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Illinois Coverage Basics

A Liability Insurer Cannot Be Forced To Pay Indemnity Above Its Limits, Unless It Is Found Guilty of Bad Faith.

An order compelling payment beyond a policy's indemnity limits could be a liability insurer's worst nightmare. Being forced to pay more than the amount of the policy limits raises a host of serious problems, both for the insurer and for the claims professionals whose conduct is placed at issue. So it is worthwhile asking: what must be shown to "open up" a liability insurer's limits under Illinois law?

The Illinois rule is that an insurer cannot be required to pay a judgment beyond its indemnity limits, unless the insurer is found to be in "bad faith." (See Reis v. Aetna Casualty and Surety Company of Illinois, 69 Ill.App.3d 777, 387 N.E.2d 700 (1st Dist. 1978); DeGraw v. State Security Insurance Company, 40 Ill.App.3d 26, 351 N.E.2d 302, 312 (1st Dist. 1976).) That said, the operative question becomes: what must be shown to establish "bad faith"?

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 (1996), 174 Ill.2d 513, 675 N.E.2d 897.) 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 (2001), 198 Ill.2d 409, 763 N.E.2d 299.)

To establish an insurer's bad faith failure to settle, something more than a mere mistake on the part of the insurer must be shown. Traditionally, it was said that when an insurer fails to settle a case within policy limits through either fraud, negligence, 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, 393 N.E.2d 718, 720 (1st Dist. 1979); Cernocky v. Indemnity Insurance Company, 69 Ill.App.2d 196, 216 N.E.2d 198, 203 (2nd Dist. 1966).)

Early cases indicated that negligence alone would not be sufficient to sustain liability beyond an insurer's limits and that "bad faith" would be found only where an insurer is engaged in "vexatious, unreasonable or outrageous" conduct toward its insured. (Country Mutual Insurance Company v. Anderson, 257 Ill.App.3d 73, 628 N.E.2d 499, 503 (1st Dist. 1993); Pekin Insurance Company v. Home Insurance Company, 134 Ill.App.3d 31, 479 N.E.2d 1078, 1080 (1st Dist. 1985).) However, Cramer and Haddick have more recently suggested 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 a mere negligence standard. Thus, Illinois courts might hold that

mere negligence is sufficient to establish “bad faith” liability based on Cramer and Haddick, although the stronger view is that vexatious, outrageous or unreasonable conduct must be shown.

A recent Appellate Court case (post-Cramer and post-Haddick) reconfirms the traditional principle that when an insurer is pursued for its refusal to settle a claim, “bad faith” lies in the insurer’s failure to give at least equal consideration to the insured’s interests when the insurer arrives at a decision on whether to settle the claim. (O’Neill v. Gallant Insurance Company, 329 N.E.2d 1166, 769 N.E.2d 100, 106 (5th Dist. 2002).) The O’Neill court identified seven factors that are relevant to the assessment of bad faith under these circumstances:

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
7. The potential for damages to exceed the policy limits.

The O’Neill list of factors does not provide a mathematical formula for determining when an insurer’s conduct is in bad faith; it only describes the factors that a court will consider in its evaluation of a claim of bad faith. The Appellate Court found that each of these seven factors weighed against the insurer in O’Neill. The court not only found that the insurer in O’Neill acted in bad faith; it also upheld a substantial award of punitive damages against the insurer.

Can an insurer be in “bad faith” when its decision not to settle is 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, 628 N.E.2d 810, 815 (1st Dist. 1993); Alliance Syndicate, Inc. v. Parsec, Inc., 318 Ill.App.3d 590, 741 N.E.2d 1039, 1049 (1st Dist. 2000).) Unfortunately, Cramer and Haddick did not address this particular rule, so it is not clear at this point whether Illinois courts will continue to hold that there can be no bad faith liability when the insurer’s decision to settle is based on a “fairly debatable” coverage determination.

The bright line rule in Illinois is that “bad faith” must be established in order for a court to compel a liability insurer to pay indemnity in excess of its limits. However, considerable flexibility exists, both legally and factually, in defining what constitutes “bad faith.” As a result, insurers doing business in Illinois should remain conscious of the need to build a record that will reflect its sound reasons for deciding not to settle a claim against its insured, which will serve to demonstrate its affirmative good faith in responding to settlement opportunities.

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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.