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Illinois Coverage Basics

How Illinois Insureds Force Liability Insurers to Resolve Claims When Coverage Is in Dispute

Much of Illinois insurance practice is focused on avoiding estoppel, because the Illinois estoppel rule is so harsh on insurers. Under Illinois law, a liability insurer that wishes to preserve a coverage defense must generally defend under reservation of rights or file a declaratory judgment action. *See* Employers of Wausau v. Ehlco Liquidating Trust, 186 Ill.2d 127 (1999). Although defending under reservation of rights or filing a declaratory judgment action will protect an insurer from estoppel, it will not prevent the insured from settling a claim before the coverage dispute has been resolved and then seeking payment from its insurer.

In Illinois, an insured who plans to settle a claim and then demand payment from his insurer despite the existence of a coverage dispute has two potential legal routes to that goal. Under a contract theory, the insured can argue that he has the right to make a good faith settlement without the insurer's consent if the insurer has not acknowledged coverage. Under a tort theory, the insured can argue that the insurer's tortious (bad faith) failure to respond to a demand within the policy limits should expose the insurer to liability for the entire amount of the settlement.

The Insured's Contract Law Theory Supporting Right to Settle. The general rule articulated by the Illinois Supreme Court is that an insured must obtain the consent of its insurer before settling a claim, unless the insurer has breached its duty to defend. Guillen v. Potomac Insurance Co., 203 Ill.2d 141, 149 (2003). Under the Guillen rule, if an insurer has breached its duty to defend, the insured may then enter into a reasonable settlement without foregoing its right to seek indemnification. Id. at 158. However, intermediate appellate court rulings in Illinois have significantly expanded that right. Under the appellate court holdings, an insured may enter into a reasonable settlement without foregoing its right to seek indemnification, whenever an insurer provides the insured with independent counsel under reservation of rights. Myoda Computer Center, Inc. v. American Family Mutual Insurance Co., 2009 WL 884902, at 8 (1st Dist. 2009); Commonwealth Edison v. National Union Fire Insurance Co., 323 Ill.App.3d 970, 984-985 (1st Dist. 2001). This conflict in authority has not yet been resolved by the Illinois courts.

To seek reimbursement for a settlement made without the consent of the insurer under the contract theory, an insured must show that the settlement was made in "reasonable anticipation" of liability. Commonwealth Edison, 323 Ill.App.3d at pp. 980-981; United States Gypsum Company v. Admiral Insurance Company, 268 Ill.App.3d 598, 625-626 (1st Dist. 1994). After a case has been settled, the insured need only prove that the allegations in the underlying complaint were covered under the policy language, not that the allegations would actually have been proven at trial. Continental Casualty Company v. Coregis Insurance Company, 316 Ill.App.3d 1052, 1063 (1st Dist. 2000). In other words, the insured must show that he settled the

claim in the reasonable anticipation that he would have been found liable and that the allegations of the complaint fell within the coverage of the policy.

The Insured's Tort Law Theory Supporting Right to Settle. Aside from the duties imposed under contract law, Illinois recognizes a common law cause of action in tort for "bad faith" based upon an insurer's wrongful failure to settle a claim against an insured. Cramer v. Insurance Exchange Agency, 174 Ill.2d 513 (1996). An insurer's common law duty to settle arises once a third-party claimant has made a demand for settlement of a claim within policy limits and, at the time of the demand, there is a reasonable probability of a finding of liability against the insured and recovery in excess of policy limits. Haddick v. Valor Insurance, 198 Ill.2d 409 (2001). A recovery in a bad faith action does not necessarily require proof of fraud or bad faith; the bad faith failure-to-settle tort is based on a breach of the insurer's duty to act in good faith in responding to settlements, so mere negligence may trigger common law bad faith damages.

In Illinois, insureds typically use these tort rules to settle with claimants in the following manner. First, the claimant makes a policy limit demand. Second, if the insurer refuses to meet the demand, the claimant and the insured reach a settlement for the amount of the policy or an amount in excess of the policy limit. The operative features of the settlement agreement between the insured and the claimant are (a) a covenant not to execute given by the claimant, and (b) an assignment of all policy and bad faith rights given by the insured. Third, pursuant to the assignment, the claimant prosecutes the claim against the insurer for the full amount of the settlement, even to the extent that it exceeds the limits of the policy.

Of course, the insurer is not required to pay every policy limit demand. Such "bad faith" exposure exists only if the insurer failed to act "reasonably" in responding to the demand. Bashaw v. American Family Mutual Insurance Co., 2006 WL 3591318, 3 (N.D.Ill. 2006); O'Neill v. Gallant Insurance Co., 329 Ill.App.3d 1166 (5th Dist. 2002). It has been held that there can be no "bad faith" liability if an insurer's decision not to settle was based on a "fairly debatable" coverage issue. Stevenson v. State Farm Fire & Casualty Company, 257 Ill.App.3d 179 (1st Dist. 1993); Alliance Syndicate, Inc. v. Parsec, Inc., 318 Ill.App.3d 590 (1st Dist. 2000).

Summary. Even when a coverage dispute exists, an insured may settle a claim without consent of its insurer and later seek an order requiring its insurer to pay. Illinois contract law and tort law both offer support for this kind of maneuvering by an insured. Such settlements can place an insurer at a serious disadvantage because: (1) the insurer will have limited ability to challenge the amount of the settlement; (2) the coverage issues will be decided within the context of a settlement that was purposefully designed to support a finding of coverage; and (3) a coverage ruling in favor of the insurer will be more difficult to obtain because a ruling in favor of the insurer will necessarily mean taking money away from the injured party and potentially disrupting the settlement between the insured and the injured party.

The lesson here is that insurers' reservations of rights and declaratory judgment actions do not provide them with complete safety. Potential settlements by insureds should be monitored.

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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.