court had addressed the issue in *State Farm Fire & Casualty Co. v. Martin*, 710 N.E.2d 1228 (1999), which held that an insurer taking the position that a complaint "potentially alleging coverage is actually not covered under the insurance policy" has two choices: (i) it may defend the suit under a reservation of rights, or (ii) it may seek a declaratory judgment that there is no coverage. According to the court, "pursuant to the supreme court's ruling in *Martin*, an insurer's duty to defend is suspended upon its filing for a declaratory judgment that there is no coverage." Although the court noted that there was contrary authority from other jurisdictions, it explained that those cases are not binding in Illinois.

The appellate court rejected the argument by the agency and its principals that application of the *Martin* rule would be "unfair" because it would deprive them of "protection from financial harm that insurance policies are presumed to give." The court noted that if the insurer were to lose then it could be liable for the cost of

defense it should have provided. It also pointed out that two additional risks would limit the incentive of insurers to put forth baseless arguments in a declaratory judgment action in order to avoid providing coverage. First, if the insurer is found to have denied a defense "vexatiously" it could face statutory penalties. In addition, "an insurer that opts to file for a declaration that it owes no defense, as opposed to defend the insured under a reservation of rights, trades the burden of initially providing the cost of defense for the ability to protect the insurer's potential interest in the underlying litigation."

The court also noted that "the situation of the parties in this case does not dictate that we depart from our holding as a matter of equity." It did, however, quote the holding of the trial court, which reached the same conclusion, but also stated that in a case involving "extreme financial circumstances . . . the rules as set forth here could have some variation."