

Illinois Coverage Basics

Insurability of Punitive Damages in Illinois and How a Punitive Damages Claim Impacts the Duty to Defend

In most tort actions for bodily injury or property damage in Illinois, claims for punitive damages cannot be pleaded without prior court approval. But when a court grants such approval, the filing of a punitive damages claim can have important consequences for a defendant's liability insurer. Since courts frequently do not allow punitive damages claims until discovery has provided a factual basis for such claims, the filing of a punitive damages claim may require an insurer to make significant mid-case adjustments in its handling of the defense.

Prerequisites for Pleading Punitive Damages in Illinois

By statute, in all actions for bodily injury or property damage based on allegations of negligence or product liability, no punitive damages claim may be filed absent prior approval of the court. The statute, 735 ILCS 5/2-604.1, requires that leave to file a punitive damages claim may be sought by pretrial motion. Such a motion may be filed any time up to 30 days after the close of discovery. By terms of the statute, a plaintiff must be allowed to file a punitive damages claim if she can establish a "reasonable likelihood" of proving facts at trial sufficient to support an award of punitive damages.

Insurability of Punitive Damages Under Illinois Law

Whether punitive damages are insurable depends upon two factors: (1) the policy language and (2) the factual basis for the particular punitive damages claim. Exclusions for punitive damages in liability policies are enforceable in Illinois, consequently an award of punitive damages will not be covered if the policy in question contains a clear punitive damages exclusion. However, even in the absence of such a specific policy exclusion, Illinois public policy precludes insurance coverage for certain punitive damages claims.

In Illinois, public policy prohibits insurance coverage for punitive damages liability that arises out of one's own misconduct. Beaver v. Country Mutual Insurance Company, 95 Ill.App.3d 1122 (5th Dist. 1981). The rationale for this rule is that if a person were allowed to insulate himself from punitive damages exposure predicated on his own misconduct, the remedial purposes of allowing punitive damages would be subverted. However, the same rule does not apply to punitive damages awards that are based on vicarious liability principles. For example, when punitive damages are awarded against a corporate defendant based on the misconduct of an employee, public policy does not preclude coverage, because where the employer has done no wrong, the remedial purposes of punitive damages are not undercut by providing insurance coverage to the employer.

Punitive Damages Claims and Conflicts of Interest

Claims for punitive damages have immediate and important consequences for an insurer's duty to defend. The general rule in Illinois is that a conflict of interest is created between an insurer and its insured when a punitive damages claim is pleaded against the insured. If such a conflict of interest arises, an insurer is obligated to address the conflict in the same manner as other types of conflicts. First, the insurer must advise the insured of the existence and nature of the conflict. Second, the insurer must inform the insured of its right to independent defense counsel (to be paid by the insurer), which may entail a transfer of control of the defense.

The Illinois case law on this issue is not extensive, but it is relatively clear. In Nandorf, Inc. v. CNA Insurance Companies, 134 Ill.App.3d 134 (1st Dist. 1985), the complaint against the insured sought a large amount of punitive damages and a relatively small amount of compensatory damages. The Appellate Court found that the punitive damages claim in the case created a conflict of interest, because the insurer had little risk in going to trial, while the insured faced a great risk because any punitive damages award made by the jury would not be covered by insurance. The Court in Nandorf found that under these circumstances the insurer had little interest in providing a vigorous defense, and for that reason the insurer was required to provide the insured with independent counsel to fully protect the insured's interests.

The punitive damages conflict of interest issue was presented on another set of facts in Mobil Oil Corporation v. Maryland Casualty Company, 288 Ill.App.3d 743 (1st Dist. 1997). In Mobil Oil, it was undisputed that a verdict against the insured at or near the policy limit was a probable outcome if the case were to be tried. The allegations against the insured included a punitive damages claim. The Court in Mobil Oil found that under this set of facts the insurer had little to lose by allowing the case to go to trial, while the insured had a strong interest in a pretrial settlement that would protect the insured from an uninsured punitive damages award. This conflict of interest required the insurer to provide the insured with independent defense counsel.

A more absolute conflict rule is suggested by Illinois Municipal League Risk Management Association v. Seibert, 223 Ill.App.3d 864 (4th Dist. 1992). In Seibert, the Appellate Court ruled that the proportionality between the compensatory and the punitive damages claims in a case should not be a guiding factor in determining the conflict of interest issue. In contrast to Nandorf and Mobil Oil, the Seibert Court perceived that a conflict exists not *only* because the insurer may have a passive and diminished interest in providing a vigorous defense at trial. Rather, the Court in Seibert found that a conflict of interest exists primarily because the insurer has an active interest in promoting a verdict against the insured based on willful and malicious misconduct because those findings would support application of the insurer's punitive damages exclusion. Under Seibert, a conflict is arguably created by every punitive damages claim.

Where punitive damages are pleaded, the conflict of interest issue should be carefully addressed. The outcome of the analysis may depend upon the appellate district in which the case is filed.

* * *

This newsletter provides information on recent legal developments. It is not intended to provide legal advice for a specific situation or to create an attorney-client relationship. If you have questions, please feel free to contact Jim Horstman (312.332.8494; jkh@crayhuber.com).