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18 Extra-Contractual Damages

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I. [18.1] SCOPE OF CHAPTER

Under Illinois law, policyholders who, believing that their insurer has failed to fulfill its obligations under the parties' insurance contract, seek to recover relief other than that afforded by the insurance contract itself have certain limited remedies. Practitioners representing insureds and insurers must understand the statutes and common law actions affording such extra-contractual remedies in order to maximize effective representation of either the insured or insurer when insurance policy rights and obligations are at issue. Accordingly, this chapter focuses on the types of causes of action and remedies that are available in coverage disputes involving extra-contractual damages.

An insurer that fails to fulfill its contractual and legal obligations under the policy of insurance can be held liable for breaching its insurance contract. In such cases under Illinois law, however, the aggrieved insured or claimant typically is limited to recovering only those damages available in a traditional breach of contract suit. That is, the policyholder may be able to recover only the contractual benefits to which it was entitled, without recompense for any delay in receiving those benefits. In such circumstances, insurers might be tempted to delay acknowledging their legal and contractual obligations, even with regard to legitimate claims, in order to maximize use of their money. The Illinois legislature wanted to ensure that a penalty could be imposed on any insurer who unreasonably fails to fulfill its obligations under the insurance contract.

To address this concern, the Illinois legislature promulgated a statute intended to provide insureds with a recovery not limited to the insurance contract itself. This chapter discusses that statute, §155 of the Illinois Insurance Code (215 ILCS 5/155). Section 155 of the Insurance Code provides a limited monetary recovery, together with attorneys' fees, for an insurer's unreasonable and vexatious failure to fulfill its contractual and legal obligations to its policyholders.

Another potential (albeit less frequently utilized) remedy is provided by the Consumer Fraud and Deceptive Practices Act (Consumer Fraud Act), 815 ILCS 505/1, *et seq.* This chapter also discusses how practitioners in Illinois have tried to use the Consumer Fraud Act to recover extra-contractual damages when an insurer has failed to pay or resolve claims appropriately.

In addition to the foregoing statutes, there are also certain tort theories under which an aggrieved policyholder may seek extra-contractual damages. As discussed below, the Illinois Supreme Court has determined that, in many insurance disputes, there is no common law "bad-faith" tort action under Illinois law. However, a policyholder may assert a bad-faith action against a liability insurer that has failed to act in good faith in responding to a settlement offer. Furthermore, policyholders may seek extra-contractual recoveries under traditional tort theories of recovery, such as fraud.

II. [18.2] EXTRA-CONTRACTUAL DAMAGES: STATUTORY RIGHTS OF ACTION

As set forth above, §155 of the Insurance Code is the Illinois statute most frequently cited by aggrieved insureds seeking to recover extra-contractual damages from insurers. In addition, in certain circumstances, policyholders also may be able to recover extra-contractual damages from insurers based on Illinois' Consumer Fraud and Deceptive Practices Act. Sections 18.3 – 18.4 below provide a brief overview of these two statutes.

A. [18.3] Section 155

Prior to the enactment of Insurance Code §155, if an insurer failed to fulfill its duties and obligations under its insurance contract, policyholders typically were limited to suing such insurers for breach of contract to receive the proceeds of the policy. Punitive damages and attorneys' fees usually were not available. This history is clearly set out in the Illinois Supreme Court's decision in *Cramer v. Insurance Exchange Agency,* 174 Ill.2d 513, 675 N.E.2d 897, 901, 221 Ill. Dec. 473 (1996). As described in *Cramer,* the Illinois legislature enacted Insurance Code §155 in order to create a limited statutory exception to this general rule. Section 155 was intended to make policyholder suits economically feasible and to punish insurers that vexatiously and unreasonably fail to fulfill their obligations to policyholders. Section 155 of the Illinois Insurance Code provides as follows:

> **Attorney Fees. (1) In any action by or against a company wherein there is in issue the liability of a company on a policy or policies of insurance or the amount of the loss payable thereunder, or for an unreasonable delay in settling a claim, and it appears to the court that such action or delay is vexatious and unreasonable, the court may allow as part of the taxable costs in the action reasonable attorney fees, other costs, plus an amount not to exceed any one of the following amounts:**
>
> **(a) 25% of the amount which the court or jury finds such party is entitled to recover against the company, exclusive of all costs;**
>
> **(b) $25,000;**
>
> **(c) the excess of the amount which the court or jury finds such party is entitled to recover, exclusive of costs, over the amount, if any, which the company offered to pay in settlement of the claim prior to the action.**

Although many view Insurance Code §155 as primarily relating to "first-party" insurance claims (claims for loss submitted by the policyholder to its insurer for payment, such as those under automobile or fire insurance policies), Insurance Code §155 also applies to "third-party" liability insurance (such as commercial and professional liability insurance) that provides policyholders with defense and/or indemnity benefits. *Prisco Serena Sturm Architects, Ltd. v. Liberty Mutual Insurance Co.,* 126 F.3d 886, 894 – 895 (7th Cir. 1997) (statute is generally applicable to third-party as well as first-party insurance); *Richardson v. Illinois Power Co.,* 217 Ill.App.3d 708, 577 N.E.2d 823, 160 Ill.Dec. 498 (5th Dist. 1991).

The relief provided in Insurance Code §155 is not limited strictly to policyholders. It is well established that the rights and remedies available under Insurance Code §155 can be extended to assignees of policyholders. *See, e.g., Garcia v. Lovellette,* 265 Ill.App.3d 728, 639 N.E.2d 935, 203 Ill.Dec. 376 (2d Dist. 1994); *Peerless Enterprise, Inc. v. Kruse,* 317 Ill.App.3d 133, 738 N.E.2d 988, 250 Ill.Dec. 519 (2d Dist. 2000).

The "general" five-year statute of limitations (735 ILCS 5/13-205) applies to a cause of action filed under Insurance Code §155. *See Marcheschi v. Illinois Farmers Insurance Co.,* 298 Ill.App.3d 306, 698 N.E.2d 683, 232 Ill.Dec. 592 (1st Dist. 1998) (specifically rejecting insurer's contention that cause of action under Insurance Code §155 is subject to the two-year statute of limitations for actions involving personal injuries or penal statutes).

In comparison with the potential recoveries against insurance companies under common law, the recoveries permitted under Insurance Code §155 are limited. In addition, the insured must prove that the insurer's action in denying liability, refusing to pay a covered loss, or delaying the settlement of a claim was vexatious and unreasonable. *Buckner v. Causey,* 311 Ill.App.3d 139, 724 N.E.2d 95, 243 Ill.Dec. 786 (1st Dist. 1999). This burden can be difficult to meet. As such, practitioners typically will not limit their actions against insurance companies solely to an action under Insurance Code §155, with its capped recovery amounts. Rather, practitioners representing insureds typically couple an Insurance Code §155 action with other common law tort actions. Regardless of the difficulty that may be involved in attempting to prove that an insurer acted vexatiously and unreasonably, insureds frequently will plead a cause of action under Insurance Code §155 to try to recover attorneys' fees and penalties that might not be otherwise recoverable under the insurance contract or common law.

