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Illinois Supreme Court Takes Minority View in Reimbursement of Defense Costs

By Jennifer L. Smith

In *General Agents Insurance Company of America, Inc. v. Midwest Sporting Goods Company,* the Illinois Supreme Court decided to follow the minority view regarding an insurer's right to reimbursement of defense costs. 2005 Ill. LEXIS 324 (Docket No. 98814, March 24, 2005). In so doing, the court refused to permit an insurer to recover defense costs pursuant to a reservation of rights absent an express provision to that effect in the insurance contract between the parties.

In *Midwest Sporting Goods,* the City of Chicago sued Midwest Sporting Goods Company ("Midwest"), alleging that they created a public nuisance by selling guns to inappropriate purchasers. Midwest tendered its defense on both the City of Chicago's original and first amended complaints to its insurance carrier, General Agents Insurance Company of America ("General Agents"). On July 23, 1999, General Agents responded to Midwest with a reservation of rights letter stating that Midwest does not have coverage under its policy. The letter also stated that General Agents agreed to provide a defense, "without waiving any of its rights and defenses, including the right to recoup any defense costs paid in the event that it is determined that the Company does not owe the Insured a defense in this matter…." General Agents conceded that the insurance policy did not provide for reimbursement of defense costs, but attempted to expand its reservation of rights to include the right to reimbursement. Midwest failed to respond to the letter and accepted General Agents' payment of defense costs, for the payment of its own independent counsel.

On October 28, 1999, General Agents filed a declaratory judgment action seeking a declaration that it did not owe Midwest a defense in the underlying litigation. Both parties submitted summary judgment motions, and the issue turned on whether the plaintiffs in the underlying complaint were seeking damages in the nature of economic loss or bodily injury. The trial court held that the damages sought amounted to only economic loss, and granted General Agents' motion. The case went on appeal, and the appellate court affirmed the trial court's judgment. The trial court then decided General Agents' motion seeking to recover the defense costs that it had paid to Midwest's independent counsel in the underlying litigation, in which they were asking for a total of $40,517.34. The trial court held that General Agents had reserved its right to recoup its costs, and ordered Midwest to pay General Agents the full amount. Midwest then appealed the trial court's ruling, and the appellate court

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The Illinois Supreme Court has adopted the minority view regarding an insurer's right to reimbursement of defense costs following an award of declaratory judgment in its favor. An insurer may not recoup defense costs absent an express provision in the insurance policy to that effect. Insurers desiring recovery of defense costs must protect themselves by including cost recovery language in their contracts with their insureds, and then properly reserving their rights to such recovery. For current policies without such language, in order to avoid paying defense costs, the court was unsympathetic in holding that it is the insurer's duty to determine if coverage exists and therefore deny a tender of defense up front. This places insurance companies in a difficult position, being that their duty to defend an insured is much broader than their duty to indemnify.

again affirmed the trial court's ruling. The Supreme Court allowed Midwest's petition for leave to appeal.

Midwest argued on appeal that General Agents could not reserve the right to recoup defense costs because the insurance contract between the parties did not contain a provision allowing General Agents the right to recoup defense costs. General Agents argued that there was no contract governing the relationship between the parties because both the trial and appellate courts had held that the policies issued did not apply to the underlying litigation. General Agents maintained that it had no duty to defend Midwest, and thus was entitled to recoup the amounts paid.

The Supreme Court reviewed numerous cases from different jurisdictions on the issue. The majority of jurisdictions hold that an insurer is entitled to reimbursement of defense costs when (1) the insurer did not have a duty to defend, (2) the insurer timely and expressly reserved its right to recoup defense costs, and (3) the insured either remains silent in the face of the reservation of rights or accepts the insurer's payment of defense costs. These decisions are based on the finding that there was a contract implied in fact or law, or a finding that the insured was unjustly enriched when its insurer paid defense costs for claims that were not covered by the insured's policy. The Supreme Court held that as a matter of public policy, it could not condone an arrangement where an insurer can unilaterally modify its contract, through a reservation of rights, to allow for reimbursement of defense costs in the event that a court later finds that the insurer owes no duty to defend.

The court went on to state that to recognize such an implied agreement would be to place the insured in the position of making a choice between accepting conditions on its defense or losing its right to a defense from the insurer. In addition, the court could not find that an insured is unjustly enriched when its insurer tenders a defense, because an insurer is protecting its interests as much as it's insured when it tenders a defense or pays defense counsel pursuant to a reservation of rights. It is an insurance carrier's duty to make the decision as to whether there is a duty to defend an insured, and if it believes that no coverage exists, it should deny it's insured a defense at the beginning instead of defending and later attempting to recoup from its insured the costs of defense. The court found that if an insurer wishes to retain its right to seek reimbursement of defense costs in the event it later is determined that the underlying claim is not covered by the policy, the insurer should include such a term in its insurance contract.

The court then went on to adopt the minority view, where an insurer is not permitted to recover defense costs pursuant to a reservation of rights absent an express provision to that effect in the insurance contract between the parties. In essence, a reservation of rights letter serves to retain only those defenses that an insurer has under its policy. Because General Agents did not have an express provision regarding reimbursement of defense costs in its contract with Midwest, the court found it was not entitled to reimbursement of defense costs.

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