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Insurance Law

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Insurance Law

*Edward J. Zulkey**
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TABLE OF CONTENTS

I.	INTRODUCTION	605
II.	THE INSURER'S DUTY TO DEFEND AND INDEMNIFY	606
	<i>A. Toxic Tort Litigation: The Triggering of Coverage</i>	606
	<i>B. Manufacturer's Liability Insurance</i>	611
	<i>C. The "Other Employee" Exclusion</i>	612
	<i>D. Conflict of Interest: Punitive Damages</i>	614
	<i>E. Estoppel: The Prejudice Requirement</i>	616
III.	OBTAINING AND CANCELLING COVERAGE	618
	<i>A. Misrepresentation in Application</i>	618
	<i>B. Cancellation by Substitution</i>	619
	<i>C. Notification of Cancellation to Certificate Holder</i>	621
IV.	THE INSURER'S CONDUCT	622
	<i>A. The Duty of Good Faith Conduct</i>	000
	<i>B. Insurer's Vexatious Conduct</i>	625
V.	UNINSURED AND UNDERINSURED MOTORIST COVERAGE	626
	<i>A. Insurer's Duty of Good Faith Representation</i>	627
	<i>B. "Offer" Defined</i>	628
	<i>C. Physical Contact as a Condition Precedent to Recovery</i>	630
VI.	SPOUSAL HEALTH INSURANCE REFORM ACT	631
VII.	CONCLUSION	632

I. INTRODUCTION

The area of insurance law developed significantly during the

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Survey year. The cases decided encompassed a variety of important issues. The *Survey* year included, for example, a definition of the scope of bodily injury coverage in the toxic tort field. On a more familiar level, the courts discussed the approaches to both uninsured and underinsured motorist coverage. Additionally, the legislature offered insurance coverage protection to two previously disadvantaged groups — spouses of deceased wage-earners and divorced homemakers.

II. THE INSURER'S DUTY TO DEFEND AND INDEMNIFY

A. Toxic Tort Litigation: The Triggering of Coverage

Because of the multitude of asbestos-related claims affecting millions of dollars of insurance coverage,¹ the need to determine when asbestos-related diseases triggered insurance coverage became of tantamount importance. The Illinois Appellate Court for the First District addressed this issue in *Zurich Insurance Co. v. Raymark Industries, Inc.*² The court held that coverage was initiated by exposure to asbestos or by manifestation of a diagnosable asbestos-related disease.³ Additionally, the court defined the scope of an insurer's duty to defend once policy limits are exhausted. The *Zurich* court decided that under the policies at issue, an insurer's duty to defend a claim against its insured ceased when the indemnity limit of the policy had been reached.⁴

Raymark Industries, Inc., one of the defendants in *Zurich*, has been named as a defendant in a multitude of asbestos products liability actions.⁵ Over the span of years that it manufactured asbestos products,⁶ Raymark had been insured by various insurance companies under several comprehensive general liability policies.⁷

1. See *infra* note 5 and accompanying text.

2. 145 Ill. App. 3d 175, 494 N.E.2d 634 (1st Dist. 1986).

3. *Id.* at 190, 494 N.E.2d at 643. Asbestos-related diseases include asbestosis, mesothelioma, and bronchogenic carcinoma. *Id.*

4. *Id.* at 196, 494 N.E.2d at 647.

5. *Id.* at 180, 494 N.E.2d at 637. Over the last several years, approximately 25,000 claimants have filed suits against Raymark, alleging injuries related to asbestos exposure. *Id.*

6. The underlying claims alleged exposure to asbestos during the 1940's, 1950's, and 1960's, the span of years during which Raymark manufactured asbestos products. *Id.*

7. *Id.* at 180, 494 N.E.2d at 637. The insurance companies and their periods of coverage were as follows: May 1, 1941 to May 1, 1945 and February 4, 1947 to February 4, 1950 — Commercial Union Insurance Company; February 1950 to September 1951 — Globe Indemnity Company; September 26, 1951 to September 1967 — Federal Insurance Company; September 1967 to October 15, 1969 — Commercial Union; and October 15, 1969 to the present — Zurich Insurance Company. Raymark also had been covered by

Because of the number of claims and insurers involved, Zurich Insurance Company, one of Raymark's insurers, filed a declaratory judgment action to determine questions of coverage and defense obligations for the actions filed against Raymark.⁸ The coverage provisions of the policies involved were nearly identical in language, providing for the insurer to pay "all sums which the insured shall become legally obligated to pay as damages because of bodily injury . . . caused by an occurrence" The policies defined "bodily injury" to include "bodily injury, sickness or disease sustained by any person."¹⁰

The time at which a "bodily injury" had occurred due to asbestos-related disease was at issue in *Zurich* because such a disease often fails to manifest itself until several years after exposure to asbestos. Zurich, Raymark, and Raymark's other insurers advanced three different theories to determine when coverage was triggered: the exposure theory, the manifestation theory, and the *Keene* theory.¹¹

Under the exposure theory, coverage of asbestos claims depends solely on the individual claimant's period of active exposure to asbestos. This theory provides that all insurers whose policies were in effect during the exposure period share any indemnity and defense obligations pro rata.¹² Medical evidence establishing that tissue damage occurs shortly after inhalation of asbestos fibers supports application of this theory.¹³

Under the second theory, the manifestation theory, an insurer's coverage and defense obligations are triggered only by a medically detectable and diagnosable "bodily injury."¹⁴ As a result, coverage would not begin until an individual developed some recognizable signs of an asbestos-related disease.¹⁵

policies of excess insurance issued by Northbrook Excess & Surplus Insurance Company since 1976. *Id.*

8. *Id.* at 180-81, 494 N.E.2d at 637.

9. *Id.* at 181, 494 N.E.2d at 638.

10. *Id.*

11. *Id.*

12. *Id.* The exposure theory has been adopted by the Sixth Circuit in *Insurance Co. of North America v. Forty-Eight Insulations*, 633 F.2d 1212 (6th Cir.), *cert. denied*, 455 U.S. 1109 (1981); the Fifth Circuit in *Porter v. American Optical Corp.*, 641 F.2d 1128 (5th Cir.), *cert. denied*, 454 U.S. 1109 (1981); and the Eleventh Circuit in *Commercial Union Ins. Co. v. Sepco Corp.*, 765 F.2d 1543 (11th Cir. 1985).

13. *Id.* at 189, 494 N.E.2d at 643. The exposure theory was advanced by Zurich and Northbrook. *Id.*

14. *Id.* at 182, 494 N.E.2d at 638. The manifestation theory was advanced by Commercial Union and Federal. *Id.*

15. *Id.* The United States Court of Appeals for the First Circuit adopted the manifes-

The third theory provides that coverage for an insured commences with the first inhalation of asbestos and continues through both the exposure and clinical manifestation stages of an asbestos-related disease.¹⁶ Based on *Keene Corp. v. Insurance Co. of North America*,¹⁷ this theory has come to be known as the *Keene*, hybrid, or triple trigger theory.¹⁸ The *Keene* approach provides an insured with the maximum coverage because policies in effect only during the latent period of an asbestos-related disease are triggered in addition to policies in effect at the time of exposure and manifestation.¹⁹

During the *Zurich* trial, the parties called both pathologists and clinicians to define the terms "injury" and "disease." The pathologists defined "injury" as "an alteration of structure and function of a cell, tissue or organ."²⁰ Accordingly, the pathologists viewed asbestos-related diseases as a process beginning with inhalation and continuing through manifestation.²¹ The clinicians, however, testified that an "injury" required a noticeable harm.²² The clinicians concluded that because the body's defenses appear to negate effectively the harmful effects of asbestos for varied periods of time, a "disease" does not occur until it can be diagnosed.²³ Based upon this evidence and the policy provisions, the trial court held that coverage should be provided if an insurer's policy was in effect either during the claimant's exposure period or when an asbestos-related disease manifested itself in the claimant, but not if the policy was in effect only during the period after a claimant was ex-

theory in *Eagle-Picher Indus., Inc. v. Liberty Mut. Ins. Co.*, 682 F.2d 12 (1st Cir. 1982), *cert. denied*, 460 U.S. 1028 (1983).

16. *Zurich*, 145 Ill. App. 3d at 182, 494 N.E.2d at 638. Only Raymark advanced the hybrid theory. *Id.* See *infra* notes 17-19 and accompanying text.

17. 667 F.2d 1034 (D.C. Cir. 1981), *cert. denied*, 455 U.S. 1007 (1982). Keene Corporation manufactured asbestos and sought a declaratory judgment of its rights and obligations under several comprehensive general liability policies issued to it. The court held that coverage was triggered by inhalation exposure, exposure in residence, and manifestation. *Id.* at 1047.