B. [18.4] Illinois Consumer Fraud and Deceptive Business Practices Act

Another statute that may afford policyholders an opportunity to seek extra-contractual damages is the Consumer Fraud Act. The Consumer Fraud Act generally protects consumers by outlawing certain deceptive or misleading actions:

> **Unfair methods of competition and unfair or deceptive acts or practices, including but not limited to the use or employment of any deception, fraud, false pretense, false promise, misrepresentation or the concealment, suppression or omission of any material fact, with intent that others rely upon the concealment, suppression or omission of such material fact, or the use or employment of any practice described in Section 2 of the "Uniform Deceptive Trade Practices Act," approved August 5, 1965, in the conduct of any trade or commerce are hereby declared unlawful whether any person has in fact been misled, deceived or damaged thereby.** 815 ILCS 505/2.

Although most reported Illinois decisions addressing the Consumer Fraud Act do not involve insurance companies, Illinois courts have recognized that the Consumer Fraud Act may apply to insurers. *Fox v. Industrial Casualty Insurance Co.,* 98 Ill.App.3d 543, 424 N.E.2d 839, 54 Ill.Dec. 89 (1st Dist. 1981). In *Fox,* a class of insureds brought suit against their insurer alleging, inter alia, violations of Consumer Fraud Act. The insurer moved to dismiss such allegations, arguing that insureds are limited to seeking the remedies provided by the Insurance Code. 424 N.E.2d at 841. The court rejected this argument, holding that the "sale of insurance is clearly a service and insureds are thus consumers and within the protection of the Consumer Fraud Act." 424 N.E.2d at 842. Therefore, it appears that alleged wrongdoing arising out of the sale of insurance may be actionable under the Consumer Fraud Act.

Generally, in order to plead a cause of action under the Consumer Fraud Act properly, a plaintiff must allege (1) a deceptive act or practice, (2) that the defendant intended for the plaintiff to rely on the deception, (3) that the deception occurred in the course of conduct involving trade or commerce, and (4) that the plaintiff suffered damages. *Barille v. Sears Roebuck & Co.,* 289 Ill.App.3d 171, 682 N.E.2d 118, 122 – 123, 224 Ill.Dec. 557 (1st Dist. 1997); *Bernhauser v. Glen Ellyn Dodge, Inc.,* 288 Ill.App.3d 984, 683 N.E.2d 1194, 1200, 225 Ill.Dec. 531 (2d Dist. 1997). To prevail, a plaintiff must prove each of these elements by a preponderance of the evidence. *Avery v. State Farm Mutual Automobile Insurance Co.,* 321 Ill.App.3d 269, 746 N.E.2d 1242, 1261 – 1262, 254 Ill.Dec. 194 (5th Dist. 2001).

The elements required to establish fraud under the Consumer Fraud Act are less stringent than the elements necessary to establish common law fraud. *Id.* For example, in an action under the Consumer Fraud Act, unlike a common law fraud action, a plaintiff is not required to demonstrate that he or she actually relied on the deception. *Bernhauser, supra.* Furthermore, the intention of the person or entity making the misrepresentation is not material; an innocent misrepresentation is actionable under the Consumer Fraud Act. *Smith v. Prime Cable of Chicago,* 276 Ill.App.3d 843, 658 N.E.2d 1325, 213 Ill.Dec. 304 (1st Dist. 1995). However, a plaintiff is required to plead an action under the Consumer Fraud Act with the same specificity as is required of common law fraud actions. 658 N.E.2d at 1335. The Consumer Fraud Act contains a three-year statute of limitations. 815 ILCS 505/10a(e).

Any person who suffers "actual damage" as a result of a violation of the Consumer Fraud Act may bring an action to recover actual economic damages and "any other relief which the court deems proper," including injunctive relief, reasonable attorneys' fees, and costs. 815 ILCS 505/10a(a), 505/10a(c). However, the existence of "actual damages" is a predicate to a suit under the Consumer Fraud Act. *See Smith, supra* (dismissing complaint under Consumer Fraud Act because plaintiffs did not allege that they were entitled to actual damages). Punitive damages, although disfavored, may also be recovered in an action under the Consumer Fraud Act if the alleged misconduct is "outrageous," because the acts at issue either were performed with malice or an evil motive or were performed with reckless indifference toward the rights of others.

As a practical matter, it may be difficult for a policyholder to prove a violation of the Consumer Fraud Act. Accordingly, as described in §18.3 above with regard to actions under Insurance Code §155, practitioners representing insureds typically allege an action under the Consumer Fraud Act in conjunction with several other causes of action. Because of the level of proof required to demonstrate an insurer violated the Consumer Fraud Act, the use of the Consumer Fraud Act as part of an insurance coverage dispute is generally the exception rather than the rule.

III. EXTRA-CONTRACTUAL DAMAGES: TORT ACTIONS

A. [18.5] "Bad-Faith" Actions

For many years, practitioners asserted a separate "bad-faith" action against insurers that failed to fulfill their responsibilities under their insurance contract. *See, e.g., Ledingham v. Blue Cross Plan for Hospital Care of Hospital Service Corp.*, 29 Ill.App.3d 339, 330 N.E.2d 540 (5th Dist. 1975), *rev'd on other grounds,* 64 Ill.2d 338 (1976). Such actions were found to arise out of the implied contractual covenant of good faith and fair dealing and were independent of any action under Insurance Code §155. In 1996, however, the Illinois Supreme Court generally rejected the notion of a separate tort action against an insurer for "bad faith," or "breach of the contractual covenant of good faith and fair dealing." *Cramer v. Insurance Exchange Agency,* 174 Ill.2d 513, 675 N.E.2d 897, 900, 901, 221 Ill.Dec. 473 (1996) (noting that implied covenant of good faith and fair dealing "is used only as a construction aid in determining the intent of the contracting parties," and concluding that "the tort of bad faith is not a separate and independent tort action that is recognized in Illinois").

However, the *Cramer* decision recognized an exception for instances in which an insured contends that its liability insurer has failed to settle a suit against its insured within the policy limits. The court noted that, "[i]n the typical 'duty to settle' case, [a] third party has sued the policyholder for an amount in excess of the policy limits but has offered to settle the claim against the policyholder for an amount equal to or less than those policy limits." 675 N.E.2d at 903. The court also noted that in such cases, "the policyholder does not have a contractual remedy because the policy does not specifically define the liability insurer's duty when responding to settlement offers." *Id.* Therefore, in such cases, Illinois courts have found that an insurer has a duty to act in good faith in responding to settlement offers and that such duty may give rise to a tort action when the insurer fails to act in good faith in the context of responding to a settlement offer. Subsequent decisions have interpreted *Cramer* as having "acknowledged that an independent tort action has been recognized in 'duty to settle' cases, because, absent policy provisions defining the insurer's liability for failing to respond to settlement offers, the policyholder has no contractual remedy." *Buckner v. Causey,* 311 Ill.App.3d 139, 724 N.E.2d 95, 103, 243 Ill.Dec. 786 (1st Dist. 1999).

