THE ILLINOIS ASSOCIATION OF DEFENSE TRIAL COUNSEL
IDC QUARTERLY

Insurance Law Update

Patrick D. Cloud
Heyl, Royster, Voelker & Allen, P.C., Edwardsville

An Examination of Reasonableness Requirements for Settlements by Insureds: *Central Mutual Insurance Company v. Tracy's Treasures, Inc.*

For the typical claim against an insured where liability insurance is in play, the insurer has exclusive control over the defense of the insured. This control usually includes exclusive control over the settlement of the claim against the insured. However, in what circumstances may the insured enter into a settlement of a covered claim without the insurer's consent and still seek indemnification from the insurer for that settlement amount? And, in those circumstances, what safeguards are in place to protect the insurer from fraud and collusion? This column briefly addresses these two questions, with a particular emphasis on the reasonableness requirements of an unauthorized settlement by the insured, as explored by *Central Mutual Insurance Co. v. Tracy's Treasures, Inc.*, 2014 IL App (1st) 123339.

A Background on Unauthorized Settlements by Insureds

Almost all liability insurance policies have a voluntary payments clause, which precludes an insured from settling a covered claim against it without the insurer's consent. These clauses provide that if an insured settles a covered claim without consent, the settlement constitutes a breach of the policy and the insurer is not obligated to indemnify the insured for the settlement amount.

However, insurers cannot rely on voluntary payment clauses to prevent unauthorized settlements of covered claims in at least two scenarios. First, if there is a conflict of interest between the insured and insurer and the "insurer surrenders control of the defense [to the insured], it also surrenders its right to control the settlement of the action and to rely on a policy provision requiring consent to settle." *Standard Mut. Ins. Co. v. Lay*, 2014 IL App (4th) 110527-B, ¶ 35. Second, the insured does not need the insurer's consent to settle a lawsuit where the insurer has breached its duty to defend the insured. As noted by the Illinois Supreme Court, "once an insurer breaches its duty to defend, the insured may enter into a reasonable settlement agreement without foregoing its right to seek indemnification." *Guillen v. Potomac Ins. Co. of Ill.*, 203 Ill. 2d 141, 158 (2003).

Allowing the insured to settle a covered claim without the insurer's consent can pose a significant hazard to the insurer. This is particularly true when the settlement reached between insured and underlying claimant is structured so that the insured is not personally liable for funding the settlement, but rather, the claimant may seek recovery of the settlement only from the insurer. These settlement agreements typically identify a settlement amount, specify that the claimant may only recover the settlement amount from the insurer, and assign all of the insured's rights against its insurer to the claimant. As one court observed, these types of scenarios "present[] a great danger to the insurer" because, "[t]o relieve himself of personal exposure, the insured may be persuaded to enter into almost any type of agreement or

stipulation by which the claimant hopes to bind the insurer." *United Services Automobile Ass'n v. Morris*, 741 P.2d 246, 252-53 (Ariz. 1987); *see also Guillen*, 203 Ill. 2d at 163 (discussing the potential of fraud and collusion with these types of settlement agreements).

Consequently, to reduce the risk of fraud and collusion between the insured and underlying claimant in this scenario, an unauthorized settlement between the insured and underlying claimant is binding on the insurer only if the settlement is "reasonable." *Guillen*, 203 Ill. 2d at 163. This reasonableness requirement has two prongs: 1) the insured's decision to settle must be reasonable; and 2) the amount of the settlement must be reasonable. *Id*. "[W]ith respect to the insured's decision to settle, the litmus test must be whether, considering the totality of the circumstances, the insured's decision 'conformed to the standard of a prudent *uninsured*.'" *Id*. (*quoting Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983)) (emphasis in the original). Similarly, "with respect to the amount of damages agreed to, the test 'is what a reasonably prudent person in the position of the [insured] would have settled on the merits of plaintiff's claim.'" *Guillen*, 203 Ill. 2d at 163. (*quoting Miller v. Shugart*, 316 N.W.2d 729, 735 (Minn. 1982)). This aspect of the reasonableness inquiry "involves a commonsense consideration of the totality of 'facts bearing on the liability and damage aspects of plaintiff's claim, as well as the risks of going to trial.'" *Guillen*, 203 Ill. 2d at 163. (*quoting Miller*, 316 N.W.2d at 735).

The burden of proving reasonableness falls on the insured and the underlying claimant, not the insurer. This is appropriate "both out of fairness" (because the underlying claimant and insured are the ones who agreed to the settlement) and "out of practicality" (because the underlying claimant and insured "will have better access to the facts bearing upon the reasonableness of the settlement"). *Guillen*, 203 Ill. 2d at 164. That said, "the insurer retains the right to rebut any preliminary showing of reasonableness with its own affirmative evidence bearing on the reasonableness of the settlement agreement." *Id.*

Exploration of the Reasonableness Requirements Imposed on Unauthorized Settlements

In *Central Mutual Insurance Company v. Tracy's Treasures, Inc.*, 2014 IL App (1st) 123339, the Illinois Appellate Court, First District, explored the parameters surrounding the reasonableness inquiry for unauthorized settlements. In *Tracy's Treasures,* the claimant brought a class action against the insured alleging that the insured violated the Telephone Consumer Protection Act (TCPA) by distributing unsolicited faxes. *Id*. ¶ 1. Although the insured's commercial liability carrier provided the insured a defense, it also allowed the insured to choose its own counsel due to a conflict of interest between the carrier and the insured regarding coverage. *Id*. ¶¶ 10-11.

