March 1, 2006

Re: Illinois Costs and Fees Update

In the 2005 Illinois Supreme Court decision entitled General Agents Insurance Company of America, Inc. v. Midwest Sporting Goods Company, 215 Ill.2d 146, 828 N.E.2d 1092 (2005), the court foreclosed an insurer's ability to recoup defense costs expended while defending under a reservation of rights, unless the policy under which the action was defended contains an explicit provision allowing for reimbursement of attorney fees and costs. Most liability policies currently in force do not contain such a provision. Accordingly, language often used in reservation of rights letters referencing the insurer's right to recoup fees in the event that there is a determination of no coverage becomes meaningless. Hence, as the new year begins, it may be prudent to re-evaluate your policies to determine whether modifications are in order to help bolster your ability to recover fees in certain circumstances.

In GAINSCO the City of Chicago and Cook County sued Midwest Sporting Goods, a gun manufacturer, and other defendants for creating a public nuisance by selling guns to inappropriate purchasers. Midwest tendered defense of the suit to GAINSCO, its liability carrier.

GAINSCO responded to Midwest's tender on July 23, 1999, with a reservation of rights letter. The reservation of rights letter cited various provisions that limited or excluded coverage. It also noted that to the extent that the claim sought injunctive relief, the claim was not a claim for damages and, was not afforded coverage under the policy. Additionally, it advised that coverage for punitive or exemplary damages was not afforded under the policy.

The reservation of rights letter also included the following section: "Subject to the foregoing, and 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,*** the Company agrees to provide the Insured a defense in the captioned suit."

On October 28, 1999, GAINSCO filed a declaratory judgment action seeking a declaration that it did not owe Midwest a defense in the underlying litigation. The declaratory judgment action also asserted a claim for recovery of all defense costs paid to Midwest's independent counsel on behalf of Midwest in the underlying litigation. Thereafter, GAINSCO filed a motion for summary judgment and Midwest filed a cross-motion for summary judgment.

The circuit court entered summary judgment in favor of GAINSCO, declaring that GAINSCO had no duty to defend Midwest in the underlying litigation. The appellate court affirmed the trial court's judgment.

The trial court then considered GAINSCO's motion for entry of judgment for recovery of defense costs, seeking to recover the defense costs that it had paid to Midwest's independent counsel for Midwest's defense of the underlying litigation. The trial court held

that GAINSCO had reserved its right to recoup its costs for defending Midwest and therefore granted GAINSCO's motion. The trial court ordered Midwest to pay GAINSCO $40,517.34. Midwest then appealed the trial court's ruling on the motion for recovery of defense costs. The appellate court affirmed the trial court's judgment.

On appeal, Midwest argued that GAINSCO had paid the defense costs pursuant to the insurance contract, which made no provision for the recovery sought by GAINSCO. In addition, because the relationship between the parties was governed by contract, GAINSCO could not recover defense costs under a theory of unjust enrichment. The appellate court rejected Midwest's argument,

Supreme Court Decision

In its appeal to the Supreme Court, Midwest argued that GAINSCO could not reserve the right to recoup defense costs because the insurance contract between the parties does not contain a provision allowing GAINSCO the right to recoup defense costs. GAINSCO responded that there was no contract governing the relationship between the parties because both the circuit and appellate courts have held that the policies issued by GAINSCO to Midwest did not apply to the underlying litigation. Accordingly, GAINSCO maintained that it had no duty to defend Midwest and was entitled to recoup the amounts paid for Midwest's defense.

The Supreme Court determined that the analysis used by a minority of jurisdictions on this issue was more persuasive and more in line with Illinois case law than the cases cited by GAINSCO. Those minority jurisdictions refused to allow an insurer to obtain reimbursement of its defense costs even though the underlying claim was not covered by the insurance policy and the insurer had specifically reserved its right to reimbursement.

The Court stated that when an insurer tenders a defense or pays defense costs pursuant to a reservation of rights, the insurer is protecting itself at least as much as it is protecting its insured. Thus, it could not say that an insured is unjustly enriched when its insurer tenders a defense in order to protect its own interests, even if it is later determined that the insurer did not owe a defense. Moreover, the Court stated 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 is free to include such a term in its insurance contract."** Absent such a provision in the policy, however, an insurer cannot later attempt to amend the policy by including the right to reimbursement in its reservation of rights letter.

This decision was anxiously awaited by Illinois coverage attorneys. The GAINSCO decision makes it clear that insurers who want to preserve their right to recoup costs incurred while defending under a reservation of rights must amend their policies in order to do so.

Very truly yours,

C. William Busse, Jr.