B. [18.6] Common Law Fraud

Cramer v. Insurance Exchange Agency, 174 Ill.2d 513, 675 N.E.2d 897, 902, 221 Ill.Dec. 473 (1996), also left open the possibility of an independent tort action when an insurer's wrongful conduct exceeds the level necessary to establish liability under Insurance Code §155:

> **[**Section 155**] provides an extracontractual remedy for insurer misconduct that is vexatious and unreasonable. Well-established tort actions, such as common law fraud, require proof of different elements and remedy a different sort of harm than [**Section 155**] does. These torts address insurer misconduct that is not merely vexatious and unreasonable. [**Section 155**] was not intended to insulate an insurer from such tort actions.**

The court continued:

> **In cases where a plaintiff actually alleges and proves the elements of a separate tort, a plaintiff may bring an independent tort action, such as common law fraud, for insurer misconduct.** 675 N.E.2d at 904.

In order to state a cause of action for common law fraud, the following elements must be pleaded with specificity: (1) the existence of a false statement of material fact; (2) the party making such statement knew or believed it to be untrue; (3) the party to whom the statement was made had a right to rely on the statement; (4) the party to whom the statement was made did in fact rely on it; (5) the statement was made for the purpose of inducing the other party to act; and (6) the person to whom the statement was made suffered injury as a result of his or her reliance. 675 N.E.2d at 905, citing *Siegel v. Levy Organization Development Co.,* 153 Ill.2d 534, 607 N.E.2d 194, 198, 180 Ill.Dec. 300 (1992). Fraud actions are subject to a five-year statute of limitations. *McCarter v. State Farm Mutual Automobile Insurance Co.,* 130 Ill.App.3d 97, 473 N.E.2d 1015, 85 Ill.Dec. 416 (3d Dist. 1985).

While an insured can sue its insurer for fraud, those actions are often difficult to prove. As is the case with Insurance Code §155 and the Consumer Fraud Act, practitioners representing insureds typically do not proceed solely on a fraud claim because of the difficulties of prevailing in such actions. However, if there is some factual support for bringing a traditional fraud claim against an insurer, practitioners may choose to include fraud allegations in an attempt to motivate the insurer to compromise the coverage dispute.

IV. [18.7] INSURERS' LIABILITY FOR EXTRA-CONTRACTUAL DAMAGES

Having reviewed the statutes and common law actions that might expose an insurer to extra-contractual damages, §§18.8 – 18.16 below discuss some of the acts and omissions by insurers that might result in liability and damages under the foregoing statutes and common law actions.

A. Failure To Defend

1. [18.8] Section 155/Unreasonable and Vexatious Failure To Defend

As explained in Chapter 6, insurers may have a duty to defend their insured under certain circumstances. It is well established that an insurer can be liable for extra-contractual damages and penalties under Insurance Code §155 if it vexatiously and unreasonably refuses to defend its insured in an underlying action that potentially falls within the policy's coverage. *See, e.g., Richardson v. Illinois Power Co.,* 217 Ill.App.3d 708, 577 N.E.2d 823, 160 Ill.Dec. 498 (5th Dist. 1991); *Bedoya v. Illinois Founders Insurance Co.,* 293 Ill.App.3d 668, 688 N.E.2d 757, 228 Ill.Dec. 59 (1st Dist. 1997) (upholding award of attorneys' fees and assessment of statutory 25-percent penalty against insurer that refused to defend its insured against all counts of underlying complaint, despite well-established Illinois law holding that insurer must defend insured against entire lawsuit even if only one count of underlying complaint potentially falls within policy's coverage).

An insurer may be found to have vexatiously and unreasonably refused to defend its insured, and therefore be subject to extra-contractual damages and penalties pursuant to Insurance Code §155, if the undisputed facts demonstrate that the insurer both (a) had a duty to defend its insured and (b) failed to defend its insured under a reservation of rights or to file a declaratory judgment action timely prior to resolution of the conclusion of the underlying action against its insured. *Employers Insurance of Wausau v. Ehlco Liquidating Trust,* 186 Ill.2d 127, 708 N.E.2d 1122, 237 Ill.Dec. 82 (1999).

In *Employers Insurance of Wausau,* the Illinois Supreme Court upheld an order assessing attorneys' fees and costs of suit under Insurance Code §155 because of the insurer's failure to defend its insured. In that case, the insurer was provided with notice of a suit against its insured in January 1992. However, the insurer refused to defend its insured and, in response to numerous requests by the insured, merely responded that "it was searching for its policies." 708 N.E.2d at 1127. The insured ultimately settled the suit against it without the insurer's assistance. The insurer did not file a declaratory judgment action until nearly four months after its insured had settled the underlying action. The Illinois Supreme Court found that, under these circumstances, the insurer had unreasonably and vexatiously refused to defend its insured and was therefore liable for attorneys' fees and costs under Insurance Code §155. 708 N.E.2d at 1139. *Accord Shell Oil Co. v. AC&S, Inc.,* 271 Ill.App.3d 898, 649 N.E.2d 946, 208 Ill.Dec. 586 (5th Dist. 1995) (finding that when insurer failed to respond to its insured's tender of defense until after insured filed declaratory judgment action against it, insurer was estopped from asserting policy defenses and was liable for attorneys' fees pursuant to Insurance Code §155).

In light of the foregoing decisions, an insurer that reasonably believes it does not have a duty to defend and intends to seek a declaratory judgment to that effect should promptly file the declaratory action. Otherwise, the insurer risks being estopped from asserting any policy defenses and being found to have acted unreasonably and vexatiously. Importantly, an insurer will not be found to have acted vexatiously and unreasonably if the insurer timely files a declaratory judgment suit and the court later declares that the policy did not provide coverage. *Westchester Fire Insurance Co. v. G. Heileman Brewing Co.,* 321 Ill.App.3d 622, 747 N.E.2d 955, 254 Ill.Dec. 543 (1st Dist. 2001).

2. [18.9] Common Law Bad-Faith Failure To Defend

It is not entirely clear whether, after the decision in *Cramer v. Insurance Exchange Agency,* 174 Ill.2d 513, 675 N.E.2d 897, 221 Ill.Dec. 473 (1996), decision, a policyholder still may be able to assert a common law bad-faith claim based on a liability insurer's failure to defend its policyholder. Although *Cramer* rejected the notion of an independent tort of bad faith, the Supreme Court's holding was arguably restricted to first-party insurance and, therefore, may not be applicable to third-party commercial and professional liability insurance.