18. *Zurich*, 145 Ill. App. 3d at 182, 190, 494 N.E.2d at 638-39.

19. *Id.* at 182, 494 N.E.2d at 638. For example, under the *Keene* theory, if an individual was first exposed to asbestos in 1970 but did not manifest any disease until 1975, a policy effective from 1971 to 1974 would be triggered. The *Keene* theory was adopted by the Third Circuit in *AC and S, Inc. v. Aetna Casualty & Sur. Co.*, 764 F.2d 968 (3d Cir. 1985). *Accord* *Lac d'Amiante du Quebec, Ltee v. American Home Assurance Co.*, 613 F. Supp. 1549 (D.C. N.J. 1975).

20. *Zurich*, 145 Ill. App. 3d at 183, 494 N.E.2d at 639.

21. *Id.* at 184, 494 N.E.2d at 639.

22. *Id.* at 183, 494 N.E.2d at 639.

23. *Id.* at 183-86, 494 N.E.2d at 639-41.

posed but before an asbestos disease manifested itself.²⁴ Thus, the trial court adopted both the exposure and manifestation theories, but rejected the *Keene* or hybrid approach.

In affirming the trial court's ruling, the appellate court noted at the outset that because of the disjunctive language of the policy provisions, coverage could be commenced by "bodily injury," "disease," or "sickness."²⁵ Because asbestos caused damage at the cellular level immediately after inhalation, the court reasoned that a "bodily injury" had occurred, triggering coverage.²⁶ In addition, the court concluded that the fact that the damage was "subclinical and require[d] medical research to verify d[id] not detract from the fact that a real injury [had] occur[red]."²⁷

The *Zurich* court upheld manifestation as a triggering event because manifestation clearly fell within the plain meaning of "disease."²⁸ Furthermore, the court noted that coverage could be triggered before an asbestos disorder occurred if the individual suffered from a "weakened or disordered condition" because such a condition would fall within the plain meaning of the term "sickness."²⁹

The court rejected the *Keene* approach for two reasons. First, the court determined that the medical evidence failed to support the finding that injury always occurs in the absence of exposure.³⁰ In addition, the *Keene* court had not relied on medical evidence in reaching its decision, but rather had concluded that the terms "bodily injury," "disease," and "sickness" were ambiguous and could not be used to determine the events triggering coverage.³¹ Consequently, the *Keene* court utilized the "reasonable expectations" doctrine in making its determination, construing the insurance policies to effect the reasonable expectations of the insured.³²

24. *Id.* at 186, 494 N.E.2d at 641.

25. *Id.* at 187-88, 494 N.E.2d at 642.

26. *Id.* at 187, 494 N.E.2d at 642. The evidence presented at trial established that asbestos fibers caused physical damage to cells in the lung within hours of inhalation. The body's apparent ability to repair the initial damage proved irrelevant to the court's determination of coverage. Thus, the court dismissed Commercial Union's and Federal's "manifestation-only" argument that one could not determine when a "disease" had commenced because the body repaired itself. *Id.* at 188-90, 494 N.E.2d at 642-43.

27. *Id.* at 189, 494 N.E.2d at 643.

28. *Id.* at 190, 494 N.E.2d at 644.

29. *Id.*

30. *Id.* at 191, 494 N.E.2d at 644. The *Zurich* court noted that no evidence had been presented to show that a new injury always occurred in the absence of exposure to asbestos. *Id.*

31. *Id.*

32. *Id.* at 191-92, 494 N.E.2d at 645. The "reasonable expectations" doctrine pro-

Illinois, however, does not recognize this doctrine.³³

Having determined when coverage was triggered, the appellate court in *Zurich* addressed when the insurers' duty to defend ceased. The court held that the policy provisions clearly established that no duty to defend existed after the policy limits had been exhausted.³⁴

Finally, the court rejected Zurich's argument that all insurers share indemnity payments and defense costs pro rata determined by the insurer's period of coverage in relation to the total period of exposure.³⁵ Based on the policy language, the court held each carrier independently liable to Raymark for the full costs of defense and indemnity, thus leaving the insurers to determine their share of contribution among themselves.³⁶ The court reasoned that the insurers' right to contribution should not affect their duty to their insured.³⁷

The *Zurich* opinion is significant because of the number of cases and amount of money involved.³⁸ More importantly, however, this case represents the first time that an Illinois appellate court has defined the scope of coverage in bodily injury toxic tort cases. By rejecting the *Keene* theory, however, the *Zurich* court's holding has invited further litigation in this area. Its rejection of the *Keene* theory leaves a potential gap in the coverage between the years of exposure and the time when the disease manifests itself. As a practical matter, this gap may coincide with the insured's maximum coverage. Moreover, it is conceptually difficult to understand how a bodily injury can occur during exposure but not again until manifestation.

vides that the "objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though a painstaking study of the policy provisions would have negated these expectations." *Keene*, 667 F.2d at 1042 n.12.

33. *Zurich*, 145 Ill. App. 3d at 192, 494 N.E.2d at 645. *Accord* *Bain v. Benefit Trust Life Ins. Co.*, 123 Ill. App. 3d 1025, 463 N.E.2d 1082 (5th Dist. 1984); *Insurance Company of North America v. Adkisson*, 121 Ill. App. 3d 224, 459 N.E.2d 310 (3d Dist. 1984).

34. *Zurich*, 145 Ill. App. 3d at 193, 494 N.E.2d at 645-46. The insuring agreements of the policy specifically were made subject to the limits of liability, and thus the duty to defend was linked to the indemnity limits. *Id.*

35. *Id.* at 200, 494 N.E.2d at 650. For a criticism of this pro rata approach, see *Sandoz, Inc. v. Employer's Liability Assurance Corp.*, 554 F. Supp. 257 (D.C. N.J. 1983).

36. *Zurich*, 145 Ill. App. 3d at 200-01, 494 N.E.2d at 650-51.

37. *Id.*

38. *See* *Zurich Ins. Co. v. Raymark, Inc.*, No. 78 L 8760 (Cir. Ct. of Cook County August 1, 1986). The order indicates that approximately 30,000 cases have been filed against Raymark, with an average of 900 filings per month over the past year. *Id.* To date, millions of dollars have been expended in the defense of these claims.

The *Zurich* holding that the duty to defend terminates upon exhaustion of policy limits also is important because it applies to policies issued both before and after 1966. In 1966, the standard form policy added this termination limitation on the duty to defend.³⁹ Most courts interpreted this revision as an indication that the pre-1966 policies were designed to provide a defense obligation even after limits were exhausted.⁴⁰ The *Zurich* court held that the duty to defend did not exist in cases filed after limits were exhausted and that affected insurers could withdraw their defense of such pending cases. The court reasoned that an insurer could not be expected to defend when it had no indemnity money at stake. Many prior decisions had held that the duty to defend was separate and independent of the duty to indemnify. This aspect of the opinion, if not reversed, represents a major victory for the insurance industry by eliminating potential financial obligations on the part of insurers.

B. *Manufacturer's Liability Insurance*

During the *Survey* year, the Illinois Appellate Court for the First District confronted the issue of whether a manufacturer's general liability policy extends coverage to claims against the insured for property damage to the insured's own product. The court in *Great Southwest Fire Insurance Co. v. Greenlee*⁴¹ applied the recent decision of the Illinois Supreme Court in *Western Casualty & Surety Co. v. Brochu*⁴² and held that coverage did not extend to claims arising from damage to the insured's own product or work.⁴³

In *Greenlee*, the insurer, Great Southwest, sought a declaration of its obligation to defend and indemnify its insured, Greenlee.⁴⁴ The underlying plaintiffs sought recovery against Greenlee for the collapse of grain storage bins that Greenlee had constructed and installed.⁴⁵ The complaint alleged that the bins had collapsed and were extensively damaged.⁴⁶

The appellate court granted summary judgment for Great

39. *Zulkey & Pollard, The Duty to Defend After Exhaustion of Policy Limits*, 27 FOR THE DEFENSE 21, 22 (1985).

40. For a discussion and review of the insurer's duty to defend after exhaustion of policy limits, see generally *Zulkey & Pollard, supra* note 39, and cases cited therein.

41. 134 Ill. App. 3d 816, 481 N.E.2d 28 (1st Dist. 1985).

42. 105 Ill. 2d 486, 475 N.E.2d 872 (1985).

43. *Greenlee*, 134 Ill. App. 3d at 821, 481 N.E.2d at 31.

44. *Id.* at 817, 481 N.E.2d at 28.

45. *Id.*

46. *Id.* at 817, 481 N.E.2d at 29.

