

November 3, 2008

Re: Effect of Interpleader on Duty to Defend

Insurers seeking to terminate their duties to defend and indemnify often file an interpleader action to achieve their objectives. However, as discussed in a recent case considered by a Federal Court in the Southern District of Indiana, Illinois courts may not always grant the insurer's wish.

The court in Carolina Casualty Insurance Co., v. Estate of Studer, 555 F.Supp. 2d 972 (S.D.Ind. 2008), discussed what happens when an insurer files an interpleader tendering and surrendering its liability policy to the court and admits liability. Specifically, the court considered the issue of whether an insurer's duty to defend its insured is terminated when it files an interpleader. The court analyzed the issue under Indiana and Illinois law. The court concluded that where an insurer paid its policy limits into the court registry, totally surrendered the limits, and admitted liability with no possibility of retrieving the funds, the insurer was discharged from any duty to defend or indemnify the insured.

Carolina Casualty filed a complaint for interpleader and declaratory relief seeking to interplead its \$1 million dollar insurance policy limit and obtain a declaration that its duty to defend ceased upon payment of the interpleader funds. The policy named HMD Trucking as the named insured and Forward Air, Inc. as an additional insured. Carolina paid its limit into the court registry, as allowed by the court. Thereafter, Carolina Casualty contended that it was entitled to summary judgment that it had discharged its duty to indemnify and duty to defend. Forward Air responded that Carolina Casualty did not exhaust its duty to defend by merely interpleading the policy limits.

The court first concluded that Carolina was discharged from its duty to indemnify. It agreed with Carolina's contention that Carolina discharged its duty to indemnify by paying its \$1 million policy limit into the court's registry. Forward Air did not dispute this contention. The court determined that summary judgment regarding indemnity in favor of Carolina was proper. The court considered the duty to defend

issue and noted a difference in the law of Indiana and Illinois regarding the affect of interpleader on the duty to defend, when funds have not been unconditionally tendered or distributed. Any difference between Illinois and Indiana law would not affect the outcome if the insurer irretrievably surrendered its policy limits.

The court noted that Carolina made an unconditional tender of its policy limit and relinquished any claim to those funds. Citing the Zurich v. Raymark, 118 Ill.2d 23 (1987) case, the court concluded that although the duty to defend is separate and distinct from the duty to indemnify, it is only broader than the duty to indemnify in certain circumstances. If the complaint alleges facts which bring the claim within a potential for coverage, the insurer is obligated to defend the action, even if it may not later be obligated to indemnify the insured. If, the insurer has exhausted its indemnity limits, it cannot be obligated to indemnify the insured. Thus, the duty to defend is broader than the duty to indemnify only when the insurer has the potential obligation to indemnify. The court concluded that Carolina had no duty to defend because it had no potential indemnity obligation.

The Carolina Casualty court distinguished two Illinois: American Standard v. Basbagill, 333 Ill.App.3d 11, 775 N.E. 2d 255 (2002), and Douglas v. Allied American Insurance, 312 Ill.App.3d 535, 727 N.E. 2d 376 (2000). The appellate court in each case declined to discharge the duty to defend after the insurers tendered policy limits to the court. The Carolina Casualty court determined that Douglas and Basbagill were factually distinguishable because the Douglas insurer tendered its policy limits without admitting liability and withdrew its defense without knowing whether its policy limits would actually be exhausted. The Carolina Casualty noted that the Basbagill insurer refused to admit any liability and conceded that it would get some, if not all, of the interpled funds back in the event that it was not found liable or was liable for less than the full amount. The Basbagill court made its decision based upon an interim agreement to cover whatever liability the plaintiff might incur in the future. This differed substantially from the actions taken by Carolina. Thus, the Carolina Casualty court concluded that Carolina Casualty had no potential obligation to indemnify and was discharged from its duty to defend under either Illinois or Indiana law.

The Carolina Casualty case confirms that insurers may extinguish their duty to defend and indemnify by filing an interpleader action, but cautions that insurers may not give with one hand take away with the other. Instead, an insurer must unconditionally tender the policy limit to the court registry, as opposed to conditioning payment upon a future event which may or may not occur. The insurer must waive any potential to recover any portion of the policy limit paid into the court. These criteria are meant to allow an insurer to exhaust its policy limits in an interpleader action as if it had done so through settlement or judgment and not be required to defend its insureds indefinitely.

Please contact Bill Busse, Jr. Ed Grassé, or Jason DeVore of Busse, Busse & Grassé if you have any questions related to the issues discussed herein or any other coverage matter.

Very truly yours,

BUSSE, BUSSE & GRASSÉ, P.C.

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