Some subsequent decisions appear to recognize implicitly an independent tort action for an insurer's bad-faith failure to defend its insured. *See, e.g., Chandler v. Doherty,* 299 Ill.App.3d 797, 702 N.E.2d 634, 640, 234 Ill.Dec. 294 (4th Dist. 1998) (recognizing tort action for bad faith, but noting that such action cannot be brought in connection with statutory garnishment proceedings). *See also LaGrange Memorial Hospital v. St. Paul Insurance Co.,* 317 Ill.App.3d 863, 740 N.E.2d 21, 251 Ill.Dec. 191 (1st Dist. 2000) (affirming summary judgment in favor of insured, based both on the insurer's breach of its duty to defend *and* its unreasonable and vexatious conduct under Insurance Code §155). However, at least one subsequent decision states that a tort-based claim for "failure to settle" is the *only* recognized exception to the doctrine set forth in *Cramer*. *Chicago Motor Club v. Robinson,* 316 Ill.App.3d 1163, 739 N.E.2d 889, 250 Ill.Dec. 892 (1st Dist. 2000).

3. [18.10] Damages Resulting from Failure To Defend

If an insurer is found to have wrongfully refused to defend its insured, the following elements of damage may be awarded:

a. the amount of the underlying judgment against the insured, up to the policy limits (unless the insurer was guilty of negligence, fraud, or bad faith, in which case the insurer may be liable for the full amount of the judgment even if such judgment exceeds its policy limits);

b. the expenses incurred by the insured in defending the underlying suit; and

c. any additional damages traceable to the insurer's failure to defend.

Conway v. Country Casualty Insurance Co., 92 Ill.2d 388, 442 N.E.2d 245, 65 Ill.Dec. 934 (1982); *Chandler v. Doherty,* 299 Ill.App.3d 797, 702 N.E.2d 634, 234 Ill.Dec. 294 (4th Dist. 1998); *Mohr v. Dix Mutual County Fire Insurance Co.,* 143 Ill.App.3d 989, 493 N.E.2d 638, 97 Ill.Dec. 831 (4th Dist. 1986). In addition, if an insured is forced to bring a declaratory judgment action to enforce its right to coverage, Insurance Code §155 may permit the insured to recover its attorneys' fees incurred in both the underlying suit and the declaratory action. *Mobil Oil Corp. v. Maryland Casualty Co.,* 288 Ill.App.3d 743, 681 N.E.2d 552, 562, 224 Ill.Dec. 237 (1st Dist. 1997).

However, an insurer may be liable only for a "reasonable" underlying judgment or settlement and for "reasonable" attorneys' fees and costs. Because of the concern that a displeased insured may enter into a collusive or unreasonable settlement, an insurer normally is entitled to contest the reasonableness of the underlying judgment or settlement or the insured's claimed expenses. *See, e.g., Platinum Technology, Inc. v. Federal Insurance Co.,* No. 99 C 7378, 2001 WL 109814 (N.D.Ill. Feb. 2, 2001) (holding that insurer that already had been estopped from asserting policy defenses, nonetheless had right to contest reasonableness of underlying settlement negotiated by its insured). *But see Liberty Mutual Insurance Co. v. Westfield Insurance Co.,* 301 Ill.App.3d 49, 703 N.E.2d 439, 234 Ill.Dec. 578 (1st Dist. 1998) (finding, in equitable contribution action between two insurers, that insurer that refused to defend its insured or participate in settling underlying case had waived its right to contest reasonableness of underlying settlement).

The issue of reasonableness is within the discretion of the trial court. *Westchester Fire Insurance Co. v. G. Heileman Brewing Co.,* 321 Ill.App.3d 622, 747 N.E.2d 955, 254 Ill.Dec. 543 (1st Dist. 2001) (finding that awarding insured $1,056,479.08 as reimbursement for expenses it incurred in defending underlying action was reasonable, and noting that, although trial court had set matter for prove-up and gave insurer opportunity to present evidence as to whether such amount was reasonable, insurer had failed to present any such evidence).

B. [18.11] Failure To Settle Within Policy Limits

In addition to the duty to defend, an insurer may also have a duty to indemnify its insured with respect to a judgment or settlement within the policy limits. Illinois courts have determined that whenever an insurer has an opportunity to settle a suit against its insured within the policy limits, and thereby protect its insured from excess liability, the insurer has a duty to "faithfully consider" such opportunity and give the insured's interests at least as much respect as its own. *La Rotunda v. Royal Globe Insurance Co.,* 87 Ill.App.3d 446, 408 N.E.2d 928, 935, 42 Ill.Dec. 219 (1st Dist. 1980), citing *General Casualty Company of Wisconsin v. Whipple,* 328 F.2d 353, 356 (7th Cir. 1964); *Cernocky v. Indemnity Insurance Company of North America,* 69 Ill.App.2d 196, 216 N.E.2d 195 (2d Dist. 1966).

To state a cause of action for breach of the insurer's duty to settle, a plaintiff must allege sufficient, well-pleaded facts indicating such a duty arose, the insurer breached the duty through either fraud, negligence, or bad faith, and such breach was the legal cause of harm to the insured. *Adduci v. Vigilant Insurance Co.,* 98 Ill.App.3d 472, 424 N.E.2d 645, 53 Ill.Dec. 854 (1st Dist. 1981). In order to establish proximate cause, the plaintiff must prove that there was an opportunity for the insurer to settle the suit against its insured within the policy limits. *California Union Insurance Co. v. Liberty Mutual Insurance Co.,* 920 F.Supp. 908 (N.D.Ill. 1996). A plaintiff will not be able to maintain a bad-faith failure to settle an action when the insurer was never presented with a settlement demand within its policy limits. *Van Vleck v. Ohio Casualty Insurance Co.,* 128 Ill.App.3d 959, 471 N.E.2d 925, 927, 84 Ill.Dec. 159 (3d Dist. 1984) (dismissing complaint that did not allege that insurer was ever presented with settlement demand within its $100,000 policy limits, and noting that insurer's duty to settle within its policy limits "does not impose upon the insurer the obligation to perform the impossible").

1. [18.12] Parties Entitled To Bring an Action for Bad-Faith Failure To Settle

Of course, an insured may bring a bad-faith action against his or her insurer based on the insurer's failure to settle a suit against the insured properly. However, in certain circumstances, other parties also may be entitled to bring a bad-faith failure-to-settle action against an insurer.

The rule in Illinois, and nearly all jurisdictions, is that, in the absence of statutory or contractual language holding otherwise, an injured third party does not have standing to bring a direct action against an insurer for bad faith by virtue of such third party's standing as judgment creditor of the insured. *Scroggins v. Allstate Insurance Co.,* 74 Ill.App.3d 1027, 393 N.E.2d 718, 30 Ill.Dec. 682 (1st Dist. 1979). However, the insured may assign its right to bring an action against its insurer for bad-faith failure to settle to third parties, either in conjunction with a settlement or with a judgment against the insured. *Browning v. Heritage Insurance Co.,* 33 Ill.App.3d 943, 338 N.E.2d 912, 916 (2d Dist. 1975). *See also La Rotunda v. Royal Globe Insurance Co.,* 87 Ill.App.3d 446, 408 N.E.2d 928, 42 Ill.Dec. 219 (1st Dist. 1980) (following entry of adverse verdict in amount of $420,000, insured assigned to its judgment creditor its rights to sue its insurer for failing to settle suit within $25,000 policy limits).

