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Illinois Coverage Basics

No "Pay and Walk" in Illinois: Insurer's Payment of Limits Does Not Necessarily Terminate Its Duty to Defend

In Illinois the law is crystal clear that once an insurer exhausts its indemnity limits by the payment of judgments or settlements, it no longer has any duty to defend. Zurich Insurance Co. v. Raymark Industries, Inc., 118 Ill.2d 23, 52, 514 N.E.2d 150, 163 (1987). In cases where the eventual exhaustion of primary limits seems inevitable, frustrated primary insurers often ask whether they can cut to the chase by tendering their limits and close their file. Early exhaustion of the primary insurer's indemnity limits would be an attractive alternative in such cases, because by exhausting its indemnity limits the insurer could at the same time terminate its duty to defend and avoid the further costs of defending.

Unfortunately, Illinois does not permit a primary insurer to simply tender its limits to escape its duty to defend ("pay and walk"). In Illinois, a tender of limits terminates an insurer's duty to defend *only* if the insurer's payment of limits is made pursuant to a settlement or judgment that results in a full release of the insured. Illinois law on this subject is firmly established by a 25-year-old opinion of the state's highest court. Interestingly, the law is to the contrary in Illinois' neighboring state to the north, Wisconsin. *See* Gross v. Lloyds of London Insurance Co., 121 Wis.2d 78, 81, 358 N.W.2d 266, 268 (1984).

The governing case authority in Illinois is Conway v. Country Casualty Insurance Company, 92 Ill.2d 388, 442 N.E.2d 245 (1982), where the issue arose in the context of a vehicular accident. In Conway, the insurer tendered its full indemnity limits to the injured plaintiff in an effort to close its involvement in the case. Although the plaintiff accepted the payment from the insurer, she did not release either the insurer or the insured in return. Instead, she continued to actively prosecute her damages action against the insured. When the insured requested the insurer to defend him in the plaintiff's damages action, the insurer refused, citing a provision in its policy that terminated its defense obligation whenever its indemnity limits became "exhausted by payments of any judgments or settlements." The insurer argued that its payment of its limits to the plaintiff should terminate both its defense and its indemnity obligations.

The Illinois Supreme Court accepted the Conway case for review and ruled that an insurer cannot discharge its duty to defend its insured simply by making payments to a claimant in the amount of its indemnity limits. The Conway Court noted that an insurer's duty to defend and duty to indemnify are separate and distinct. Although the language of the policy stated that the insurer's duty to defend terminated upon exhaustion of its indemnity limits through payment of settlements or judgments, the Court found that the insurer in Conway had a continuing duty to

defend because its payment was not made pursuant to a settlement or judgment. In the absence of a bona fide settlement and release, the payment of the insurer's limits did nothing to relieve it of its duty to defend.

The Illinois Supreme Court's analysis in Conway relied heavily upon policy language that expressly terminated the insurer's duty to defend upon exhaustion of its limits "through settlement or judgment." However, the same result has also been reached by Illinois courts with respect to policies that do not contain the particular language examined in Conway.

In Douglas v. Allied American Insurance, 312 Ill.App.3d 535, 727 N.E.2d 376 (5th Dist. 2000), multiple seriously injured plaintiffs brought suit against the insured, whose liability policy carried a $40,000 aggregate limit. Seeing that the limits of the policy were insufficient to adequately compensate all of the claimants, the insurer tendered its $40,000 limit to the court, leaving the task of distributing the policy proceeds to the court. After the insurer paid its indemnity limits to the court, it withdrew from the insured's defense.

The insurance policy in Douglas did not contain the particular language examined in Conway, but it stated that the insurer's duty to defend would end when its limits were "exhausted by payment." In addition, the insurance policy at issue in Douglas limited the insurer's indemnity obligation to paying "sums which the insured shall be become *legally* obligated to pay." In the absence of any other guidance in the policy, the Douglas Court concluded that the insurer's voluntary payment of the amount of its indemnity limits to the court did not constitute a payment for which the insured was *legally* obligated to pay, in that it was not made pursuant to a settlement or judgment. Consequently, the payment that the insurer made to the court in Douglas could not terminate the insurer's duty to defend. The Douglas Court concluded that, regardless of the particular language of the insurance contract, the public policy of the State of Illinois prohibits a liability insurer from escaping its duty to defend by simply tendering its limits to a court.

Similarly, in American Standard Insurance Co. v. Basbagill, 333 Ill.App.3d 11, 16, 775 N.E.2d 255, 260 (2nd Dist. 2002), the policy at issue provided that the insurer would continue to defend only until its indemnity limit was "paid." Although the insurer paid its entire indemnity limit to the court via interpleader, the Appellate Court found, on the basis of the insured's "reasonable expectations," that the payment did not terminate the insurer's duty to defend. The court in Basbagill reasoned that, regardless of the language of the policy, "A typical policyholder would normally expect to be defended until the claims against him have been resolved."

The lesson of Conway, Douglas and Basbagill is that an insurer's payment of an amount equal to its indemnity limits will not terminate its duty to defend, unless the payment is made pursuant to a settlement or judgment that results in a full release of the insured. This rule applies regardless of whether the payment is made to the court vial interpleader or directly to the claimant.

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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.