Southwest based on exclusions in the policy which provided that the insurance did not apply to property damage to the insured's own products or work.⁴⁷ In finding that these provisions excluded coverage of the claim, the court relied on the recent Illinois Supreme Court decision in *Western Casualty & Surety v. Brochu*⁴⁸ which interpreted identical exclusions. In *Brochu*, the court held that such a work product exclusion applied when the complaint sought recovery for damage to the property itself.⁴⁹ The *Greenlee* court, noting that the case before it was identical to *Brochu*, held that no coverage existed because the complaint sought recovery for "damage to the property itself rather than damage resulting from an accident caused by the bin" ⁵⁰ Accordingly, the *Greenlee* application of *Brochu* definitively establishes the exclusion from coverage of damage to property which is the subject of the contract between the insured contractor or manufacturer and the claimant.

C. The "Other Employee" Exclusion

The standard contractor's general liability policy names the contractor's employees as additional insureds. Consequently, liability for the negligent acts of the contractor's employees falls within coverage of the standard policy. Such coverage, however, is normally excluded for bodily injury to another employee. These exclusions, known as "other employee" or "co-employee" exclusions, preclude insurance coverage of injuries to employees of the contractor caused by the negligence of their fellow employees. Such injuries normally fall within the purview of the Worker's Compensation Act.⁵¹

The issue of whether the "other employee" exclusion in a contractor's comprehensive general liability policy precludes coverage of a third-party claim brought against an employee was reviewed in *Howalt v. Ohio Casualty Insurance Co.*⁵² The Illinois Appellate

47. *Id.* at 817-18, 481 N.E.2d at 29. The policy provided that the insurance did not apply:

(n) to property damage to the named insured's products arising out of such products or any part of such products;

(o) to property damage to work performed by or on behalf of the named insured arising out of the work or any portion thereof, or out of materials, parts or equipment furnished in connection therewith,

Id.

48. 105 Ill. 2d 486, 475 N.E.2d 872 (1985).

49. *Id.* at 496-97, 475 N.E.2d at 877.

50. *Greenlee*, 134 Ill. App. 3d at 821, 481 N.E.2d at 31.

51. ILL. REV. STAT. ch. 48, para. 138.1 (1985).

52. 142 Ill. App. 3d 435, 491 N.E.2d 1207 (1st Dist. 1986).

Court for the First District held that such exclusions do not preclude coverage of third-party contribution actions brought against an employee arising from injuries to a fellow employee.⁵³

In *Howalt*, the insurer, Ohio Casualty, issued to Mozden Construction Company a liability policy with a rider extending coverage for claims against its employees, excepting those brought by co-employees.⁵⁴ Howalt, an employee of Mozden Construction, was operating a crane when the crane tipped over and struck Rory Mozden, another employee.⁵⁵ Rory Mozden filed suit against Howalt, the crane manufacturer, and the general contractor. The latter two parties filed third-party contribution actions against Mozden Construction,⁵⁶ which in turn filed a third-party contribution action against Howalt.⁵⁷ As an employee of Mozden Construction and an additional insured under its policy, Howalt tendered the defense of Rory Mozden's direct claim and Mozden Construction's third-party action to Ohio Casualty.⁵⁸ Ohio Casualty refused the tender of defense based upon the policy's "other employee" exclusion.⁵⁹

The *Howalt* court determined that the "other employee" exclusion did not exclude the insurer's obligation to defend and indemnify a third-party claim for contribution, even though that claim arose from an underlying claim involving injury to a co-employee.⁶⁰ The court noted that the language of the exclusion was unambiguous, applying solely to a claim by one employee against his fellow employee and not to contribution actions against the employee arising out of injury to a co-employee.⁶¹ The court, utilizing simple "contract construction" principles, found that the "co-employee" exclusion did not extend to contribution claims brought against the tortfeasor-employee.⁶²

The *Howalt* court, in dicta, cited with approval the New York case of *Weeks v. County of Oneida*.⁶³ *Weeks* concerned a general

53. *Id.* at 441, 491 N.E.2d at 1211.

54. *Id.* at 437, 491 N.E.2d at 1209.

55. *Id.* at 437, 491 N.E.2d at 1208.

56. *Id.* at 437, 491 N.E.2d at 1208-09.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.* at 440, 491 N.E.2d at 1211. The "other employee" exclusion provided that "the insurance afforded to such employee does not apply to bodily injury to another employee of the same employer arising out of or in the course of his employment" *Id.*

61. *Id.* at 440-41, 491 N.E.2d at 1211.

62. *Id.*

63. 91 A.D.2d 1165, 459 N.Y.S. 2d 334 (1983).

liability policy which contained an exclusion eliminating coverage for areas covered by Workmen's Compensation. The standard exclusion precluded coverage for bodily injury suffered by an employee in the course of his employment and for the employer's obligation to indemnify another arising out of such injury.⁶⁴ The wording of this standard Workmen's Compensation exclusion pre-dates contribution actions. The court held that the use of the phrase "to indemnify" in the standard exclusion did not extend indemnification to contribution actions against a plaintiff's employer.⁶⁵ The *Weeks* court's interpretation means that coverage is provided under both workmen's compensation and general liability policies. While Illinois may wish to endorse *Weeks*, unfortunately the *Howalt* opinion, involving totally different contractual principles, merely devoted three sentences in dicta to the contribution issue, and thus, provided future support for a major revision in insurance law.

D. Conflict of Interest: Punitive Damages

When, in the defense of a claim, a conflict of interest exists between an insurer and its insured,⁶⁶ the insured may retain independent counsel at the insurer's expense.⁶⁷ The Illinois Appellate Court for the First District expanded the scope of such conflict situations in *Nandorf v. CNA Insurance Cos.*⁶⁸ The court held that when punitive damages represent a substantial portion of potential liability in an underlying action, an insurer's reservation of rights as to indemnification for these damages creates a conflict of interest between the insurer and the insured sufficient to warrant retention of independent counsel at the insurer's expense.⁶⁹

In *Nandorf*, CNA Insurance issued a comprehensive general liability policy to Nandorf. Pursuant to the policy, Nandorf tendered to CNA the defense of a false imprisonment action filed against it. CNA accepted the defense but reserved its indemnification rights regarding any punitive damages assessed against Nandorf.⁷⁰

64. *Id.* at 1167, 459 N.Y.S. 2d at 336.

65. *Id.*

66. The seminal Illinois cases treating conflicts of interest between insurer and insured are as follows: *Murphy v. Urso*, 88 Ill. 2d 444, 430 N.E.2d 1079 (1981); *Thornton v. Paul*, 74 Ill. 2d 132, 384 N.E.2d 335 (1978); and *Maryland Casualty Co. v. Peppers*, 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

67. *Thornton v. Paul*, 74 Ill. 2d 132, 384 N.E.2d 335 (1978); *Maryland Casualty Co. v. Peppers*, 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

68. 134 Ill. App. 3d 134, 479 N.E.2d 988 (1st Dist. 1985).

69. *Id.* at 140, 479 N.E.2d at 993-94.

70. *Id.* at 135, 479 N.E.2d at 990.

Nandorf contended that CNA's reservation of rights created a conflict of interest and, therefore, CNA was responsible for the attorney's fees incurred by Nandorf's retention of independent counsel.⁷¹

The court held that a conflict of interest existed,⁷² noting that the actions against Nandorf sought large punitive damage awards and relatively small amounts of compensatory damages.⁷³ Because any punitive damage award would have fallen outside policy coverage, a finding of small compensatory damages but substantial punitive damages would have been in CNA's best interests.⁷⁴ Nandorf, however, would have been best served by a finding of no punitive damages because all other damages would fall under potential policy coverage.⁷⁵ The court thus determined that the parties' interests were divergent. Accordingly, the court reasoned that CNA lacked an incentive to defend vigorously the allegations which would have supported an imposition of punitive damages, leaving Nandorf with both the greater interest and risk in the litigation.⁷⁶ The *Nandorf* court held that an insurer's reservation of rights regarding punitive damages leaves the insurer and the insured in a conflict of interest.⁷⁷

Despite the court's admonition that its holding did not imply "that an insured [was] entitled to independent counsel whenever punitive damages are sought in the underlying action,"⁷⁸ the *Nandorf* decision potentially leaves insurers liable for their insured's retention of independent counsel whenever a reservation of rights regarding punitive damages is made. While the court recognized that punitive damages formed a "substantial portion of [CNA's] potential liability,"⁷⁹ it set forth neither guidelines nor parameters indicating when a reservation regarding punitive damages creates a conflict. For example, the court left undecided whether the amount of punitive damages sought should be the sole factor in determining what is a "substantial portion" or whether the critical factor is the amount of punitive damages relative to the potential for compensatory damages. Without further delineation, insurers

71. *Id.* at 136, 479 N.E.2d at 990-91.

