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Illinois Coverage Basics

What Happens When an Insured Settles a Covered Claim and Then Seeks Reimbursement from Its Insurers?

Smart insurers doing business in Illinois are careful to avoid estoppel, so when a dispute arises concerning coverage, a reservation of rights or a declaratory judgment action is usually not far behind. But, neither a reservation of rights nor a declaratory judgment action will delay the progress of the underlying claim litigation. While coverage remains in dispute, an insured can move forward to settle an underlying claim and later seek reimbursement from its insurers, if and when coverage is ultimately determined to exist.

The rules that govern an insured's efforts to obtain reimbursement for such settlements were recently discussed by a panel of the Illinois First District Appellate Court in Federal Insurance Company v. Binney & Smith, Inc., 2009 WL 1905284 (1st Dist. 2009).

The Underlying Claim and the Insured's Settlement

Binney & Smith was a class action brought against the manufacturer of Crayola brand crayons seeking damages under several causes of action, including breach of warranty, consumer fraud and deceptive trade practices. Each of the theories of recovery pleaded by the class arose from the fact that crayons manufactured and marketed by Binney & Smith (labeled "non-toxic" and "safe for children") contained harmful asbestos fibers.

During the years in which the asbestos-laden crayons were manufactured, Binney & Smith was continuously insured for approximately 30 years under a series of general liability policies issued by Federal Insurance Company. However, only three of the policies issued by Federal Insurance provided insurance for "advertising injury," which was the only coverage potentially implicated by any of the class claims. Binney & Smith tendered the class action to Federal Insurance, and in response Federal Insurance filed a declaratory judgment action denying any duty to defend or duty to indemnify Binney & Smith for the underlying class action.

While the insurer's declaratory judgment action was still pending, Binney & Smith settled the underlying claim with its own money. It then sought reimbursement from Federal Insurance. The trial court found in favor of Binney & Smith and against Federal Insurance on the coverage issues and ordered the insurer to pay reimbursement for the full amount of the settlement plus prejudgment interest. Federal Insurance appealed to the First District Appellate Court.

The Insurer's Appeal

On appeal, Federal Insurance contended that the trial court erred in ordering it to pay any part of

the insured's settlement, much less pay for the whole settlement. However, the Appellate Court found that the trial court had not erred in finding that the insurer owed a duty to repay at least some part of the insured's settlement, because the insured had satisfied its burden of proving that the settlement was made "in reasonable anticipation of liability." To support its burden Binney & Smith was not required to show that it had actual liability to the class, but only potential liability based on the facts it knew, "culminating in an amount reasonable in view of the size of possible recovery and degree of probability of claimants' success against the insured."

Although Binney & Smith felt that the underlying action was without merit, it recognized that there was a risk inherent in proceeding with any litigation. The emotional impact of the claim on a jury was of particular concern. Upon finding that Binney & Smith lacked any absolute defenses to the theories of recovery pleaded by the underlying class, the Appellate Court concluded that there was no reason to disturb the trial court's determination that the insured had settled in reasonable anticipation of liability. This resolved all disputes concerning the amount of the settlement and the insurer's liability for at least some of the settlement amount.

Nonetheless, Federal Insurance argued that it should not be required to pay for the entire settlement, because only one of the multiple causes of action pleaded by the class claimants was even potentially covered. While the Appellate Court did not disagree that only one of the class causes of action was potentially covered (i.e., the consumer fraud claim), it ruled that any effort to make an allocation of the settlement between covered claims and non-covered claims was unnecessary because "the plaintiff demonstrated the primary focus of the underlying litigation was a covered loss and it settled in reasonable anticipation of that litigation."

Federal Insurance next argued that Binney & Smith had the burden of proving what portion of the settlement, if any, was attributable the three periods of coverage in which the policies provided coverage for advertising injury. The Appellate Court agreed with Federal Insurance on this point and remanded the case for factual findings to determine which portion of the settlement related to class members who purchased Binney & Smith crayons during the three years of the advertising injury coverage. The Court instructed that if Binney & Smith was unable to establish which portion of the settlement related to injuries occurring during the three operative years of advertising injury coverage, the settlement would be apportioned using a pro rata time-on-the-risk formula. Inasmuch as advertising injury insurance was in place for 3 of the roughly 30 years in question, Federal Insurance would not be liable for more than approximately one-tenth of the total settlement based on its relative time-on-the-risk.

Binney & Smith teaches that a settlement need only be made "in reasonable anticipation of liability" for the insured to obtain reimbursement. If a covered claim is the "primary focus" of the underlying settlement, there will be no allocation among covered claims and non-covered claims (i.e., the insurer will be required to reimburse for the entire settlement). However, when multiple periods of coverage are at issue, the insured has the burden to show what portion of the settlement is allocable to each policy, or a default time-on-the-risk allocation will be made.

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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.