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Illinois Coverage Basics

Appellate Court Decision Signals Disturbing Change in Illinois Bad Faith Law

Illinois' law of bad faith is generally favorable to liability insurers because it clearly defines the conduct that constitutes bad faith and narrowly limits the remedy. Unfortunately, a recent ruling of the Illinois Fifth District Appellate Court now throws the bright-line clarity of the bad faith rules into question. The new ruling holds, for the first time, that an insurer can be found to be in bad faith, even if a claim could not be settled within the amount of its policy limits.

In Illinois, the common law action for bad faith failure to settle was clearly and narrowly defined by the Illinois Supreme Court in Cramer v. Insurance Exchange Agency, 174 Ill.2d 513 (1996) and Haddick ex rel. Griffith v. Valor Insurance, 198 Ill.2d 409 (2001). The Cramer and Haddick opinions established:

- a. When an insurer breaches its duty to settle, it may be liable for the full amount of a judgment against the policyholder, regardless of policy limits;
- b. An insurer's duty to settle arises when a claim has been made against the insured and there is a reasonable probability of (i) a finding of liability against the insured, and (ii) a recovery in excess of policy limits;
- c. Illinois law generally does not require an insurance provider to initiate settlement negotiations; and
- d. An insurer's duty to settle does not arise until a third party demands settlement within policy limits.

For decades, Illinois courts have told insurers that there can be no liability for bad faith failure to settle unless a demand has been made within the insurer's policy limits. See Adduci v. Vigilant Insurance Co., Inc., 98 Ill.App.3d 472, 475 (1st Dist. 1981); LaRotunda v. Royal Globe Insurance Co., 87 Ill.App.3d 446, 454 (1st Dist. 1980). However, in an opinion published earlier this year, the Fifth District Appellate Court raised profound questions regarding the continuing vitality of that bedrock principle of Illinois bad faith law.

In Central Illinois Public Service Co. v. Agricultural Insurance Co., 2008 WL 141763 (January 14, 2008) ("CIPS case") the Fifth District Appellate Court ruled that a cause of action for bad faith can be maintained against a liability insurer, even in the absence of a settlement demand within the insurer's policy limits. The Fifth District held that while the existence of a demand within policy limits may be important in some cases, it is not necessary in all cases, and the

operative question for all cases is simply whether the insurer participated in settlement negotiations “in a meaningful way.” The Appellate Court allowed a bad faith action to proceed against an insurer in the CIPS case even though it was undisputed that the plaintiffs would not have settled within that insurer’s policy limits.

The CIPS case involved 23 bodily injury claims that resulted from an elevator failure. The claimants brought suit against both the premises owner (CIPS) and the elevator manufacturer. CIPS had several layers of insurance to respond to liability claims, although its primary and first-level excess insurance fully exhausted upon the settlement of the first ten claims. CIPS’ second-level excess insurer (Great American, with limits of \$15 million) and the third-level excess insurer (AISLIC, with limits of \$25 million) then settled the remaining claims for \$29 million, subject to subsequent allocation to be determined in a fault trial between CIPS and the elevator manufacturer.

At the fault allocation trial, CIPS was found to be primarily at fault, requiring Great American to pay its \$15 million limits and ASLIC to pay \$10.325 million of its limits. Afterwards, CIPS filed a declaratory judgment action against its insurers, and ASLIC filed a cross-claim against Great American alleging that Great American ignored ASLIC’s demands to enter into good faith settlement efforts or tender its limits to ASLIC. In its defense, Great American submitted an affidavit from plaintiffs’ counsel to establish that plaintiffs would not have settled below the ultimate settlement amount, and, also, affidavits from the attorneys for CIPS and the elevator manufacturer to establish that the elevator manufacturer would not have agreed to share any settlement equally with CIPS. The trial court dismissed AISLIC’s cross-claim against Great American based on the rule that an insurer has no duty to settle in excess of its policy limits.

On appeal, the Fifth District Appellate Court held that the trial court had erred in finding that an underlying insurer has no duty with respect to settlement unless it is capable of settling within its policy limits. The Appellate Court’s opinion purported to distinguish the prior cases holding that no duty to settle exists unless a third party demands settlement within policy limits. Without citation to any authority, the Fifth District held that Great American had a duty to “participate in settlement negotiations in a meaningful way” to save ASLIC from greater damages, even though Great American had no ability to settle the claims within its policy limits.

The Fifth District’s opinion in the CIPS case is a bad development for insurers in two ways. First, the CIPS opinion appears to overturn the well established Illinois rule that an insurer has no duty to settle unless it is capable of settling within its policy limits. Second, it leaves Illinois’ bad faith law regarding the duty to settle in complete confusion. Under the traditional Illinois rule insurers knew that they could have no bad faith exposure unless there was a demand within the insurer’s policy limits; however, the Fifth District’s opinion in the CIPS case now requires insurers to “participate in settlement negotiations in a meaningful way,” even if it is clear that the case cannot be settled within that insurer’s limits.

The time for seeking Illinois Supreme Court in the CIPS case has not yet expired.

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If you have questions or would like to discuss the implications of this report further, please feel free to contact James K. Horstman at Cray Huber Horstman Heil & VanAusdal LLC, 303 West Madison, Suite 2200, Chicago IL 60606; 312-332-8494; jkh@crayhuber.com.