72. *Id.* at 140, 479 N.E.2d at 993.

73. *Id.* at 138-39, 479 N.E.2d at 992.

74. *Id.*

75. *Id.* Each claimant sought \$5,000 in compensatory damages and \$100,000 in punitive damages. *Id.* at 135, 479 N.E.2d at 990.

76. *Id.* at 138, 479 N.E.2d at 992.

77. *Id.*

78. *Id.* at 140, 479 N.E.2d at 993.

79. *Id.* at 140, 479 N.E.2d at 993-94.

stand at risk for reimbursement of independent counsel every time they reserve their rights to indemnification of punitive damage awards.⁸⁰

Additionally, the *Nandorf* decision contravenes a recent appellate court decision, *Pekin Insurance Co. v. Home Insurance Co.*⁸¹ The two decisions interpret differently the conflict of interest which arises when a reservation has been made to indemnification. In *Pekin*, the insurer agreed to defend a claim against an additional insured but reserved its rights to any indemnification because the policy limits had been exhausted in a settlement on behalf of a co-insured.⁸² The Illinois Appellate Court for the First District in *Pekin* held that although the insurer had no indemnity funds at risk in the litigation, no conflict of interest existed.⁸³

Under the *Pekin* decision, the mere fact that an insurer's indemnity funds are not at risk in defending a claim involving punitive damages would not create a conflict of interest.⁸⁴ The *Nandorf* decision, however, creates a potential per se conflict of interest situation each time an insurer reserves its rights to indemnification of punitive damages.

E. Estoppel: The Prejudice Requirement

During the *Survey* year, the Illinois Appellate Court for the First District determined when an insurer may be estopped from asserting a defense of noncoverage. In *Economy Fire & Casualty v. Green*,⁸⁵ the court held that invocation of the estoppel doctrine required a showing of prejudice by the insured.⁸⁶ Moreover, the court determined that no prejudice resulted when the insurer, accepting the defense of an action without any reservation of rights,

80. Several commentators have argued that no conflict of interest existed in *Nandorf* because CNA simply had taken an erroneous position on the insurance of punitive damages. Hamilton & Smith, 75 ILL. B.J. 14 (1986). CNA had asserted that punitive damages were not covered under Illinois law. *Nandorf*, 134 Ill. App. 3d at 135, 479 N.E.2d at 990. *Nandorf*, however, involved punitive damages for which the insured would be held vicariously liable. Arguably, the insuring of such damages is permitted under the holding of *Scott v. Instant Parking, Inc.*, 105 Ill. App. 2d 133, 245 N.E.2d 124 (1st Dist. 1969). As a result, the *Nandorf* court had no reason to decide whether a conflict of interest existed. See generally Hamilton & Smith, *supra*.

81. 134 Ill. App. 3d 31, 479 N.E.2d 1078 (1st Dist. 1985). See *infra* notes 131-50 and accompanying text.

82. *Pekin*, 134 Ill. App. 3d at 32-33, 479 N.E.2d at 1080.

83. *Id.* at 35, 479 N.E.2d at 1081-82.

84. *Id.* For a discussion of this viewpoint and the *Nandorf* decision, see Hamilton & Smith, 75 ILL. B.J. 14 (1986).

85. 139 Ill. App. 3d 147, 487 N.E.2d 100 (1st Dist. 1985).

86. *Id.* at 151, 487 N.E.2d at 103.

subsequently filed a declaratory action to determine coverage.⁸⁷

In *Economy Fire*, the insured, Green, tendered to her insurer, Economy Fire, the defense of a contribution claim alleging her negligent supervision of her child.⁸⁸ Green's seven year-old child had been injured when struck by a truck.⁸⁹ Economy Fire informed Green that although it would provide a defense to the contribution action, it would not defend certain allegations of the complaint. The attorneys retained by Economy Fire entered an appearance, and eight months later Economy Fire filed a declaratory judgment action to determine coverage.⁹⁰ Green asserted that because Economy Fire had undertaken her defense without reserving its rights to later deny coverage, Economy Fire was estopped from asserting noncoverage.⁹¹

The appellate court granted summary judgment for Economy Fire relying on *Maryland Casualty Co. v. Peppers*.⁹² The *Economy Fire* court reaffirmed the Illinois Supreme Court holding that an insured may be estopped from asserting noncoverage when it has undertaken that defense of an action and prejudice to the insured results from that undertaking.⁹³ The *Economy Fire* court observed that the facts failed to indicate that Green had suffered any prejudice, and thus the estoppel doctrine could not be applied.

The *Economy Fire* decision is noteworthy for two reasons. First, it establishes that an insured does not suffer prejudice per se when an insurer accepts the defense of certain counts of a complaint, rejects the defense of other counts, and later files a declaratory action to determine coverage under the complaint although the insurer had not reserved its rights to deny coverage. Secondly, it requires a showing of prejudice to the insured prior to invoking estoppel. Under the *Economy Fire* holding, the insured carries the burden of establishing its prejudice by the insurer's actions when attempting to invoke the estoppel doctrine.

87. *Id.*

88. *Id.* at 148, 487 N.E.2d at 101.

89. *Id.*

90. *Id.* at 150, 487 N.E.2d at 102.

91. *Id.*

92. 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

93. *Economy Fire*, 139 Ill. App. 3d at 151, 487 N.E.2d at 103 (citing *Maryland Casualty Co. v. Peppers*, 64 Ill. 2d 187, 195, 355 N.E.2d 24, 29 (1976)).

III. OBTAINING AND CANCELLING COVERAGE

A. *Misrepresentation in Application*

The effect of an insured's knowledge of possible claims against it when applying for an insurance policy was considered in *Great West Steel Industries, Ltd. v. Northbrook Insurance Co.*⁹⁴ The Illinois Appellate Court for the First District held that no material misrepresentation occurs when an insured fails to report on its application, circumstances which the insured does not believe constitute a possible claim against it.⁹⁵ In *Great West*, the insurer, Northbrook, issued to Great West Steel Industries a professional liability insurance policy covering engineers' errors and omissions.⁹⁶ The policy application required the insured to list any circumstances which might result in a possible claim against it.⁹⁷ In responding to this question, Great West neglected to mention the collapse of the roof on one of its projects. Prior to completion of the application, the roof collapsed.⁹⁸ Another part of the roof collapsed after its completion.⁹⁹ Subsequently, two lawsuits were filed against Great West concerning the second collapse.¹⁰⁰ Northbrook, contending that Great West's answers to the application questions constituted a material misrepresentation in light of the roof collapses, refused to defend Great West.¹⁰¹

The appellate court held that Great West had no knowledge of the design defects leading to the second roof collapse because evidence demonstrated that the cause of the second collapse was unrelated to the first collapse.¹⁰² In addition, the *Great West* court

94. 138 Ill. App. 3d 84, 484 N.E.2d 847 (1st Dist. 1985).

95. *Id.* at 93, 484 N.E.2d at 853.

96. *Id.* at 87, 484 N.E.2d at 849. The professional liability insurance policy provided coverage for "any act, error or omission committed or alleged to have been committed by the [i]nsured . . . provided always that . . . [t]he [i]nsured has no knowledge of such act, error, or omission on the effective date of this Policy." *Id.*

97. *Id.* at 87-88, 484 N.E.2d at 849-50. The application included the following questions: 19A. Has any claim ever been made against the firm or against any persons named in question #8 above? If so, state briefly the cause and nature of the claim including the amount involved and names of the project and the claimant, the date when the claim was made, the date the act giving rise to the claim was committed and the final disposition: 19B. Is the Applicant aware of any circumstances which may result in any claim against him, his predecessors in business, or any of the present or past partners or officers? — Yes — No. If yes, please give full details on the same basis as 19A. *Id.*

98. *Id.* at 87, 484 N.E.2d at 849.

99. *Id.*

100. *Id.* at 88, 484 N.E.2d 850.

101. *Id.* A material misrepresentation is one which reasonably might have influenced the insurer in deciding whether to accept or reject the risk. *Safeway Ins. Co. v. Duran*, 74 Ill. App. 3d 846, 850, 393 N.E.2d 688, 691 (1st Dist. 1976).

