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Illinois Coverage Basics

If An Insurer Exhausts Its Indemnity Limits By Settling On Behalf Of An Insured, It Owes No Further Duty To Defend Or Indemnify As To Other Insureds.

When a liability insurer is defending multiple insureds in a suit for damages, the rights of those insureds to the indemnity limits can become an important question. The question becomes critical if an opportunity to settle is presented and the indemnity limits are insufficient to purchase the release of all insureds.

Under these circumstances, insureds frequently argue that any settlement concluded by the insurer must secure the release of every insured, on the theory that each insured is entitled to equal treatment under the policy. Insureds often contend that a settlement which leaves any insured at risk violates the terms of the insurance policy and constitutes bad faith by the insurer.

On the other hand, an insurer faced with a demand providing for releases to some, but not all, insureds must analyze the consequences of failing to meet such a demand. Well-established rules governing the conduct of insurers require that an insurer must exercise good faith in responding to opportunities to settle within its policy limits. An insurer failing to secure the release of an insured when presented with a demand within the limits of the policy may be met with bad faith allegations from the insureds who are left at risk following settlement.

Caught in this dilemma, what can an insurer safely do? In some jurisdictions (e.g., California and New York), it constitutes bad faith for an insurer to enter into a settlement exhausting its policy limits, if the settlement leaves any insured at risk. In Illinois, the rule is different. Entering into a settlement that leaves one or more insureds exposed does not necessarily constitute bad faith and may be safely undertaken, with proper safeguards.

For example, in Pekin Insurance Company v. Home Insurance Company, 134 Ill.App.3d 31, 479 N.E.2d 1078 (1st Dist. 1985), an employee of the Chicago White Sox baseball team was involved in an automobile collision in the course of his employment. He was an insured of Pekin, which paid its entire \$25,000 indemnity limits to secure his release. However, the plaintiff expressly reserved rights to pursue the White Sox, which was an additional insured under the Pekin policy, and he later filed suit against the franchise. Pekin offered to defend the White Sox but reserved its right not to pay indemnity with respect to the White Sox, because it had already exhausted its indemnity limits. The Sox declined the offer, and Pekin then filed a declaratory judgment action to obtain a ruling that the exhaustion of its limits freed it of any responsibility to the White Sox.

The Appellate Court held that Pekin had acted properly in settling on behalf of the driver while leaving the White Sox exposed to liability. Ruling that Pekin had properly executed its responsibilities under the policy, the Appellate Court took particular note of the fact that Pekin had promptly filed a declaratory judgment action to obtain a ruling on the issue *and* had also offered to provide a defense to the White Sox. The court further noted that the White Sox would receive a set off for the full amount of the settlement paid on behalf of the driver-employer.

In Country Mutual Insurance Company v. Anderson, 257 Ill.App.3d 73, 628 N.E.2d 499 (1st Dist. 1993), the plaintiff was injured in a collision with a gravel truck. She sued the owner and the lessee of the truck, as well as the company for which the gravel was being hauled. The insurers for the owner and the lessee of the truck acknowledged coverage for all three defendants and offered their full limits in settlement. The plaintiff agreed to accept the indemnity limits of the truck owner's and lessee's insurers, but refused to grant their request for a release of the gravel company. A settlement was subsequently finalized, exhausting the limits of the truck owner's and lessee's insurance policies and securing the release of the truck owner and lessee only. The insurers participating in the settlement then filed a declaratory judgment action to establish their rights as to the gravel company, which was not released by their settlement.

In the coverage action, the gravel company argued that the settling insurers owed it a continuing duty even after exhaustion of their indemnity limits, because its rights were "co-equal" with those of the truck owner and lessee. The Appellate Court, citing Pekin, rejected the gravel company's argument. The court ruled that the insurers had acted properly in connection with the settlement, because had they forgone the opportunity to settle, they would have jeopardized the interests of the truck owner and lessee. The court observed "It is an insurer's unreasonable failure to pursue a settlement offer, rather than its acceptance of one, which will expose it to liability for bad faith." Moreover, as the settlements were proper and necessary to protect the interests of the truck owner and lessee, the Appellate Court ruled that the insurers' exhaustion of their limits relieved them of any further obligations to the gravel company.

However, Great Lakes Dredge & Dock Company v. Commercial Union Assurance Company, 1999 U.S. LEXIS 13914 (N.D.Ill. 1999) warns that an insured who is not released by an insurer's settlement may have estoppel and bad faith claims against an insurer that has failed to properly preserve its position before concluding the settlement. In Great Lakes, the insurer ignored an insured's tender and then proceeded to exhaust its limits in a settlement paid solely on behalf of other insureds. The District Court held that by failing to properly respond to the tender – by either filing a declaratory judgment action, or alternatively, by defending under reservation of rights – the insurer acted in bad faith and thus owed continuing obligations to the insured, despite the exhaustion of its indemnity limits. The lesson of Great Lakes is that a settlement exhausting an insurer's indemnity limits will not absolve the insurer of mishandling of a tender taking place prior to the settlement.

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If you have questions or would like to discuss the subject of this article further, please feel free to contact James K. Horstman at Cray Huber Horstman Heil & VanAusdal LLC, 303 West Madison Street, Suite 2200, Chicago IL 60606; 312-332-8494; jkh@crayhuber.com.