Furthermore, because an excess insurer may face potential exposure to liability if an excess judgment is entered against its insured, the excess insurer also may bring such a claim. *Schal Bovis, Inc. v. Casualty Insurance Co.,* 314 Ill.App.3d 562, 732 N.E.2d 1082, 247 Ill.Dec. 750

(1st Dist. 1999). To prevail on a bad-faith failure-to-settle action, an excess insurer must show not only that the primary insurer had a duty to settle and breached that duty, but also that the primary insurer's failure to settle within policy limits proximately caused the excess insurer to be harmed by having to contribute money to the excess verdict or settlement. *California Union Insurance Co. v. Liberty Mutual Insurance Co.,* 920 F.Supp. 908, 923 (N.D.Ill. 1996).

2. The Insurer's Duty To Settle

a. [18.13] Acts Constituting a Breach of the Duty To Settle

As set forth above, when an insurer has an opportunity to settle a suit against its insured within its policy limits, the insurer has a duty to consider such an opportunity carefully and give its insured's interests as much consideration as it gives its own. However, insurers generally do not have an affirmative duty to initiate settlement negotiations. *Kavanaugh v. Interstate Fire & Casualty Co.,* 35 Ill.App.3d 350, 342 N.E.2d 116 (1st Dist. 1976). Illinois courts have recognized that imposing such a duty would place insurers at a negotiating disadvantage not imposed on any other litigant. 342 N.E.2d at 121, citing *Oda v. Highway Insurance Co.,* 44 Ill.App.2d 235, 194 N.E.2d 489, 499 (1st Dist. 1963).

However, courts have recognized a significant exception to this general principle: when the "probability of an adverse finding on liability is great and the amount of probable damages would greatly exceed the primary coverage, the insurer may owe a duty to initiate settlement negotiations if the plaintiff has not done so." *California Union Insurance Co. v. Liberty Mutual Insurance Co.,* 920 F.Supp. 908, 920 – 921 (N.D.Ill. 1996). However, this duty is to be imposed sparingly, and only when the liability is "glaring," as it places an insurer at a disadvantage in negotiating. 920 F.Supp at 921. In *California Union,* the court held that because the insurer never attempted to find out whether the case could settle for an amount within its policy limits and because its own claims handler had expressed optimism that the case could settle within policy limits, the insurer's failure to explore settlement further constituted a breach of its duty of care. 920 F.Supp at 922.

Courts have also recognized an exception to the general rule against imposing an affirmative duty to negotiate on insurers when the insurer has failed, in response to a specific request, to disclose its policy limits. In *Cernocky v. Indemnity Insurance Company of North America,* 69 Ill.App.2d 196, 216 N.E.2d 198 (2d Dist. 1966), the court held it was error to grant the insurer's motion for directed verdict when the insurer failed to disclose its policy limits to a requesting third party. In *Cernocky,* the injured third party's attorney made frequent requests that the insurer disclose its policy limits so that the third party could achieve a settlement agreement. However, the insurer failed to disclose the limits and refused the third party's invitation to negotiate. The court found that such conduct demonstrated that the insurer did not give equal consideration to the insured's interest.

After establishing that the insurer had a duty to settle, a plaintiff must prove that an insurer breached its legal and contractual duties through fraud, negligence, or bad faith. In this context, "bad faith" is similar to negligence, in that it means unfaithfulness to the duty owed an insured. *California Union, supra*. Illinois law, however, does not require that an insurer settle within policy limits without exception, or else invariably suffer the consequences of an excess liability judgment for breach of its fiduciary duty. *Kavanaugh, supra.* If it appears that the probability of an adverse finding on liability is great and the amount of damages would exceed the policy limits, the insurer has a duty to settle within the policy limits or face an excess liability claim for a breach of the duty owed to the insured. *Phelan v. State Farm Mutual Automobile Insurance Co.,* 114 Ill.App.3d 96, 448 N.E.2d 579, 69 Ill.Dec. 861 (1st Dist. 1983). In *Phelan,* the court found that there was a possibility of an adverse finding on liability (because there was a witness who opined that the insured had been negligent) and that damages would exceed the $100,000 policy limits (because the auto accident at issue rendered the plaintiff a quadriplegic). However, Illinois courts also recognize that if an insurance company offers to settle and that offer is refused for no reason, the failure to settle does not constitute bad faith. *Meixell v. Superior Insurance Co.,* 230 F.3d 335, 337 (7th Cir. 2000) (finding that insurer did not act in bad faith when insured demanded policy limits in settlement but inexplicably refused insurer's offer, three months later, to pay its policy limits).

An insurer's breach of its duty to defend also may give rise to an action for a bad-faith failure to settle. In these instances, Illinois courts have held a wrongful refusal to defend does not alter the legal standard by which the insurer's failure to settle is judged. Simply put, an insurer cannot absolve itself of its obligation to consider settlement offers in good faith simply by breaching its duty to defend. *La Rotunda v. Royal Globe Insurance Co.,* 87 Ill.App.3d 446, 408 N.E.2d 928, 42 Ill.Dec. 219 (1st Dist. 1980). However, if an insurer has failed to fulfill its duty to defend, the insured has an obligation to protect itself. In *La Rotunda,* the court noted that by denying coverage, the insurer waived its right to control the litigation and, therefore, the insured was free to make its own settlement. However, the insured has some duty to act reasonably and in good faith to "make the best of the situation." 408 N.E.2d at 936. An insured is not generally on equal footing with its insurer, and, therefore, when the company refuses to defend, the insured will not be held to the same standard of conduct as a professional insurance company. The fact that the insured refused a settlement offer that the insurer would have accepted, or that the insured executed a less vigorous and effective defense than the insurer might have, does not necessarily discharge the insurer from the consequences of its own misconduct. *Id.*

b. [18.14] When the Insurer's Duty To Settle Arises

Another consideration in failure-to-settle cases is when the insurer's duty to settle arises. In a recent Illinois Supreme Court case, the parties argued that the duty to settle arises either immediately after the filing of a lawsuit or at the conception of the insurance contract. The court, however, disagreed with both propositions and held that an insurance provider'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 recovery in excess of policy limits and a reasonable probability of a finding of liability against its insured." *Haddick ex rel. Griffith v. Valor Insurance,* No. 90226, 2001 WL 1475209 at *5 (Ill. Nov. 21, 2001).

