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Illinois Appellate Court Addresses Insurer-Insured Conflict of Interest Created By Allegations of Punitive Damages

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Recently, in *Xtreme Protection Services., LLC v. Steadfast Ins. Co.*, 2019 IL App (1st) 181501 (May 3, 2019), the Illinois Appellate Court addressed whether and when allegations of punitive damages not covered by an insurance policy are sufficient to create a conflict of interest entitling an insured to independent counsel. In the underlying complaint the plaintiff alleged that he suffered damages when the insured's employee placed listening devices in plaintiff's office, attached GPS devices to his vehicles, and sent threatening or harassing text messages. The complaint sought "not less than" \$120,000 in compensatory damages and \$2.1 million in punitive damages against the insured. The insured had a policy with Steadfast that excluded coverage for "intentional, criminal, fraudulent, malicious or dishonest" acts. Steadfast, however, explicitly waived its right to deny coverage for compensatory damages based on these acts, but it reserved the right to deny coverage of any punitive damages.

Typically, an insurance carrier's duty to defend also includes the right to defend. Thus, with the duty to defend comes the insurer's right to control the defense and protect its financial interest in the outcome of the litigation. An exception exists, however, where the interests of the insurer and the insured are not aligned creating a conflict of interest. Generally speaking, when an actual conflict of interest exists between the insurance carrier and its insured, the insured is entitled to select independent counsel of its own choosing, at the insurer's expense.

In revisiting earlier Illinois case law, the Appellate Court began with the general rule in determining whether a conflict of interest exists: "we compare the allegations in the complaint to the policy and consider whether the insurer's interests would be furthered by providing a less-than-vigorous defense to those allegations." Similarly, the court noted that a conflict may exist when the facts to be resolved in the underlying case would allow the insurer-retained counsel to "lay the groundwork" for a subsequent denial of coverage. Often, conflicts of interest can manifest where an insurance carrier has a duty to defend one claim, but reserves the right to deny coverage for remaining claims that are excluded under the policy. The Xtreme Protection Court also recognized that a conflict can also exist if the underlying suit seeks punitive damages based on intentional or reckless conduct where the insurer's policy explicitly denies coverage for such conduct. In such cases, according to the court, "it is in the interest of the insured to be found negligent because the resulting damages would be covered by the policy, but it is in the insurer's interest to have a finding that the insured acted intentionally or with malice." *Xtremeat* ¶ 21 quoting *Nandorf, Inc. v. CNA Ins. Cos.*, 134 Ill. App. 3d 134 (1st Dist. 1985).

The court cautioned that the Nandorf holding did not mean an insured is entitled to independent counsel whenever the underlying action seeks punitive damages. Rather, in the case before it where “punitive damages formed a substantial portion of the potential liability in the [underlying action] and CNA’s disclaimer of liability for punitive damages left Nandorf with the greater interest and risk in the litigation,” a conflict of interest was created entitling the insured to retain independent counsel paid for by the carrier. *Id.* at ¶ 21. The Xtreme Protection Court also relied upon *Mobil Oil Corp. v. Maryland Casualty Co.*, 288 Ill. App. 3d 743 (1st Dist. 1997), which held that where the compensatory damages claims would likely exhaust the policy limits and there was the potential for a large punitive damages award not covered by the policy, a conflict existed because the insured had an interest to settle the case before trial whereas the insurer “would have lost nothing by letting the case go to the jury.”

Ultimately, to determine whether a conflict existed in the present case, the Xtreme Protection Court compared the allegations in underlying complaint to Steadfast’s policy and considered whether the insurer’s interests “would be furthered by providing a less-than-vigorous defense to those allegations.” As was the case in Nandorf and Mobil Oil, the underlying complaint sought a substantially greater amount of punitive damages than compensatory damages, but the policy explicitly denied coverage for punitive damages, and the carrier did not waive its reservation of rights regarding punitive damages. Based on the allegations and nature of underlying conduct, the Appellate Court found that an award of punitive damages was not inconceivable. “Where punitive damages form a substantial portion of the potential liability in the underlying action and Steadfast disclaims liability for punitive damages, Xtreme is left with the greater interest and risk in the litigation. Therefore, a conflict of interest exists, entitling Xtreme to obtain independent counsel paid for by Steadfast.” *Id.* at ¶ 29. Additionally, the Appellate Court reasoned that because the insurer denied coverage for punitive damages, it had little interest in defending against Plaintiff’s claims for punitive damages, further supporting the court’s analysis of a conflict.

The decision in Xtreme Protection is important in providing additional guidance to carriers as to whether and when allegations of punitive damages can create a conflict of interest entitling the insured to independent counsel. First and foremost, the Appellate Court reaffirmed that a reservation of rights or denial of coverage based solely upon an award of punitive damages may create a conflict of interest between an insured and its insurer, although that should not always be the case. While the Appellate Court did not offer a specific formula for determining such a conflict, where uncovered punitive damages form a “substantial portion of the potential liability” in the underlying action, and the insured is left with the greater interest and risk in the litigation, a conflict of interest will exist. Of course, like so much in coverage, where to draw that line is not so clear cut.