

# Cray • Huber

## **Illinois Coverage Basics**

### *In Illinois an Insurer Can Exhaust Its Indemnity Limits and Terminate Its Defense Obligation by Settling Some Claims against Its Insured, While Leaving Other Claims Unresolved*

When multiple claims are asserted against an insured that might exceed the indemnity limits of the insured's policy, the interests of the insured and the insurer may collide. Although an insured typically wants its insurer to settle claims, at the same time it does not want its insurer to completely exhaust the indemnity limits of the policy, because the insured has a strong interest in receiving a defense from the insurer for the remaining claims. On the other hand, if the insurer believes that the claims against the insured will ultimately consume the indemnity limits of the policy, the insurer may prefer to exhaust its limits sooner rather than later, in order to terminate its duty to defend the insured. From the insured's point of view, the insurer's right to settle claims may seem to conflict with the insurer's duty to defend any unresolved claims.

The question is, what is the insurer supposed to do when its interests and those of its insured conflict in circumstances like this? The answer in Illinois is relatively clear, at least with respect to auto liability policies. The Illinois rule is that an insurer can exhaust its indemnity limits and terminate its defense obligation by settling some claims against its insured, while leaving other claims against the insured unresolved. But there is an important caveat. Settling some but not all of the claims pending against an insured will exhaust the policy limits only if the insurer acts in good faith in settling the claims.

This caveat has important procedural ramifications for an insurer who wishes to exhaust its limits and escape any further defense expense. It means that when an insurer wants to terminate its defense obligation by settling fewer than all claims, an issue regarding the insurer's good faith is created. Although there is a presumption that an insurer has acted in good faith if there is no claim or evidence of bad faith, that presumption can be challenged. Whether the insurer acted in good faith is normally a question of fact that must be determined from an examination of the insurer's motives and the circumstances of the settlements.

A strategic question that must be considered under these circumstances is the risk of estoppel. Under Illinois' rule of estoppel, an insurer has only two ways to preserve a policy defense; it must either defend a claim under a reservation of rights, or it must file a declaratory judgment action. If an insurer undertakes neither of those alternatives, it may be barred from later raising any policy defenses. So long as an insurer is defending, there is no risk of estoppel; however, an issue as to estoppel may arise if the insurer exhausts its limits and then withdraws from the defense of remaining unresolved claims. An insurer in this position may feel that it has an absolute right to withdraw from the defense of the remaining claims because its indemnity limits have been exhausted. But that is not entirely true: the insurer has a right to withdraw from the

defense of the remaining claims only if it exhausted its limits by settlements made in good faith. To avoid the risk of estoppel, the insurer must file a declaratory judgment action to obtain a declaration that the settlements and exhaustion of its limits were undertaken in good faith.

In State Farm Mutual Automobile Insurance Company v. Murphy, 38 Ill.App.3d 709 (2nd Dist. 1979), the insured driver was involved in a collision that injured four people. His auto liability insurer settled three of those claims, which completely consumed the indemnity limits of his policy. However, shortly before those settlements were finalized, the fourth injured person filed a suit against the insured. In response to the insured's tender of the defense of the fourth claimant's suit, the insurer declined to defend on grounds that it had paid out its entire indemnity limits. The trial court agreed with the insurer's rationale and ruled that the insured had no duty to defend or indemnify with respect to the fourth claimant's claim and suit. The insured was apparently judgment-proof and did not appeal the ruling on the duty to defend, but the claimant himself appealed the ruling on the insurer's duty to indemnify.

The Appellate Court in Murphy found that "the insurer is given the right both by policy and by statute to settle claims against its insured." The policy contained a standard right-to-settle clause. The statute referenced by the Appellate Court was Section 7-317 (f)(3) of the Illinois Vehicle Code, which provides that "the insurance carrier shall . . . have the right to settle any claim covered by the policy, and if such settlement is made in good faith, the amount thereof shall be deductible from the limits of liability specified in the policy." The Appellate Court ruled that the prior settlements would not exonerate the insurer from duties with respect to the fourth claimant's law suit unless the settlements were made in good faith. However, as no one either alleged or offered evidence that the insurer had acted in bad faith, the presumption of the insurer's good faith would prevail. Since no bad faith was alleged or shown, the Appellate Court affirmed the trial court's determination that the insurer's exhaustion of its limits by settlement of the first three claims absolved the insurer of any obligations with respect to the fourth claim.

Western States Insurance Company v. O'Hara, 357 Ill.App.3d 509 (4th Dist. 2005) involved a similar multi-claimant automobile collision in which the insurer paid out its limits by settling some, but not all, of the claims against its insured. In O'Hara, the insurer filed a declaratory judgment action to determine its rights and took the position that its payment of its indemnity limits eliminated any duties it otherwise might owe to its insured. The Appellate Court found that by contending the prior settlements had exhausted its indemnity limits, the insurer necessarily placed its good faith in issue. Because the trial court had not made any determination regarding the insurer's good faith, the Appellate Court ruled that it could make no determination on the exhaustion issue, but remanded the case to the trial court make findings as to whether the insurer had settled the prior claims in good faith.

The bottom line is that it is proper and possible for an insurer to exhaust its indemnity limits and terminate its defense obligation by settling some claims while leaving others unresolved. However, to accomplish that goal safely and securely, the insurer must file a declaratory judgment action to obtain a ruling that it acted in good faith when it settled the prior claims.

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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.