102. *Great West*, 138 Ill. App. 3d at 91, 484 N.E.2d at 852.

determined that no material misrepresentation existed because the evidence also showed that in Great West's "professional judgment" the first roof collapse was caused by construction error rather than design defects.¹⁰³ Because Great West was not responsible for construction, its failure to report the first roof collapse did not constitute a material misrepresentation; in its own judgment, the collapse was caused by construction error. Accordingly, the court determined that Great West could not have had knowledge of a possible claim against it.¹⁰⁴

In a strong dissent, Justice Jiganti argued that the trial court's finding that Great West had knowledge of a potential claim regarding the collapsed roof was not against the manifest weight of the evidence.¹⁰⁵ He framed the issue simply as whether Great West had knowledge of an error, noting that Great West knew certain experts believed there had been a design defect.¹⁰⁶ Thus, Justice Jiganti asserted that the "knowledge" provision of the policy should be construed broadly, requiring the insured to report even those acts, errors, or omissions which it did not believe to represent a potential claim.¹⁰⁷

The decision in *Great West* relaxes an insured's duty to reveal circumstances which might constitute a possible claim against it. The court subjectively interpreted the word "knowledge", concluding that the insured had only a duty to report those occurrences that might constitute a claim in its own judgment. This subjective interpretation of the word "knowledge" allows an insured to ignore any incident which, in its own judgment, does not fall within the parameters of the application's inquiries. The result in *Great West* undermines the extent to which an insurance application can serve effectively as a measure of an applicant's potential risk exposure.

B. Cancellation by Substitution

In *Copley v. Pekin Insurance Co.*,¹⁰⁸ the Illinois Supreme Court modified the requirements of cancellation by substitution.¹⁰⁹ The court, implicitly rejecting the cancellation requirements set out in

103. *Id.*

104. *Id.* at 93, 484 N.E.2d at 853.

105. *Id.* at 95, 484 N.E.2d at 855.

106. *Id.* at 99, 484 N.E.2d at 857.

107. *Id.*

108. 111 Ill. 2d 76, 488 N.E.2d 1004 (1986). The old requirements had been set out in *Sizelove v. INA Ins. Co.*, 104 Ill. App. 3d 864, 433 N.E.2d 696 (4th Dist. 1982).

109. *Id.* at 85, 488 N.E.2d at 1003.

the appellate court case of *Sizelove v. INA Insurance Co.*,¹¹⁰ held that a policy could be cancelled only by strict compliance to the cancellation provisions of the policy itself, or by mutual consent of the insurer and the insured.¹¹¹

Copley, the insured, filed a claim under a multiperil insurance policy issued by Pekin Insurance Company ("Pekin"). Pekin denied the claim, maintaining that under the doctrine of cancellation by substitution, the policy had been cancelled.¹¹² Meanwhile, Copley had obtained another insurance policy from Federated Mutual Insurance Company. With Copley's consent, the agent for Federated Mutual met with Pekin's insurance agent and relayed Copley's desire to cancel the Pekin policy.¹¹³ Federated Mutual's agent failed, however, to either return the actual policy issued by Pekin or tender a written release of the policy signed by Copley.¹¹⁴ Pekin's agent testified that he did not consider the policy cancelled after he had met with the Federated Mutual agent.¹¹⁵

The supreme court in *Copley* held that "insurance policies, like other contracts, may be cancelled only in accordance with the terms of the insurance contract, or through the mutual consent of the insurer and the insured."¹¹⁶ Applying this test, the court concluded that Copley's policy was effective at the time in question. Copley had not cancelled under the policy terms, nor had there been mutual consent to cancel the policy because Pekin's own agent testified that he had not accepted Copley's cancellation.¹¹⁷

The *Copley* decision severely restricts the application of the cancellation by substitution doctrine. Under the *Copley* standard, unilateral notification of an intent to cancel can no longer invoke the doctrine. Under the old *Sizelove* standard, an insured's actions could have led to cancellation if those actions disclosed an intent to cancel. This new standard requires mutual consent; only an agree-

110. 104 Ill. App. 3d 864, 433 N.E.2d 695 (4th Dist. 1982). The *Sizelove* court set out the following requirements:

(1) The insured must have secured substitute coverage and either acted in such a manner as would disclose to the insurer an intent to cancel the existing coverage or requested cancellation under terms of the existing policy; or ;

(2) The insured must have secured substitute coverage and mutual consent to cancel the existing coverage must exist between the insured and the insurer.

Id. at 868, 433 N.E.2d at 698.

111. *Copley*, 111 Ill. 2d at 85, 488 N.E.2d at 1008.

112. *Id.* at 78, 488 N.E.2d at 1005.

113. *Id.* at 80, 488 N.E.2d at 1006.

114. *Id.* at 85, 488 N.E.2d at 1008.

115. *Id.* at 80, 488 N.E.2d at 1006.

116. *Id.* at 85, 488 N.E.2d at 1008.

117. *Id.* at 86, 488 N.E.2d at 1009.

ment between the insured and the insurer excusing both parties from the insurance contract successfully will invoke the doctrine.¹¹⁸ Thus, an insured's own unwitting actions cannot lead to an unintended cancellation of the policy. This result stands in sharp contrast to the holding in *Sizelove*. Applying the *Sizelove* standard, an insured's actions which disclosed an intent to cancel could lead to cancellation.

C. Notification of Cancellation to Certificate Holder

The Illinois Appellate Court for the Fourth District addressed the effectiveness of an insurer's attempt to cancel a policy when the insurer notified the insured but failed to notify the certificate holder in *Smith v. Richard*.¹¹⁹ In *Smith*, the court held that the cancellation was ineffective because the policy required notification of cancellation to be given to the certificate holder as well as to the insured.¹²⁰

In *Smith*, the plaintiff filed a personal injury action based upon the defendant's alleged negligent operation of a van.¹²¹ At the time of the accident, the defendant was delivering mail pursuant to a subcontract with the United States Postal Service.¹²² As required by the subcontract, the defendant Richard had obtained a public liability insurance policy from State Farm. Consequently, the plaintiff amended his complaint, seeking a declaratory judgment against State Farm Mutual Automobile Insurance Company ("State Farm") to determine coverage for the accident.¹²³ Previously, State Farm had sent a certificate of insurance to the Postal Service indicating that Richard's coverage had been increased.¹²⁴ The certificate provided that the "endorsement [was] part of your policy."¹²⁵ Later, when Richard failed to meet premium payments, State Farm notified Richard that the policy had been cancelled but failed to notify the Postal Service of the cancellation.¹²⁶

On appeal, the court held that the certificate issued by State Farm to the Postal Service placed State Farm under an obligation

118. *Id.*

119. 134 Ill. App. 3d 378, 480 N.E.2d 859 (4th Dist. 1985).

120. *Id.* at 382-83, 480 N.E.2d at 862.

121. *Id.* at 380-81, 480 N.E.2d at 860-61.

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.* at 382, 480 N.E.2d at 861.

126. *Id.* at 382, 480 N.E.2d at 862.

to inform the Postal Service of a cancellation of the policy.¹²⁷ The premiums paid by Richard constituted consideration for the promises to the Postal Service as contained in the certificate.¹²⁸ Because State Farm had breached its promise to notify the Postal Service of policy cancellation, its cancellation of the policy based on Richard's nonpayment of premiums was ineffective.¹²⁹ Public policy also supported the court's decision because the policy itself was required to protect the public from uninsured drivers.¹³⁰

IV. THE INSURER'S CONDUCT

A. *The Duty of Good Faith Conduct*

The *Survey* year yielded a number of appellate court decisions delineating the scope of an insurer's duty to deal in good faith with its insured. For example, the Illinois Appellate Court for the First District considered whether an insurer has a duty to notify an additional insured of a settlement between the underlying plaintiff and the named insured in *Pekin Insurance Co. v. Home Insurance Co.*¹³¹ The *Pekin* court held that an insurer's failure to notify the additional insured, in this instance a co-insured employer, did not constitute bad faith because the additional insured's position had not been altered by the settlement.¹³²

In *Pekin*, a Chicago White Sox employee was involved in an auto accident while conducting White Sox business.¹³³ The employee had been insured under a liability policy issued by Pekin. An omnibus provision of the policy named the White Sox as an additional insured,¹³⁴ while Home Insurance Company ("Home") insured the White Sox in a separate policy. Pekin obtained a covenant not to sue from a party injured in the accident in return for \$25,000, the full limit of Pekin's policy.¹³⁵ This release did not apply to the White Sox and was obtained without notice to either the White Sox or Home.¹³⁶ Home tendered the defense of the subsequent suit against the White Sox to Pekin. Pekin indicated that it

127. *Id.* at 382-83, 480 N.E.2d at 862.

128. *Id.* at 382, 480 N.E.2d at 862.

129. *Id.* at 383, 480 N.E.2d at 862.

130. *Id.*

131. 134 Ill. App. 3d 31, 479 N.E.2d 1078 (1st Dist. 1985). *See supra* notes 81-84 and accompanying text.

