June 23, 2008

Re: Disclosing a conflict in the reservation of rights letter.

One common question we receive on coverage issues revolves around the need to disclose the existence of a conflict in the reservation of rights letter. A recent Illinois Appellate Court case nicely summarizes the law on this issue and explains the clear pitfalls an insurer may face in drafting a reservation of rights letter. In this case, an insurer nearly had to pay a $400,000 claim by simply not disclosing the existence of a potential conflict of interest in its reservation of rights letter.

In the Second District Appellate Court decision entitled *Stoneridge Development Company, Inc., and Highland Glen Associates v. Essex Insurance Company*, 2008 WL 1976617, the court held that Essex did not have a conflict of interest and that the policy did not otherwise cover Stoneridge's liability.

In *Stoneridge*, the underlying plaintiffs, John and Marie Walski, brought suit against Stoneridge for damage to their townhome, allegedly caused by Stoneridge's construction of the residence. The Walskis brought claims for a breach of the purchase contract and a breach of the implied warranty of habitability. At issue in the case was whether Essex, the insurer of Stoneridge, was required to provide coverage to Stoneridge for the damage to the Walskis' home.

Essex agreed to defend Stoneridge under a reservation of rights. Essex's letter essentially argued that the damages claimed were contractual and did not amount to property damage or an occurrence, as defined by the policy.

The Walskis declaratory judgment action against Essex alleged estoppel . They alleged that Essex was estopped from denying coverage to Stoneridge, because Essex had a conflict of interest with Stoneridge in its defense of the Walskis' claim. They based this allegation on Essex's reservation of rights letter, which they argued left Stoneridge facing a potentially covered implied warranty of habitability claim as well as uncovered contract claims. According to the Walskis, Essex failed to inform Stoneridge of this conflict of interest and should therefore be stopped from denying coverage. Interestingly, the retained counsel sought to dismiss the implied warranty of habitability claim on seven occasions. The arbitrator ruled that the claim was based on contract and refused to rule on the implied warranty of habitability claim. Essex then utilized this finding in support of its claim for a lack of coverage. The Walski's argued that defense counsel was clearly trying to steer the case into the uncovered claims, rather than the potentially covered claims.

The trial court entered summary judgment against Essex, finding that it had an undisclosed conflict of interest with Stoneridge and was therefore estopped from denying coverage. The trial court found that the attorney had structured the defense so that the insured was found liable on the uncovered claim rather than on the covered implied warranty of habitability claim. Of note, the trial court based its finding on the reservation of rights letter, rather than on the complaint and the policy.

The court first analyzed estoppel and stated, "While estoppel usually requires a showing of prejudice by the insured, and while the existence of such prejudice is typically a question of fact, if, 'by the insurer's assumption of the defense the insured has been induced to surrender his right to control his own defense, he has suffered a prejudice which will support a finding that the insurer is estopped to deny policy coverage,'" citing to *Maryland Casualty Company v. Peppers*, 64 Ill.2d 187, 196 (1976). The court stated that when such a conflict exists, an insurer "must decline to defend the insured and, instead of participating in the defense, the insurer must pay for independent counsel for the insured. If, however, the insurer goes ahead and defends its insured without disclosing the conflict of interest in its reservation of rights, the insurer will be estopped from raising coverage defenses." *Stoneridge*, citing to *Murphy v. Urso*, 88 Il.2d 444, 451 (1981); *Doe v. Illinois State Medical Inter-Insurance Exchange*, 234 Ill.App.3d 129, 134 (1992).

The court then went on to state the following test for determining whether there is a conflict of interest: "If, in the underlying suit, insurer-retained counsel would have the opportunity to shift facts in a way that takes the case outside the scope of policy coverage, then the insured is not required to defend the underlying suit with insurer-retained counsel."

Analyzing the facts of this case, the appellate court found that the implied warranty of habitability "arises with the execution of the contract" and "has roots in the execution of the contract." Thus, the court found it fair to characterize the implied warranty of habitability as contractual. Thus, with regards to the reservation of rights letter, the appellate court found that Essex, in its letter, was focusing on whether the factual allegations of the Walskis' claims fit within its policy, rather than focusing on the Walskis' two theories of liability. The appellate court held that the reservation of rights letter could not be read to state that it would cover the Walskis' implied warranty of habitability claim but not their contract claim i.e. cover one claim but not the other. As such, there was no conflict in the defense by Essex through its retained counsel. Therefore, Essex was not estopped from denying coverage based on its reservation of rights letter.

Although these findings and holdings are not new, this case presents a good case study of how a standard reservation of rights letter, if not drafted correctly, can subject an insurer to liability. In this case, the mere failure to disclose the conflict of interest nearly cost Essex the full judgment of nearly $400,000. The case also creates an interesting holding for the disclosure of the conflict. Although the case states that the insurer "must decline to defend the insured" and pay for independent counsel, the case further states that if the insurer goes ahead and defends, it must disclose the conflict in order to avoid an estoppel argument. This again creates an interesting dilemma. If the insured is willing to have the insurer defend after disclosure of the conflict, must the insurer refuse to do so. That does not appear to be the case as long as proper disclosure is made.

Should you have any questions regarding the holding in this opinion, please contact the undersigned.

Very truly yours,

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