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Insurance Law Update

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Should I Stay or Should I Go? Staying Coverage Litigation Pending Resolution of the Underlying Lawsuit

Liability carriers faced with coverage issues in an underlying lawsuit generally have two options under Illinois law: defend the suit under reservation of rights or seek a declaratory judgment that no coverage exists. *See Standard Mut. Ins. Co. v. Lay*, 2013 IL 114617, ¶ 19. To avoid estoppel issues, carriers often elect to do both, defending the suit under reservation while simultaneously pursuing a declaratory judgment action.

Certain coverage defenses may turn on the facts as determined by the ultimate finding of liability in the underlying suit. Consider, for instance, a classic coverage issue: alternative theories of liability against the insured for negligent or intentional conduct. If the underlying plaintiff prevails on the negligence theory, the claim likely is covered. If the underlying plaintiff prevails on the intentional conduct theory, on the other hand, the claim likely is not. Two courts—the court in the underlying lawsuit and the court in the declaratory judgment action—may be called to decide whether the insured acted negligently or intentionally. Though the issue is the same, there is no guarantee the outcomes will be.

Litigation of coverage defenses turning on factual developments in the underlying lawsuit can be tricky. Several Illinois appellate courts recently examined how parties should proceed when these conflicts arise. When the issues in the underlying litigation and the coverage litigation overlap, the safest—and perhaps, only—course of action may be to stay the coverage litigation until the underlying suit is resolved.

Earlier this year, the Illinois Appellate Court First District analyzed at length whether to stay pending coverage litigation in *Sentry Insurance v. Continental Casualty Company*, 2017 IL App (1st) 161785. Sentry Insurance provided its insured a defense under reservation of rights against over 60 lawsuits filed against the insured, concerning alleged damage to reproductive materials the insured allegedly stored for the underlying plaintiffs, and also filed a declaratory judgment action seeking a finding of no coverage. *Sentry*, 2017 IL App (1st) 161785, ¶¶ 3-4. Sentry argued the "care, custody, or control" and "professional services" exclusions set forth in its policy barred coverage for the underlying suits. *Id.* ¶ 9.

Sentry also named as a defendant to its declaratory judgment action the insured's excess carrier Continental Casualty. *Id.* ¶ 3. Continental asserted a counterclaim for declaratory judgment with respect to its policy, seeking a declaration that it had no duty to indemnify the insured against the underlying suits based on the same exclusions as those in the Sentry policy. *Id.* ¶¶ 10-11.

The insured moved to dismiss Sentry's complaint and Continental's counterclaim, or alternatively, moved to stay the coverage litigation. *Id.* ¶ 12. The trial court stayed the coverage litigation with respect to Continental's duty to indemnify, declining to apply the policy's exclusions. *Id.* ¶¶ 18-19. While on appeal, Sentry settled with the insured, leaving only Continental's appeal as to its purported duty to indemnify pending. *Id.* ¶ 22.

On appeal, the First District ultimately determined that the trial court had not abused its discretion in staying resolution of the coverage litigation. The court examined a liability carrier's obligations under the policy and Illinois law:

the duty to defend and the duty to indemnify. *Id.*¶¶ 35-39. While a carrier has a duty to defend any claim that *potentially* implicates coverage under the policy, a carrier has a duty to indemnify only those claims that are *actually* covered. *Id.* The duty to defend typically turns on the allegations asserted against the insured; however, extrinsic evidence may be relevant to determining that duty under certain circumstances. *Id.* ¶ 37.

Generally, extrinsic evidence may be used in a coverage declaratory judgment action to defeat a carrier's duty to defend, provided the evidence does not "'determine an issue crucial to the determination of the underlying lawsuit.'" *Id.* (quoting *Pekin Ins. Co. v. Wilson,* 237 Ill.2d 446, 461 (2010)). The exception stems from what is referred to as the "*Peppers* doctrine," set forth by the Illinois Supreme Court in its seminal decision in *Maryland Casualty Company v. Peppers,* 64 Ill.2d 187 (1976). While *Peppers* is known largely for introducing independent—or "*Peppers*"—counsel to Illinois insurance law, *Peppers* also introduced the *Peppers* doctrine, prohibiting a declaratory judgment court from determining ultimate facts in the underlying lawsuit even if those facts also are critical to coverage. *Peppers,* 64 Ill.2d at 197 (finding declaratory judgment court improperly determined an ultimate fact upon which recovery was predicated in the underlying lawsuit).

Applying the *Peppers* doctrine, the First District in *Sentry* first "had to determine whether the facts to be decided in the declaratory judgment action would be considered 'ultimate facts' such that coverage litigation was premature." *Sentry,* 2017 IL App (1st) 161785, ¶ 44. But first, the court had to determine what constitutes an "ultimate fact." *Peppers* suggests "that an ultimate fact is one which would estop the plaintiff in the underlying case from pursuing one of his theories of recovery." *Sentry,* 2017 IL App (1st) 161785, ¶ 45 (quoting *Fidelity & Cas. Co. of New York v. Envirodyne Engineers, Inc.,* 122 Ill.App.3d 301, 307 (1st Dist. 1983)). Further, an "ultimate fact" is one that is critical to the insured's liability in the underlying suit. *Id.* (quoting *Envirodyne Engineers, Inc.,* 122 Ill.App.3d at 307).