132. *Pekin*, 134 Ill. App. 3d at 34, 479 N.E.2d at 1081.

133. *Id.* at 32, 479 N.E.2d at 1079-80.

134. *Id.*

135. *Id.* at 32, 479 N.E.2d at 1080.

136. *Id.*

would retain counsel for the action but reserved its rights regarding any obligation to indemnify the Sox because the policy limits already had been exhausted by the settlement.¹³⁷ Home rejected this defense, contending that Pekin had breached its duty to deal in good faith with the White Sox as an additional insured to the policy with its employee.¹³⁸

The *Pekin* court held that Pekin's actions in obtaining the release without notice to the White Sox did not constitute bad faith.¹³⁹ The court determined that the White Sox position had not been altered by the release because any judgment against them would have been reduced by the settlement amount.¹⁴⁰ As a result, with or without the release, the White Sox would have been liable only for damages greater than the policy limit.¹⁴¹ Furthermore, the court emphasized that Pekin was not actively representing the White Sox in the underlying litigation at the time of the settlement.¹⁴² Thus, the appellate court concluded that the White Sox had failed to prove any bad faith by Pekin. Moreover, Pekin had fulfilled its obligation to the White Sox by offering to defend under a reservation of rights.¹⁴³

Another aspect of the insurer's good faith conduct addressed during the *Survey* year was the insurer's duty to provide the insured with sufficient information to enable him to convert his group life insurance policy to an individual policy. In *Donnelly v. Washington National Insurance Co.*,¹⁴⁴ the Illinois Appellate Court for the First District defined these duties. The court decided that failure to provide this information breached the insurer's good faith duty to its insured.¹⁴⁵

In *Donnelly*, the children of the insured, Donnelly, sued the insurer, Washington National, for failure to pay a life insurance claim. Donnelly was covered by his employer's group life and group health policies with Washington National. Provisions in the policies allowed them to be converted to individual policies during a thirty-one day period after the termination of employment.¹⁴⁶ The trial court found that Donnelly had contacted Washington

137. *Id.* at 32-33, 479 N.E.2d at 1080.

138. *Id.*

139. *Id.* at 34, 479 N.E.2d at 1081.

140. *Id.*

141. *Pekin*, 134 Ill. App. 3d at 34, 479 N.E.2d at 1081.

142. *Id.*

143. *Id.* at 34-35, 479 N.E.2d at 1081.

144. 136 Ill. App. 3d 78, 482 N.E.2d 424 (1st Dist. 1985).

145. *Id.* at 87-88, 482 N.E.2d at 432.

146. *Id.* at 80-82, 482 N.E.2d at 427-28.

National's agent during the conversion period and had requested the necessary forms for conversion, but Washington National had failed to send Donnelly the requested materials to effect the conversion.¹⁴⁷ The appellate court affirmed the trial court ruling that Washington National's actions constituted a breach of its good faith duty, and consequently excused Donnelly's failure to sign the application and pay the premium for conversion.¹⁴⁸ Significantly, the court determined that while the duty of good faith had been breached, Washington National's omission did not constitute vexatious conduct. The court in *Donnelly* thus established that a violation of good faith does not necessarily constitute vexatious conduct.¹⁴⁹

The courts in *Pekin* and *Donnelly* adopted opposing positions in construing the insurer's duty of good faith. The *Pekin* decision narrows the scope of that duty, while the *Donnelly* holding, on the other hand, greatly expands that duty.

The *Pekin* decision implicitly holds that an insurer need not notify an additional insured of a settlement affecting the policy's indemnity limits. The holding narrows the scope of the good faith duty because the indemnity funds available to an additional insured are potentially decreased by such settlements. Under the peculiar facts of *Pekin*, however, there was no effect on the additional insured's indemnity funds. By holding that an insurer need not notify the additional insured of these settlements, the *Pekin* decision relaxes the insurer's duty to keep additional insureds informed of settlement proceedings which affect indemnity limits.

The *Donnelly* case, however, extends the insurer's duty to supply its insured with information. *Donnelly* obligates the insurer to provide the necessary information to convert a group policy to an individual policy when the insured requested the information and the insurer promised delivery.¹⁵⁰ Conceivably, the *Donnelly* principle could be applied to every situation in which an insured requested information to convert coverage, including requests to increase coverage limits or requests to add a particular risk to a policy. The *Donnelly* court left undecided the length of allowable delay by an

147. *Id.* at 82, 87, 482 N.E.2d at 428, 431.

148. *Id.* at 87-88, 482 N.E.2d at 432.

149. *Id.* at 90-91, 482 N.E.2d at 433.

150. *Id.* The apparent underlying rationale of this decision is to eliminate the risk of insureds who request such information and then face a considerable delay in receiving it. Because the insurer's inaction leaves the insured without the coverage requested, such coverage is implied, and the insurer bears the burden caused by its own inaction and delay.

insurer faced with a request for such information before coverage might be implied.

B. *Insurer's Vexatious Conduct*

During the *Survey* year, the appellate court decided two significant decisions involving a provision of the Illinois Insurance Code (the "Code") which allows an insured to recover reasonable attorney's fees and up to \$25,000 for vexatious conduct by insurance companies in handling claims.¹⁵¹ The appellate court held that the fees provision preempted an action for punitive damages against an insurer in *Kaniuk v. Safeco Insurance Co.*¹⁵²

In *Kaniuk*, the insured sought one million dollars in exemplary damages for the insurer's bad faith conduct.¹⁵³ The insurer defended on the grounds that section 155 of the Illinois Insurance Code preempted this cause of action.¹⁵⁴

The appellate court rejected the insured's argument that the earlier cases establishing preemption¹⁵⁵ failed to apply the proper rule of statutory construction.¹⁵⁶ Instead, the *Kaniuk* court held that the section precluded a common law action because it contained negative words that rendered it exclusive.¹⁵⁷ The court noted that the relevant provision of the Code allows a plaintiff to recover an amount "not to exceed" a specified amount for an insurer's vexatious conduct.¹⁵⁸

Kaniuk adheres to a long line of appellate cases which have held that section 155 preempts the common law award of punitive damages against insurers.¹⁵⁹ The Illinois Supreme Court has yet to accept one of these cases for review. Interestingly, however, the leading appellate case which has construed section 155 as not pre-

151. ILL. REV. STAT. ch. 73, para. 767 (1985).

152. 142 Ill. App. 3d 1070, 492 N.E.2d 592 (1st Dist. 1986).

153. *Id.* at 1071, 492 N.E.2d at 592.

154. *Id.*

155. See *Kinney v. St. Paul Mercury Ins. Co.*, 120 Ill. App. 3d 294, 458 N.E.2d 79 (1st Dist. 1983); *Hoffman v. Allstate Ins. Co.*, 85 Ill. App. 3d 631, 407 N.E.2d 156 (2d Dist. 1980); *Tobolt v. Allstate Ins. Co.*, 75 Ill. App. 3d 57, 393 N.E.2d 1171 (1st Dist. 1979).

156. *Kaniuk*, 142 Ill. App. 3d at 1072, 492 N.E.2d at 593.

157. *Id.* at 1073, 492 N.E.2d at 594 (citing *Kosick v. S.A. Healy Co.*, 380 Ill. 298, 302, 44 N.E.2d 27, 30 (1942)).

158. *Kaniuk*, 142 Ill. App. 3d at 1073, 492 N.E.2d at 594 (citing ILL. REV. STAT. ch. 73, para. 767 (1985)).

159. See, e.g., *Hoffman v. Allstate Ins. Co.*, 85 Ill. App. 3d 631, 407 N.E.2d 156 (1st Dist. 1980); *Tobolt v. Allstate Ins. Co.*, 75 Ill. App. 3d 57, 393 N.E.2d 1171 (1st Dist. 1979); *Urfer v. Country Mutual Ins. Co.*, 60 Ill. App. 3d 469, 376 N.E.2d 1073 (4th Dist. 1978); *Debolt v. Mutual of Omaha*, 56 Ill. App. 3d 111, 371 N.E.2d 373 (3d Dist. 1978).

empting the field, *Ledingham v. Blue Cross Plan for Hospital Care of Hospital Service Corp.*¹⁶⁰ was cited with approval in the Illinois Supreme Court decision of *Kelsay v. Motorola*.¹⁶¹ None of the appellate holdings in line with *Kaniuk* have discussed the arguable approval of *Ledingham* by the Illinois Supreme Court.