The defendant in *Haddick* relied on language in *Cramer v. Insurance Exchange Agency,* 174 Ill.2d 513, 675 N.E.2d 897, 903, 221 Ill.Dec. 473 (1996), in which the court stated that the " 'duty to settle' arises because the policyholder has relinquished defense of the suit to the insurer," to argue that the duty to settle derives from the duty to defend and, thus, does not arise until a lawsuit is filed. 2001 WL 1475209 at *3. The plaintiff in *Haddick* argued the duty to settle arises from the "conception of the insurance contract," or from the time the insurer and its insured entered into the policy. 2001 WL 1475209 at *2. The court, however, citing the decision in *Olympia Fields Country Club v. Bankers Indemnity Insurance Co.,* 325 Ill.App. 649, 60 N.E.2d 896, 905 (1st Dist. 1945), noted that when damages against the insured do not exceed policy limits, the question of whether the claim can be settled, or the manner in which it shall be defended, is "a matter of no concern to the insured." 2001 WL 1475209 at *4. The insured does become concerned with personal liability, however, once a claim arises in which there is a reasonable probability that the insured will be found liable for an excess judgment. It is this instance in which the insurer must take the insured's settlement interests into consideration. For this reason, the insurer's duty to settle does not arise when the insurance contract is entered into, nor does it depend on whether a lawsuit has been filed. *Haddick, supra.* The duty arises when a claim has been made against the insured and there is a reasonable probability of a finding of liability against the insured. The court also reminded that because Illinois law generally does not require an insurance provider to initiate settlement negotiation, the duty does not arise until a third party demands settlement within policy limits. *Id.*

c. [18.15] Damages Arising from the Insurer's Failure To Settle

In order to recover on a bad-faith action, an insured must demonstrate that it sustained damage as a result of the insurer's failure to settle. In Illinois, damage is imputed to the insured upon the entry of judgment:

> **The very fact of the entry of judgment itself constitutes damage and harm sufficient to permit recovery. The damage . . . is the creation of liability for the judgments. The rule of damages is that incurrence is equivalent to outlay.** *Wolfbert v. Prudence Mutual Casualty Company of Chicago,* 98 Ill.App.2d 190, 240 N.E.2d 176, 180 (1st Dist. 1968).

The *Wolfbert* court further explained:

> **Were payment or showing of ability to pay the rule, encouragement would be given to an insurer with an insolvent insured to unreasonably refuse to settle. Such a course would impair the use of insurance for the poor man. Further, the fullness or the emptiness of an insured's purse would be an irrelevant and poor measure of liability and performance of duty by the insurer under his contract.** *Id.*

Since the *Wolfbert* decision, Illinois courts have consistently held that entry of an excess judgment against the insured constitutes the requisite damage to the insured and it is not necessary that the insured allege payment of the excess judgment.

Generally, when the insurer's failure to settle is due to fraud, negligence, or bad faith, and results in an excess judgment, the duty is breached, and the insurer then may be liable for the full amount of the judgment irrespective of the policy limits. *Meixell v. Superior Insurance Co.,* 230 F.3d 335, 337 (7th Cir. 2000), citing *Adduci v. Vigilant Insurance Co.,* 98 Ill.App.3d 472, 424 N.E.2d 645, 53 Ill.Dec. 854 (1st Dist. 1981). In cases in which the judgment against the insured is within the policy limits, the insured is held harmless. However, if the insurer, by its own fault, converts such a case into a case beyond the policy limits, the insurer "cannot complain of the size of the judgment." *La Rotunda v. Royal Globe Insurance Co.,* 87 Ill.App.3d 446, 408 N.E.2d 928, 936, 42 Ill.Dec. 219 (1st Dist. 1980).

C. [18.16] Consumer Fraud Act

There are relatively few Illinois decisions addressing an insurer's liability for extra-contractual damages under the Consumer Fraud Act. However, it is clear that insurers are potentially liable for misrepresentations made in the course of advertising their insurance products. *Elder v. Coronet Insurance Co.,* 201 Ill.App.3d 733, 558 N.E.2d 1312, 146 Ill.Dec. 978 (1st Dist. 1990), *appeal withdrawn,* 139 Ill.2d 594 (1991); *Petersen v. Allstate Insurance Co.,* 171 Ill.App.3d 909, 525 N.E.2d 1094, 121 Ill.Dec. 787 (1st Dist. 1988). Insurers also may be liable under the Consumer Fraud Act for delaying acknowledgments of coverage, denying coverage, or refusing to acknowledge coverage for valid claims. *W. E. O'Neil Construction Co. v. National Union Fire Insurance Company of Pittsburgh, Pennsylvania,* 721 F.Supp. 984 (N.D.Ill. 1989). Finally, it appears that insurers may be liable under the Consumer Fraud Act for misrepresentations made in the course of adjusting or paying claims. *Elder, supra; P.I.A. Michigan City, Inc. v. National Porges Radiator Corp.,* 789 F.Supp. 1421 (N.D.Ill. 1992).

Importantly, an insurer will not be held liable under the Consumer Fraud Act merely because an insured contends that it misunderstood, or was misled by, the insurance policy's clear and unambiguous language. *Consumers Construction Co. v. American Motorists Insurance Co.,* 118 Ill.App.2d 441, 254 N.E.2d 265, 270 (2d Dist. 1969). Furthermore, an insurer will not be held liable to an injured third party under the Consumer Fraud Act for allegedly failing to reach an equitable settlement of an underlying personal injury action. *McCarter v. State Farm Mutual Automobile Insurance Co.,* 130 Ill.App.3d 97, 473 N.E.2d 1015, 85 Ill.Dec. 416 (3d Dist. 1985) (finding that injured plaintiff was not "consumer" and, therefore, did not have standing to sue under Consumer Fraud Act because he did not purchase insurance at issue).

In a recent decision, the Illinois Appellate Court for the Fifth District affirmed a multimillion dollar verdict against an insurer based on the insurer's violations of the Consumer Fraud Act. *Avery v. State Farm Mutual Automobile Insurance Co.,* 321 Ill.App.3d 269, 746 N.E.2d 1242, 254 Ill.Dec. 194 (5th Dist. 2001). In *Avery,* a class of policyholders brought an action under the Consumer Fraud Act, challenging their automobile insurer's nationwide claims practice of uniformly specifying cheaper, non-manufacturer replacement parts in damage estimates, despite knowing that such parts were inferior in quality and condition and would not return the damaged vehicle to its pre-accident condition. 746 N.E.2d at 1247. The trial court found that the insurer had violated the Consumer Fraud Act and awarded the policyholders damages in the amount of $730 million. *See Avery v. State Farm Mutual Automobile Insurance Co.,* No. 97 L-114, 1999 WL 1022134 (Ill.Cir. Oct. 8, 1999). On appeal, the court reversed $130 million of such award, finding that this amount was duplicative of damages awarded under other causes of action. 746 N.E.2d at 1261. However, the court affirmed the trial court's order assessing $600 million in punitive damages as a result of the insurer's violations of the Consumer Fraud Act. 746 N.E.2d at 1262. Although the *Avery* decision involves first-party automobile insurance, it nevertheless is instructive as to the magnitude of insurers' potential exposure under the Consumer Fraud Act.

D. [18.17] Common Law Fraud

Actions for common law fraud are typically brought in conjunction with an action under the Consumer Fraud Act. In addition, an insurer may be found to have committed common law fraud, and may thereby be exposed to extra-contractual damages, if it makes misrepresentations to injured third parties in connection with settlement negotiations. *See, e.g., McCarter v. State Farm Mutual Automobile Insurance Co.,* 130 Ill.App.3d 97, 473 N.E.2d 1015, 85 Ill.Dec. 416, 420 (3d Dist. 1985) (holding that it was fraudulent for insurer, who insured both injured party and injuring party and was negotiating settlement between the two, to achieve lesser settlement by making misrepresentations as to amount of its settlement authority and as to nonexistent reports allegedly demonstrating that injured party was contributorily negligent).