In *Sentry,* for instance, an "ultimate fact" crucial both to liability and to the application of the "care, custody, or control" exclusion was whether the insured exercised exclusive control over the reproductive materials at issue in the underlying lawsuits. *Id.* ¶ 51. If the insured exercised exclusive control, the "care, custody, or control" exclusion applied to remove coverage. *Id.* Yet, finding that the insured exercised exclusive control would require finding that the insured's co-defendant *did not* exercise control over those materials, contradicting plaintiffs' allegations against that co-defendant and effectively precluding plaintiffs' recovery against it. *Id.* Because this fact was critical to at least one of the underlying plaintiffs' theories of recovery (that against the insured's co-defendant), it constituted an "ultimate fact" in the underlying litigation. *Id.* Under the *Peppers* doctrine, the declaratory judgment court could not decide that ultimate fact, and the coverage action properly had been stayed with respect to Continental's duty to indemnify. *Id.*

The Illinois Appellate Courts' Second and Third Districts also applied the *Peppers* doctrine to determine whether coverage litigation should be stayed in the months following *Sentry. See State Farm Fire & Cas. Co. v. John,* 2017 IL App (2d) 170193; *see also Pekin Ins. Co. v. Johnson-Downs Construction, Inc.,* 2017 IL App (3d) 160601. *Johnson-Downs* concerned a liability carrier's duty to defend its putative additional insured, coverage for which was afforded only with respect to vicarious liability. *Id.* ¶ 3. The Third District rejected the putative insured's argument that resolution of the duty to defend required a determination of vicarious liability, an ultimate fact in the underlying suit. *Id.* ¶ 13. Instead, the appellate court held that the trial court could simply evaluate the allegations against the insured to determine whether they sufficiently alleged vicarious liability so as to trigger the duty to defend, without actually determining vicarious liability. *Id.*

Sentry and *Johnson-Downs* read together to suggest that whether coverage litigation should be stayed depends on which duty is at issue, defense or indemnity. *Sentry* upheld the stay of litigation with respect to the duty to indemnify,

whereas *Johnson-Downs* overturned the stay of litigation with respect to the duty to defend. In *Sentry,* the duty to indemnify could not be determined without resolving ultimate facts in the underlying suits, whereas in *Johnson-Downs,* the duty to defend could be determined based simply on the allegations. This could be explained by the different standards for the two duties: the duty to defend is triggered if the *allegations* are *potentially* covered, but the duty to indemnify is triggered only if the *liability* is *actually* covered. A court can evaluate the duty to defend at the outset based on the allegations, but can evaluate the duty to indemnify only after the pertinent facts are resolved in the underlying suit.

Yet, the Second District in *John* stayed determination of the insured's duties to defend *and* to indemnify pending resolution of the underlying lawsuit. *John,* 2017 IL App (2d) 170193, ¶ 30. Coverage in *John* hinged, in part, on whether the insured had acted negligently or intentionally, as well as whether the insured had breached certain coverage conditions. *Id.* ¶¶ 5-7. The Second District stayed resolution of the entire suit, rather than decide any coverage issues, including the carrier's duty to defend. *Id.* ¶ 30. However, the Second District expressly based this decision on extenuating factors, stating that a stay of the entire proceeding was appropriate under the "unique circumstances" of the case. *Id.*

Overall, these cases make clear that the declaratory judgment court should not determine facts critical to liability in the underlying lawsuit, though figuring out exactly which facts are off limits may be more complicated. Nevertheless, deference must be made to the underlying suit.

The question arises, however, as to what happens *after* the underlying suit resolves these ultimate facts. Once those ultimate facts are decided, are they binding in the coverage action?

The *Peppers* doctrine stems from an effort to avoid collateral estoppel in the underlying lawsuit if the ultimate facts already have been determined by another court in the coverage suit. Presumably, just as the ultimate fact decision in the declaratory judgment suit could be binding in the underlying suit, the ultimate fact decision in the underlying suit could be binding in the declaratory judgment suit based on these same collateral estoppel principles.

Collateral estoppel bars litigation of issues decided in a prior action. *Dancor Const., Inc. v. FXR Const., Inc.,* 2016 IL App (2d) 150839, ¶ 60. One requirement to collateral estoppel is that the party against whom preclusion is sought be a party to or in privity with a party to the prior action. *Dancor Const.,* 2016 IL App (2d) 150839, ¶ 61. It is this requirement—that the carrier be a party to or in privity with a party to the prior action—that arguably is not satisfied when an ultimate fact is sought to be used against the carrier in the coverage action. *But see U.S. Fidelity and Guar. Co. v. State Farm Mut. Auto. Ins. Co.,* 152 Ill. App. 3d 46, 49 (1st Dist. 1987) (finding carrier could not collaterally attack judgment in underlying suit in subsequent coverage litigation).

Peppers itself recognized this tension, concluding that the carrier was "entitled to have an attorney of its choosing participate in all phases of this litigation subject to the control of the case by [the insured's] attorney and [the carrier] is not barred from subsequently raising the defense of noncoverage in a suit on the policy." *Peppers,* 64 Ill.2d at 199. *Peppers* does not answer the question, however, as to whether the carrier may relitigate those ultimate facts in that subsequent suit on the policy or is bound by those facts as previously determined.

Perhaps the carrier has an argument that it should not be bound by those fact findings in the underlying lawsuit since it was not a party nor—arguably—in privy with a party to that suit, when the insured was represented by independent counsel. Perhaps the carrier may have an argument these fact findings should not be binding for reasons of fraud or collusion. *See, e.g., U.S. Fidelity,* 152 Ill. App. 3d at 49. Perhaps, on the other hand, the carrier simply is stuck with the findings in the underlying lawsuit. In that event, due process considerations may allow the insurer an argument to intervene in the underlying suit. Exactly what happens after the underlying suit is resolved and the stay has been lifted may remain something of an open question that future cases will need to answer.

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