While the insured's counsel was advising the liability carrier of a purported defense strategy, he secretly negotiated a settlement with the underlying claimant's counsel. *Id.* ¶ 15. The resulting settlement agreement provided for the entry of a $14 million judgment against the insured that was enforceable only against the liability carrier. *Id*.

In the ensuing coverage litigation, after the trial court denied the insurer's motion for summary judgment attacking the reasonableness of the settlement; the insurer appealed. *Id*. ¶ 29. On appeal, the appellate court affirmed the denial of the insurer's summary judgment, finding that questions of fact existed concerning the reasonableness of the settlement, and remanded the action back to the trial court for a reasonableness hearing. *Id*. ¶ 85. In doing so, the appellate court expounded on the two-pronged reasonableness framework for evaluating unauthorized settlements and identified factors for the trial court to consider on remand.

The appellate court considered the first prong of the framework: whether the insured's decision to settle conformed to the standard of a prudent "uninsured." The court noted that "in order for the prudent uninsured test to have any meaning,

[one] … must assume that the defendant is not on the brink of bankruptcy and instead must posit that the uninsured defendant has assets sufficient to satisfy a substantial judgment and that it must weigh whether those assets are best put to use litigating certain issues that could lower the value of the case or whether an early settlement, presumably at a discount, is more advantageous." *Id*. ¶ 64. When applying the prudent uninsured test on remand, the appellate court suggested that the trial court consider various factors, including whether a prudent uninsured would agree that it faced a significant exposure to liability on the TCPA claims, the insured's statute of limitations defense against the TCPA claims, the availability of third-party actions, the insured's defense to damages on the TCPA claim, and the reasonableness of the insured's agreement to create a large *cy pres* fund as part of the settlement given its defenses. *Id*. ¶¶ 65-73.

The appellate court also discussed the second prong of the test: the reasonableness of the settlement amount. Observing that the relevant factors for the second prong somewhat overlapped with the first, the court identified factors that bore on the evaluation of the settlement amount in particular, including whether the settlement agreement was the product of arms-length negotiations; what facts were available to defense counsel that allowed him to reliably value the plaintiff's claims at the time of settlement; what analysis was conducted by defense counsel of the insured's different defenses to plaintiff's claims; how defense counsel assessed the likelihood that a substantial verdict could be entered against the insured on the plaintiff's claims given the facts and circumstances of the case; and whether there is evidence of fraud, collusion, and bad faith. *Id*. ¶¶ 75, 79

With respect to this last factor, the appellate court remarked that "a settlement 'becomes collusive when the purpose is to injure the interests of an absent or nonparticipating party, such as an insurer.'" *Id*. ¶ 80 (*quoting Continental Cas. Co. v. Westerfield*, 961 F. Supp. 1502, 1505 (D.N.M. 1997)). Indicators of collusion for the trial court to consider include "unreasonableness, misrepresentation, concealment, secretiveness, lack of serious negotiations on damages, attempts to affect the insurance coverage, profit to the insured, and attempts to harm the interest of the insurer." *Tracy's Treasures*, 2014 IL App (1st) 123339, ¶ 80. Other factors the court found relevant to determining whether a settlement is collusive included "the amount of the overall settlement in light of the value of the case …; a comparison with awards or verdicts in similar cases involving similar injuries …; the facts known to the settling insured at the time of the settlement ….; the presence of a covenant not to execute as part of the settlement …; and the failure of the settling insured to consider viable available defenses." *Id*. ¶ 81 (*quoting Safeco Insurance Co. of America v. Parks*, 170 Cal. App. 4th 992, 1013 (Cal Ct. App. 2009)).

Conclusion

Voluntary payment clauses provide an important protection to insurers because they prevent exposure to unwarranted contractual liability, which would ultimately lead to an increase of premiums for policyholders. As a result, in those limited circumstances where a voluntary payments clause may be unenforceable and an insured can settle without consent, it is critical that a framework exists that still offers protection to insurers from inappropriate liability. In *Guillen v. Potomac Insurance Company*, the Supreme Court set forth such a framework, and in *Central Mutual Insurance Company v. Tracy's Treasures, Inc.*, the first district explored and expounded on it. These two cases should provide both practitioners and judges guidance when addressing and evaluation unauthorized settlements by insureds.

THE ILLINOIS ASSOCIATION OF DEFENSE TRIAL COUNSEL
IDC QUARTERLY

About the Author

Patrick D. Cloud is an attorney in *Heyl, Royster, Voelker & Allen, P.C.'s* Edwardsville office. Mr. Cloud concentrates his practice on insurance coverage litigation, toxic tort matters, complex civil litigation, and products liability defense. As part of his practice, he takes a lead role in significant pretrial discovery, motions and briefs, such as those involving federal preemption, *forum non conveniens,* the Illinois *Frye* doctrine, consumer fraud, and insurance coverage litigation pending throughout the Midwest.

About the IDC

The Illinois Association Defense Trial Counsel (IDC) is the premier association of attorneys in Illinois who devote a substantial portion their practice to the representation of business, corporate, insurance, professional and other individual defendants in civil litigation. For more information on the IDC, visit us on the web at www.iadtc.org or contact us at PO Box 588, Rochester, IL 62563-0588, 217-498-2649, 800-232-0169, idc@iadtc.org.