*Hall v. Svea Mutual Insurance Co.*¹⁶² presented another question regarding interpretation of section 155 of the Illinois Insurance Code. The *Hall* court confronted the question of whether a finding of vexatious conduct by the insurer necessitates an award of the full amount of the insured's attorney's fees. The Illinois Appellate Court for the Third District held that the section mandated a full award of attorney's fees.¹⁶³

In *Hall*, the insured prevailed on a section 155 action for unreasonable conduct against the insurer.¹⁶⁴ The trial court, however, neither awarded the full amount of the insured's attorney's fees nor awarded punitive damages.¹⁶⁵ On appeal, the insured argued that the court erred in failing to award full attorney's fees and punitive damages.¹⁶⁶

The appellate court reversed the trial court's decision on the issue of attorney's fees, finding that the purpose of section 155 was to discourage bad faith denials of coverage and that this purpose would not be furthered if the protection afforded by section 155 was reduced by the insured's bearing of litigation costs.¹⁶⁷ The court, however, affirmed the failure to award any punitive damages because such an award fell within the the trial court's discretion.¹⁶⁸ *Hall* thus establishes that a finding of vexatious and unreasonable conduct against an insurer does not in itself necessitate an assessment of punitive damages.

V. UNINSURED AND UNDERINSURED MOTORIST COVERAGE

Uninsured and underinsured motorist coverage policies provide coverage to motorists who are involved in accidents with motorists who are either uninsured or whose insurance coverage limits fail to provide full compensation to the injured motorist. Insurers are re-

160. 29 Ill. App. 3d 339, 330 N.E.2d 540 (5th Dist. 1975).

161. 74 Ill. 2d 172, 384 N.E.2d 353 (1978).

162. 143 Ill. App. 3d 809, 493 N.E.2d 1102 (3d Dist. 1986).

163. *Id.* at 811, 493 N.E.2d at 1105.

164. *Id.* at 810, 493 N.E.2d at 1104.

165. *Id.* at 810-11, 493 N.E.2d at 1104.

166. *Id.* at 811, 493 N.E.2d at 1104.

167. *Id.*

168. *Id.* at 813, 493 N.E.2d at 1105-06.

quired by statute to offer this coverage to all their insured motorists.¹⁶⁹ The requirements of this "offer" and other issues related to uninsured and underinsured motorist coverage were the subject of several decisions during the *Survey* year.

A. *Insurer's Duty of Good Faith Representation*

Insurers were held to a duty of good faith when making representations of coverage in *Glazewski v. Coronet Insurance Co.*¹⁷⁰ The Illinois Supreme Court in *Glazewski* held that an insurer who holds out a policy in return for a premium tacitly represents that the coverage has value.¹⁷¹ Therefore, the plaintiff successfully had stated a cause of action for fraud because he alleged that the coverage he received had no value.¹⁷²

In *Glazewski*, the plaintiffs brought a class action against a number of insurance companies, alleging fraud and a violation of the Uniform Deceptive Trade Practices Act¹⁷³ arising from the sale of underinsured motorist coverage.¹⁷⁴ The plaintiffs argued that the coverage had no value due to the statutory definition of "underinsured."¹⁷⁵

The supreme court determined that the plaintiff had successfully stated a cause of action for fraud.¹⁷⁶ The court held that the plaintiffs had alleged false representations by the insurance companies,¹⁷⁷ reasoning that the issuance of an insurance policy in return for a premium constituted a tacit representation that the policy had value.¹⁷⁸ Because a plaintiff's allegations are assumed to be true for purposes of a motion to dismiss, the court assumed that

169. ILL. REV. STAT. ch. 73, para. 755a-2 (1985).

170. 108 Ill. 2d 243, 250, 483 N.E.2d 1263, 1266 (1985).

171. *Id.* at 250, 483 N.E.2d at 1266.

172. *Id.*

173. ILL. REV. STAT. ch. 121½, para. 311-317 (1985).

174. *Glazewski*, 108 Ill. 2d at 246, 483 N.E.2d at 1264. Insurance companies are required to offer uninsured and underinsured motorist coverage under section 143a-2 of the Illinois Insurance Code. ILL. REV. STAT. ch. 73, para. 755a-2 (1985).

175. *Glazewski*, 108 Ill. 2d at 247, 483 N.E.2d at 1264. The limits provided by the policies were \$15,000 per person and \$30,000 per occurrence. *Id.* at 246, 483 N.E.2d at 1264. The Illinois Insurance Code provides that the liability limit of an insurer providing underinsured motorist coverage would be the limits of the policy less the amount recovered on applicable insurance policies on the vehicle. ILL. REV. STAT. ch. 73, para. 755a-2(3) (1985). The minimal coverage in Illinois, however, had been raised to the same \$15,000 and \$30,000 limits. ILL. REV. STAT. ch. 95½, paras. 7-203, 7-317(b)(3) (1985). Thus, plaintiffs argued, no policy holder could ever recover following an accident with an Illinois resident. *Glazewski*, 108 Ill. 2d at 248-49, 483 N.E.2d at 1265.

176. *Glazewski*, 108 Ill. 2d at 254, 483 N.E.2d at 1268.

177. *Id.* at 250, 483 N.E.2d at 1266.

178. *Id.*

the coverage had no value, as alleged in the complaint.¹⁷⁹ Accordingly, a false representation had been made and a cause of action for fraud stated. Additionally, the court noted that failure of the Director of Insurance to discontinue the coverage did not authorize the insurance company to offer and sell the policies in a misleading manner.¹⁸⁰

Under the *Glazewski* holding, each time an insurer issues a policy in return for a premium, it represents that the policy has value. Accordingly, an insured need only allege that the policy has no value in order to survive an insurer's motion to dismiss based on failure to state a cause of action for fraud.

B. "Offer" Defined

In *Cloninger v. National General Insurance Co.*,¹⁸¹ the Illinois Supreme Court addressed for the first time the issue of what constitutes a proper "offer" of underinsured motorist coverage as required by section 143a-2(3) of the Illinois Insurance Code.¹⁸² Cloninger had received a \$16,000 settlement for injuries suffered in an automobile accident, an amount representing the limit on his driver's coverage.¹⁸³ Although Cloninger's policy did not expressly provide underinsured motorist coverage, Cloninger sought a declaration that underinsured coverage was implied at law because National General Insurance Co. ("National General") had failed to make an adequate offer of the coverage.¹⁸⁴ The trial court held that the offer had been inadequate, and the appellate court affirmed.¹⁸⁵

In upholding the appellate court ruling, the supreme court noted that an insured also had the right to elect or reject underinsured motorist coverage.¹⁸⁶ In order to exercise this right, the insured must have information regarding the coverage.¹⁸⁷ Therefore, an "offer" of coverage pursuant to section 143a-2(3) must provide the insured sufficient information to decide intelligently whether to

179. *Id.*

180. *Id.* at 251, 483 N.E.2d at 1266.

181. 109 Ill. 2d 419, 488 N.E.2d 548 (1985).

182. ILL. REV. STAT. ch. 73, para. 755a-2(3) (1985). The Code requires insurance companies to "offer" underinsured motorist coverage to its policyholders. *Id.*

183. *Cloninger*, 109 Ill. 2d at 421, 488 N.E.2d at 548.

184. *Id.* at 422, 488 N.E.2d at 548.

185. *Id.* at 423, 488 N.E.2d at 549.

186. *Id.* at 424, 488 N.E.2d at 550 (citing ILL. REV. STAT. ch. 73, para. 755a-2(4) (1985)).

187. *Cloninger*, 109 Ill. 2d at 424-25, 488 N.E.2d at 550 (citing *Tucker v. Country Mut. Ins. Co.*, 125 Ill. App. 3d 329, 465 N.E.2d 956 (4th Dist. 1984)).

elect such coverage.¹⁸⁸

In determining the amount of information necessary for a proper offer, the court relied on the Minnesota decision of *Hastings v. United Pacific Insurance Co.*,¹⁸⁹ a case interpreting a similar "offer" provision. *Hastings* delineated four requirements for a valid offer: (1) notification of the offer must be commercially reasonable; (2) specification of the limits of the optional coverage; (3) intelligible communication to the insured of the nature of the option; and (4) notification to the insured that the optional coverage is available for relatively modest premium increases.¹⁹⁰

In applying this test to the facts before it, the *Cloninger* court held that National General's offer failed the third prong of the test.¹⁹¹ Though National General's offer contained a list of premiums and limits, it failed to explain the nature of the coverage.¹⁹²

Cloninger, however, left unclear what limit of coverage could be implied in situations of inadequate offers. *Logsdon v. Shelter Mutual Insurance Co.*¹⁹³ presented the Illinois Appellate Court for the Third District with this related issue. In *Logsdon*, the insured had never received any offer of underinsured motorist coverage.¹⁹⁴ In addressing the limits of coverage to be implied, the court held that section 143-2a(3) provided no limit.¹⁹⁵ The court further held that the limit of underinsured motorist coverage to be implied by law was the maximum amount of bodily injury liability coverage being offered by the insurer for the last renewal period prior to the injury.¹⁹⁶ The court noted that the *Cloninger* decision supported this

188. *Cloninger*, 109 Ill. 2d at 425, 488 N.E.2d at 550.