V. [18.18] INSURERS' DEFENSES

Although insurers potentially may face significant liability and damages exposure under Illinois statutes and common law if they fail to fulfill their contractual obligations to their policyholders, Illinois courts have recognized that insurers may to assert certain defenses an action seeking extra-contractual damages.

A. [18.19] Bona Fide Dispute as to Coverage

When there is a bona fide dispute as to whether an insurance policy provides coverage for a loss, an insurer's failure to fulfill (or its delay in fulfilling) its duties under the insurance policy will not be considered actionable. *See, e.g., Peerless Enterprise, Inc. v. Kruse,* 317 Ill.App.3d 133, 738 N.E.2d 988, 1000, 250 Ill.Dec. 519 (2d Dist. 2000); *Marcheschi v. Illinois Farmers Insurance Co.,* 298 Ill.App.3d 306, 698 N.E.2d 683, 688, 232 Ill.Dec. 592 (1st Dist. 1998); *Bedoya v. Illinois Founders Insurance Co.,* 293 Ill.App.3d 668, 688 N.E.2d 757, 763, 228 Ill.Dec. 59 (1st Dist. 1997).

Illinois courts have found that a bona fide dispute exists when an insurer relies on Illinois case law to support its coverage position. *See, e.g., Ragan v. Columbia Mutual Insurance Co.,* 291 Ill.App.3d 1088, 684 N.E.2d 1108, 1115, 226 Ill.Dec. 112 (5th Dist. 1997) (reversing trial court's order and finding that insurer did not act unreasonably and vexatiously when Illinois case law supported the insurer's coverage position, even though Illinois authority was split); *State Farm Mutual Automobile Insurance Co. v. Fisher,* 315 Ill.App.3d 1159, 735 N.E.2d 747, 754, 249 Ill.Dec. 143 (1st Dist. 2000) (finding that bona fide coverage dispute existed when there was no Illinois case law on point, but insurer argued for extension of existing case law).

Conversely, an insurer's mere assertion of a coverage defense does not create a bona fide dispute as to coverage unless there is some factual and/or evidentiary support for the defense. *See McGee v. State Farm Fire and Casualty Co.,* 315 Ill.App.3d 673, 734 N.E.2d 144, 153, 248 Ill.Dec. 436 (2d Dist. 2000), citing *Myrda v. Coronet Insurance Co.,* 221 Ill.App.3d 482, 582 N.E.2d 274, 164 Ill.Dec. 66 (2d Dist. 1991). *See also Employers Insurance of Wausau v. Ehlco Liquidating Trust,* 186 Ill.2d 127, 708 N.E.2d 1122, 1139, 237 Ill.Dec. 82 (1999) (rejecting insurer's argument that there was bona fide dispute as to coverage when insurer failed to offer any argument as to why its asserted coverage defense was bona fide); *Bedoya, supra,* 688 N.E.2d at 764 (finding no bona fide dispute as to coverage when insurer attempted to argue that it had duty to defend its insureds only against covered causes of action, even though it is well established under Illinois law that insurer must defend its insured in entire lawsuit even if only one count of complaint alleges an action under the policy).

As described in Chapter 6, Illinois law provides that under certain circumstances, an insurer who fails to defend its insured or timely file a declaratory judgment action to adjudicate coverage under its policy may be estopped from asserting any defenses to coverage. Similarly, insurers who fail to acknowledge their duty to defend or to file a declaratory judgment action may be estopped from asserting a bona fide dispute as to coverage. *See Mobil Oil Corp. v. Maryland Casualty Co.,* 288 Ill.App.3d 743, 681 N.E.2d 552, 561, 224 Ill.Dec. 237 (1st Dist. 1997). In *Mobil Oil,* the court held:

> **As [**the insurer**] failed to reserve its rights properly, and created a potential conflict of interest for its trial attorney by waiting two and a half years before raising the questioned coverage limits, [**it**] was estopped from later claiming that it was not obligated to fully indemnify [**its insured**] under the insurance policies, and therefore could not have raised a** *bona fide* **policy defense.**

B. [18.20] Preemption

An insurer also may argue that certain common law actions are preempted by Insurance Code §155. Illinois courts recognize that by enacting Insurance Code §155, the Illinois legislature intended to provide a remedy to an insured who encounters unnecessary difficulties when an insurer withholds policy benefits. *Perfection Carpet, Inc. v. State Farm Fire & Casualty Co.,* 259 Ill.App.3d 21, 630 N.E.2d 1152, 197 Ill.Dec. 28 (1st Dist. 1994). Accordingly, Insurance Code §155 has been construed to preempt common law actions that arise under contract but seek to recover extra-contractual damages.

For example, in *Perfection Carpet, Inc.,* the First District Appellate Court held that “Section 155 preempts a claim by an insured against his insurer for the breach of the duty of good faith and fair dealing, an implied term of a contract of insurance.” 630 N.E.2d at 1155. In *Perfection Carpet,* a corporation and its two shareholders attempted to allege tort and contract actions against its workers’ compensation insurer based on the insurer’s refusal to pay workers’ compensation benefits to one of the injured shareholders. 630 N.E.2d at 1154. After examining the nature of the plaintiffs’ allegations, the court concluded that the plaintiffs’ allegations related to their insurer’s refusal to pay a claim and, therefore, were preempted by Insurance Code §155. 630 N.E.2d at 1155. *Accord Cramer v. Insurance Exchange Agency,* 174 Ill.2d 513, 675 N.E.2d 897, 221 Ill.Dec. 473 (1996).

C. [18.21] Comparative Bad Faith

Insurers may attempt to argue that the insured acted in bad faith and, therefore, any recovery against the insurer should be reduced to account for the insured’s “comparative bad faith.” Illinois courts have not yet ruled on the validity of the defense of comparative bad faith. However, courts in several other jurisdictions have ruled on this issue, and most have rejected comparative bad faith as a defense.

California appeared to recognize an insurer's right to assert the insured's comparative bad faith as a defense to a bad-faith action by the insured. *See California Casualty General Insurance Co. v. Superior Court,* 173 Cal.App.3d 274, 218 Cal.Rptr. 817 (1985). However, the California Supreme Court recently addressed this issue and rejected comparative bad faith as a defense in *Kransco v. American Empire Surplus Lines Insurance Co.,* 23 Cal.4th 390, 2 P.3d 1, 97 Cal.Rptr.2d 151 (2000). In *Kransco,* the insured brought a bad-faith action against its insurer for allegedly failing to settle the underlying action within policy limits and thereby exposing the insured to damages in excess of policy limits. The trial court found the insurer liable for bad faith. On appeal, the insurer argued that the insured's comparative bad faith and comparative negligence in litigating the underlying case contributed to the verdict and, thus, should reduce the insurer's liability for damages in the bad-faith action.

