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Seventh Circuit: Policyholder Is Entitled to Independent Counsel at Insurer's Expense Where Excess Judgment Is Likely

Illinois courts have long held that a policyholder is entitled to retain independent counsel at the insurance company's expense whenever there is a conflict between the interests of the insurance company and those of the policyholder. Such a conflict typically arises where the insurer reserves its right to deny coverage and insurer-retained defense counsel would have an opportunity to shift facts in a way that takes the underlying litigation outside the scope of policy coverage. *American Family Mut. Ins. Co. v. W.H. McNaughton Builders, Inc.*, 363 Ill. App. 3d 505, 843 N.E. 2d 492 (2006). For example, where the underlying complaint alleges both negligent conduct (covered) and intentional conduct (not covered), insurer-retained defense counsel could provide a strong defense to the negligent-act allegations and a less vigorous defense to the intentional-act allegations, potentially resulting in the suit's not being covered.

For the first time, an appellate court, applying Illinois law, has held that a conflict of interest also arises between the insurer and the policyholder when it becomes clear to the insurer that a judgment against the policyholder in excess of policy limits is a "nontrivial probability." In *R.C. Wegman Construction Co. v. Admiral Insurance Co.*, 629 F. 3d 724 (7th Cir. 2011), a worker at a construction site managed by the policyholder was seriously injured in a fall and sued the policyholder. The policyholder tendered its defense to its liability insurer under a policy that had a $1 million limit. The insurer accepted the defense and retained counsel to defend the policyholder. The worker's suit proceeded to trial, and a judgment in excess of $2 million was entered against the policyholder.

The policyholder sued its insurer, alleging that the insurer was liable for the entire judgment due to its failure to inform the policyholder of the likelihood of an excess judgment. The policyholder alleged that, had it known of the likelihood of an excess judgment, it would have retained independent counsel to defend it in the underlying suit, notified its excess insurer and possibly settled the suit prior to trial. The policyholder alleged that its excess insurer denied coverage based on late notice, leaving the policyholder liable for the excess judgment.

The court found that the likelihood of an excess judgment gave rise to a conflict of interest because, due to the policy-limit cap on the insurer's liability, it had less incentive to settle than the policyholder. As such, the court held that the insurer had an obligation to notify the policyholder of the probability of an excess judgment, disclose the resulting conflict of interest and afford the policyholder the option "of hiring a new lawyer, one whose loyalty will be exclusively to him." By failing to do so, the insurer breached its fiduciary duty to the policyholder.

The *Wegman* decision is significant for policyholders in that it provides a strong basis for asserting a right to retain independent counsel at the insurer's expense where an excess judgment is a real possibility. The *Wegman* decision is also significant for insurers because it dictates that insurers must notify a policyholder where an excess judgment is a possibility and afford the option of hiring independent counsel at the insurer's expense. Where the insurer fails to do so, it may find itself liable for an excess judgment against the policyholder.

If you would like to discuss this case in further detail, please feel free to contact **Kevin J. Kuhn**, the Chair of Vedder Price's Insurance Law Practice, at 312-609-7652 or kkuhn@vedderprice.com.

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