189. 318 N.W.2d 849 (Minn. 1982).

190. *Cloninger*, 109 Ill. 2d at 425-26, 488 N.E.2d at 550.

191. *Id.* at 428, 488 N.E.2d at 551.

192. *Id.* at 427-28, 488 N.E.2d at 551. The *Cloninger* court noted, however, that an explanation of coverage similar to that accepted in *Orolin v. Hartford Accident & Indem. Co.*, 585 F. Supp. 97 (N.D. Ill. 1984), would have fulfilled the requirement. *Cloninger*, 109 Ill. 2d at 428, 488 N.E.2d at 551. The *Orolin* court stated:

The court is further convinced that the language of Hartford's stuffer sufficiently offered underinsured motorist coverage to Orolin. The stuffer makes the insured aware of the limits of liability that may be purchased. It provides examples of accidents for which coverage would be provided and affirmatively recommends the coverage. Finally, it states that an agent can provide information concerning coverages, cost and choices available to an insured. This is, as a matter of law, information sufficient for an insured to make an intelligent decision with respect to optional coverage.

Orolin, 585 F. Supp. at 101-102.

193. 143 Ill. App. 3d 957, 493 N.E.2d 748 (3d Dist. 1986).

194. *Id.* at 961, 493 N.E.2d at 751.

195. *Id.* at 962, 493 N.E.2d at 752.

196. *Id.* at 964, 493 N.E.2d at 753.

result.¹⁹⁷

Subsequently, the Illinois Appellate Court for the First District decided that section 143a-2 did not require an insurer to make an offer of uninsured motorist coverage when an insured adds a new car to an existing policy. In *Makela v. State Farm Mutual Automobile Insurance Co.*,¹⁹⁸ the court asserted that this holding was supported by the decisions of other jurisdictions.¹⁹⁹ Furthermore, the court stated that an addition of an automobile to an existing policy constituted a renewal or supplementary policy, and section 143a-2 did not require offers for such policies.²⁰⁰

C. *Physical Contact as a Condition Precedent to Recovery*

*Lemke v. Kenilworth Insurance Co.*²⁰¹ presented the Illinois Supreme Court an opportunity to reconsider a previous ruling regarding the requirement of physical contact in uninsured motorist coverage policies.²⁰² The court reaffirmed its holding in *Ferega v. State Farm Mutual Automobile Insurance Co.*,²⁰³ and held that a requirement of physical contact as a condition precedent to recovery under an uninsured motorist policy did not violate public policy.²⁰⁴

In *Lemke*, the plaintiff failed to allege physical contact in her complaint against her insurer, Kenilworth.²⁰⁵ Lemke sought to have *Ferega* overruled by arguing that the physical contact provision ran contrary to the remedial goal of section 143a-2 because it limited the potential for recovery.²⁰⁶

The court rejected this argument in reaffirming *Ferega*.²⁰⁷ The *Lemke* court noted that since the 1974 *Ferega* decision, the legisla-

197. *Id.* at 963-64, 493 N.E.2d at 753.

198. 147 Ill. App. 3d 38, 49, 497 N.E.2d 483, 490 (1st Dist. 1986).

199. *Id.* at 45-46, 497 N.E.2d at 488. *See, e.g.,* American Fire & Indem. Co. v. Spaulding, 442 So. 2d 206 (Fla. 1983); El-Habr v. Mountain States Casualty Co., 626 S.W.2d 171 (Tex. App. 1981); Myers v. Thibeaux, 365 So. 2d 266 (La. App. 1978); Hicks v. State Farm Mut. Auto Ins. Co., 568 P.2d 629 (Okla. 1977).

200. *Id.* at 49-50, 497 N.E.2d at 490-91.

201. 109 Ill. 2d 350, 487 N.E.2d 943 (1985).

202. *Id.* at 353-54, 487 N.E.2d at 945.

203. 58 Ill. 2d 109, 317 N.E.2d 550 (1974).

204. *Lemke*, 109 Ill. 2d at 354, 487 N.E.2d at 945.

205. *Id.* at 352, 487 N.E.2d at 944-45. Lemke's complaint alleged that she had been forced to veer off the road by an unidentified, unapprehended vehicle. Lemke failed to preserve for appeal an amended count alleging contact. *Id.* at 352, 487 N.E.2d at 944.

206. *Id.* at 354, 487 N.E.2d at 945. The remedial goal, asserted the plaintiff, was to ensure coverage of claims by drivers involved in accidents with "hit-and-run" or "phantom" motorists. *Id.*

207. *Id.*

ture had amended section 143a eight times without dispensing with *Ferega's* judicially imposed physical contact requirement.²⁰⁸ Because the court believed the legislature was familiar with *Ferega*, it interpreted legislative inaction subsequent to that decision as an approval of that decision's reasoning and holding.²⁰⁹

During the *Survey* year, the Illinois Appellate Court for the First District addressed the related issue of indirect physical contact under the physical contact requirements in *Yutkin v. United States Fidelity & Guaranty Co.*²¹⁰ In *Yutkin*, the evidence showed that the plaintiff's car had been struck by a piece of tire retread left on the road.²¹¹ No witnesses, however, observed either the retread leaving another vehicle or any other explanation of its presence on the road.²¹²

In denying coverage, the court held that when indirect physical contact occurs, the *Ferega* physical contact requirement mandates a causal connection which constitutes a substantial nexus between the hit-and-run vehicle and the intermediate object.²¹³ The *Yutkin* court noted that the causal connection requirement minimizes the possibilities of fraud.²¹⁴ Furthermore, the court held that the intermediate object must be transmitted to the claimant's vehicle by "a force which is continuous and contemporaneous."²¹⁵ In *Yutkin*, the court asserted that any causal connection was too attenuated. The *Yutkin* decision thus establishes that the physical contact requirement precludes recovery for accidents caused by debris strewn in the road.

Lemke and *Yutkin*, by upholding the physical contact requirements, greatly diminish the potential for fraud in uninsured motorist claims. Without the contact requirement, the difficulties of handling the so-called "phantom" hit-and-run vehicle, which triggers uninsured motorist coverage, would become even greater.

VI. SPOUSAL HEALTH INSURANCE REFORM ACT

Passed into law during the *Survey* year, the Spousal Health Insurance Reform Act ("SHIRA" or the "Act")²¹⁶ became effective

208. *Id.*

209. *Id.*

210. 146 Ill. App. 3d 953, 497 N.E.2d 471 (1st Dist. 1986).

211. *Id.* at 954, 497 N.E.2d at 472.

212. *Id.*

213. *Id.* at 956, 497 N.E.2d at 473.

214. *Yutkin*, 146 Ill. App. 3d at 955, 497 N.E.2d at 472.

215. *Id.* at 956, 497 N.E.2d at 473.

216. ILL. REV. STAT. ch. 73, para. 979.2 (1985).

December 1, 1985. Under SHIRA, an individual can elect to retain a former spouse's health insurance by paying all the required premiums, including any amounts normally contributed by the spouse's employer.²¹⁷ The Act applies to both widowed and divorced spouses, but affects only renewed policies or new group health insurance programs effective after December 1, 1985.²¹⁸ Persons choosing to continue coverage under SHIRA can do so for up to two years if they are under age fifty-five at the time coverage begins. If they are over fifty-five, they may continue coverage until they qualify for Medicare benefits.²¹⁹

SHIRA generally is considered as a victory by women's organizations because it provides needed health insurance to widows and divorcees at a period when their financial conditions are generally poor. Before passage of the Act, insurers often allowed the spouse to convert the remaining group policy to individual coverage, but the resulting coverage often proved to be far less comprehensive though sold at a higher premium. The act now provides a measure of protection for those faced with the loss of their spouse's health coverage by reason of death or divorce.²²⁰

VII. CONCLUSION

While many important issues were resolved during the *Survey* year, the resolution of insurance coverage in asbestos cases undoubtedly shall prove the most far-reaching. Additionally, the Illinois courts made noteworthy advances in defining conflict of interest situations arising between an insurer and its insured. Decisions involving the insurers' conduct in dealing with their clients further refined the insurers' duties. Finally, several questions concerning uninsured and underinsured motorist coverage were resolved by the Illinois Supreme Court.

217. *Id.*

218. *Id.*

219. *Id.*

220. For a more detailed discussion of SHIRA, see the *Family Law* article within this *Survey* issue.