The California Supreme Court disapproved the *California Casualty* decision and rejected comparative bad faith as a defense, noting that although both parties are bound by a reciprocal obligation of good faith and fair dealing,

> **the scope of the insured's duty of good faith and fair dealing, and the remedies available to the insurer for a breach of that duty, are fundamentally and conceptually distinct from the insurer's reciprocal duty, and the remedies available to the insured for a breach of that duty, under the insurance policy.** 2 P.3d at 9.

The court observed that "it is an *insurer's* breach of the covenant of good faith that is governed by tort principles. . . . In contrast, an *insured's* breach of the covenant is not a tort." [Emphasis in original.] *Id.* The court concluded:

> **Applying comparative fault principles . . . by recognizing a comparative bad faith defense in a third party insurance bad faith action would set the insurer's tortious breach of the covenant against the insured's contractual breach of the covenant, even though contractual breaches are generally excluded from comparative fault allocations. [**Citation omitted.**]** *Id.*

The court also pointed out that rejecting the defense of comparative bad faith does not leave an insurer without any remedies against the insured. *Kransco, supra,* 2 P.3d at 13. For example, evidence of the insured's misconduct may factually disprove the insurer's liability for bad faith by showing that the insurer acted reasonably, or may void coverage altogether. In addition, the insurer may have the option of pursuing an action against its insured for breach of contract or fraud.

Many other jurisdictions have taken the same approach as the California Supreme Court in *Kransco* and have rejected comparative bad faith as a defense. *See, e.g., In re Tutu Water Wells Contamination Litigation,* 78 F.Supp.2d 436 (D.V.I. 1999); *Wailua Associates v. Aetna Casualty & Surety Co.,* 183 F.R.D. 550 (D.Haw. 1998); *Water Hill Services, Inc. v. World Class Metal Works, Inc.,* 935 S.W.2d 197 (Tex.App. 1996), *rev'd on other grounds,* 959 S.W.2d 182 (Tex. 1998); *First Bank of Turley v. Fidelity & Deposit Insurance Company of Maryland,* 1996 OK 105, 928 P.2d 298 (1996); *Stephens v. Safeco Insurance Company of America,* 258 Mont. 142, 852 P.2d 565 (1993); *Nationwide Property & Casualty Insurance Co. v. King,* 568 So.2d 990 (Fla. 1990); *Stumpf v. Continental Casualty Co.,* 102 Or.App. 302, 794 P.2d 1228 (1990).

D. [18.22] Reverse Bad Faith

Some insurers have gone a step beyond arguing “comparative bad faith” as an affirmative defense and, instead, have asserted that their insureds acted in bad faith by making an insurance claim or bringing a declaratory action to challenge coverage. This theory is commonly known as “reverse bad faith.” There is no reported Illinois decision directly addressing this issue. However, the U.S. Court of Appeals for the Seventh Circuit has observed in *Willis Corroon Corp. v. Home Insurance Co.,* 203 F.3d 449 (7th Cir. 2000), that it is “very doubtful” that a reverse bad faith cause of action exists:

> **The [**insurer**] also contends that it was an abuse of discretion for the district court to deny [**it**] leave to file an amended complaint asserting a “reverse bad faith” claim. Even assuming that such a cause of action exists (a very doubtful assumption), we disagree. The court found that there was “absolutely no evidence of bad faith or wrongdoing on the part of [**the insured**].”** 203 F.3d at 453.

Courts in other jurisdictions have been hesitant to recognize a cause of action for reverse bad faith. For example, in *Johnson v. Farm Bureau Mutual Insurance Co.*, 533 N.W.2d 203 (Iowa 1995), the Iowa Supreme Court declined to adopt the tort of reverse bad faith. In *Johnson,* the insured sued its insurer for breach of contract arising out of the insurer’s alleged bad-faith declination of coverage and its refusal to defend or indemnify the insured. The insurer filed a counterclaim, asserting that the insured’s allegation amounted to reverse bad faith and abuse of process. Without directly ruling on the viability of a tort of reverse bad faith, the trial court directed a verdict against the insurer on its counterclaims of reverse bad faith and abuse of process. The insurer appealed the directed verdict.

On appeal, the insurer argued that the Iowa Supreme Court should recognize a cause of action for bad faith in favor of insurers when an insured pursues a frivolous bad-faith claim against the insurer. The insurer argued that “the mutual obligation of good faith, together with [the insurer’s] right to dispute coverage when it is fairly debatable, favors adopting the tort of reverse bad faith.” 533 N.W.2d at 207. It also argued that “the recognition of the tort of first-party bad faith has given an unfair advantage to insureds, creating the need for a reverse bad faith cause of action.” 533 N.W.2d at 207 – 208. The Iowa Supreme Court affirmed the directed verdict against Farm Bureau and refused to recognize a separate cause of action for reverse bad faith. The court noted that, to its knowledge, no jurisdiction had adopted the tort. Finally, the *Johnson* court reasoned that insurers have other remedies against an insured, including sanctions for filing frivolous claims.

Similarly, in *Agricultural Insurance Co. v. Superior Court of Los Angeles County,* 70 Cal.App. 4th 385, 82 Cal.Rptr.2d 594 (1999), a California appellate court rejected an insurer’s reverse bad-faith claim. The insured brought a bad-faith claim against its insurer. After investigating, the insurer apparently discovered that the insured had deliberately misrepresented and concealed material facts in its application for insurance. The insurer then filed a cross-complaint against the insured, alleging intentional misrepresentation and reverse bad faith. The insured demurred to the reverse bad-faith cause of action, arguing that California law did not recognize an affirmative cause of action arising out of bad faith by the insured. The trial court sustained the demurrer, and the insurer appealed.

The California appellate court refused to recognize a reverse bad-faith cause of action. The court found that insurers are not entitled to sue for reverse bad faith although they may be entitled to sue for fraud. The court noted that the "circumstances of insured and insurer are significantly different, and hence the law that governs the conduct of insureds and insurers is also different." 82 Cal.Rptr.2d at 599. The court observed that there are "significant distinctions between the objectives and circumstances of an insurer versus the objectives and circumstances of an insured." 82 Cal.Rptr.2d at 600. For example, "[a]lthough the insured depends upon the insurer for protection, the insurer does not depend on the insured in the same manner." *Id.*

Courts in Ohio and Massachusetts have similarly held that no cause of action exists for reverse bad faith, but have recognized that an insurer may sue its insured for fraud. *See, e.g., Schulz v. Liberty Mutual Insurance Co.,* 940 F.Supp. 27 (D.Mass. 1996); *Tokles & Son, Inc. v. Midwestern Indemnity Co.,* 65 Ohio St.3d 621, 605 N.E.2d 936 (1992).

Although Illinois courts have not yet ruled on the viability of "comparative bad-faith" and "reverse bad-faith" actions, it seems clear that the trend in other jurisdictions is not to recognize such theories. Since Illinois does not appear to recognize a separate cause of action for bad faith against an insurer, it is reasonable to conclude Illinois courts would also not recognize claims for comparative bad faith or reverse bad faith.