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Illinois Coverage Basics

Illinois' Bifurcated Bad Faith Standard

Illinois does not have just one bad faith standard; it has two. One was created by the courts, which applies when an insured contends that an insurer did not exercise good faith in responding to settlement opportunities. The second was created by the Illinois legislature, which applies to all other instances in which an insurer's conduct is called into question by an insured.

The elements of proof and the remedies available with respect to these two standards are entirely different. It is important to understand those differences. The common law bad faith rules permit an unlimited recovery against an insurer. In contrast, the statutory bad faith remedy is limited by a specific monetary cap.

Claims for Bad Faith Failure to Settle

Under Illinois law, a common law "bad faith" action exists for 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 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).)

Traditionally, courts held that when an insurer fails to settle a case within policy limits through fraud or bad faith, it would be liable for the full amount of a judgment against its insured, irrespective of the insured's policy limits. (See Scroggins v. Allstate Insurance Company, 74 Ill.App.3d 1027 (1st Dist. 1979); Cernocky v. Indemnity Insurance Company, 69 Ill.App.2d 196 (2nd Dist. 1966).) However, Cramer and Haddick indicate that 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, which suggests that an insurer's mere negligence may trigger common law bad faith damages.

The courts have identified seven factors that are important in the assessment of bad faith when an insurer fails to settle a claim:

1. The advice of the insurance company's own adjusters;
2. A refusal to negotiate;
3. The advice of defense counsel;
4. The extent of communications with the insured;
5. The adequacy of the investigation and defense;
6. A substantial prospect of an adverse verdict; and
7. The potential for damages in excess of the policy limits.

(Bashaw v. American Family Mutual Insurance Co., 2006 WL 3591318, 3 (N.D.Ill. 2006).)

The law remains unsettled as to whether an insurer can be found to be in “bad faith” when its decision not to settle a claim was based upon a good faith coverage position. Prior to Cramer and Haddick, the Illinois Appellate Court cases held that there could 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).) Unfortunately, Cramer and Haddick did not address this question, and the cases decided after Cramer and Haddick have not addressed whether a “fairly debatable” coverage determination constitutes a full defense to a common law failure-to-settle bad faith action.

What is very clear, however, is that if an insurer fails to act in good faith in responding to settlement offers, the insurer may be liable for the full amount of a judgment entered against a policyholder, regardless of the amount of the policy limits. Haddick; Cramer; Chandler v. American Fire and Casualty Co., 377 Ill.App.3d 253, 256 (4th Dist. 2007).

All Other Claims for Bad Faith

Under Illinois’ “bad faith” statute, extra-contractual remedies are available upon proof that an insurer “vexatiously and unreasonably” delayed or failed to pay money owed. The words “vexatious” and “unreasonable” are not defined by the statute, but the question of whether an insurer acted “vexatiously and unreasonably” within the meaning of Section 155 is ordinarily a question of fact. (See Buckner v. Causey, 311 Ill.App.3d 139 (1st Dist. 1999); Green v. International Insurance Co., 238 Ill.App.3d 929 (2nd Dist. 1992).) (Ironically, the words “bad faith” do not even appear in the statute.)

Section 155 of the Illinois Insurance Code allows a court to award both monetary penalties and attorney fees against an insurer, but the statute places a cap on the amount of monetary penalties that may be awarded. That cap is currently \$60,000. However, in addition to the amount of the penalty, a court may also award attorney fees under Section 155, both as reimbursement for past defense and for the cost of prosecuting a coverage action against a recalcitrant insurer.

In contrast to the law governing the common law bad faith remedy, it is clear that Section 155 remedies are not available where a bona fide coverage dispute exists (Liberty Mutual Insurance Co. v. American Home Assurance Co., Inc., 368 Ill.App.3d 948, 962 (1st Dist. 2006), or where the insurer takes a reasonable legal position on an unsettled issue of law. (Citizens First National Bank of Princeton v. Cincinnati Insurance Co., 200 F.3d 1102 (7th Cir. 2000).)

Section 155 provides the only remedy for bad faith in Illinois, other than the common law remedy for an insurer’s bad faith failure to settle. (Cramer v. Insurance Exchange Agency, 174 Ill.2d 513 (1996).) While there is unlimited monetary exposure for a bad faith failure to settle, the exposure under Section 155 for other alleged bad faith is capped by the statute.

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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.