SANDBERG PHOENIX

BAD FAITH BLOG

So Which Rule Applies? Wisconsin Supreme Court Justices Disagree in a Split Decision

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Summary: A Wisconsin high school discharged an employee who then sued. The school district's insurer defended the case through an adverse summary judgment, but refused to indemnify the school district for an adverse judgment even though it had never sent a reservation of rights letter. The majority ruled that the doctrines of waiver or estoppel were insufficient "to defeat... a coverage clause in an insurance contract that would otherwise justify the insurer's denial of coverage." The *Maxwell* case is primarily a coverage opinion which declares how and when the estoppel and waiver doctrines apply in state courts in Wisconsin. Because of its brief discussion of Wisconsin bad faith law it merits attention in our blog.

Maxwell v. Hartford Union High School District, 2012 WL 1937109 (Wis. May 30, 2012)

Dawn Maxwell was employed by the Hartford Union High School District from 2000 until her employment was terminated on August 31, 2007. The day before she was to be terminated, a complaint was filed seeking injunctive, declaratory, and monetary relief. Initially, the school district was defended by its general counsel, but shortly thereafter its insurance carrier, Community Insurance Corporation, retained counsel to enter an appearance and defend. The extent to which the general counsel remained involved is unclear, although it appears that he was at least indirectly involved (and was an attorney of record for the school district) until an adverse summary judgment was made against the school district, but before Maxwell was awarded compensatory damages.

Shortly after he withdrew, the general counsel sent an e-mail to defense counsel, the school district superintendent, and an insurance company representative to "make one point perfectly clear:" that the insurance company's provision of a defense to the school district without sending a reservation of rights prevented the insurance company from denying "coverage for any compensatory damages that might be awarded." (*3) The insurer's representative responded shortly thereafter informing the general counsel that the insurer "was not liable for any judgment for damages due under Maxwell's performance contract or any settlement for lost wages or lost benefits." In addition, the insurance company stated that it would continue to defend the district, but stated that it would not be liable for any damages excluded from coverage in the policy. After the compensatory damages were awarded, the school district's general counsel filed a motion for leave to file a third-party complaint to address the coverage issues.

The trial court judge determined that the complaint alleged some claims which fell within the coverage grant and, for that reason, denied the insurer's motion to dismiss. The trial court also denied the school district's motion for summary judgment ruling that because the school district "did not pay for coverage of employee salary or fringe benefits claims, and under existing Wisconsin law, [the insurance company's] conduct cannot be determined to create such coverage," the insurer was entitled to summary judgment. The Court of Appeals reversed finding an exception to what the Supreme Court majority described as the "general rule that 'coverage under an insurance policy cannot be created either by waiver or estoppel.'" (*4)

The Supreme Court majority and dissent agreed that the policy "excludes coverage 'for that part of any award or settlement which is, or reasonably could be due, to be compensation for loss of salary or fringe benefits of your employee(s).'" Based upon that policy provision it was undisputed that the policy excluded coverage. The dispute, thereafter, depended upon whether one accepts the general rule that coverage cannot be created by waiver or estoppel, the rule adopted by the majority, or "whether [the insurance company] has waived, or is estopped from asserting, any coverage defense because it controlled the [school district's] defense, throughout litigation resulting in an adverse judgment against the [school district] and only later contested coverage", the issue proposed by the dissent.

The majority went back to 1896 and quoted at length the rule recognized first in *McCoy v. Nw. Mut. Relief Ass'n.*, 92 Wis. 577, 66 N.W. 697 (1896) and, also cited its prior opinion in *Shannon v. Shannon*, 150 Wis.2d. 434, 442 N.W.2d 25 (1989) for the proposition that the well-established general rule in Wisconsin is "that the doctrine of waiver or estoppel based upon the conduct or action of the insurer or its agent is not applicable to matters of coverage as distinguished from grounds for forfeiture." (*5) According to the majority, providing a defense to an insured would never "give rise to estoppel or waiver of a *coverage* clause." (*8) However, "providing and assuming full control of a defense *may* be grounds for establishing waiver or estoppel of a *forfeiture* clause when the insurer fails to issue a reservation of rights." (*8) Here the insurance company had failed to issue a reservation of rights letter, but the exclusionary provision at issue was undeniably one which went to the issue of coverage as opposed to a forfeiture.

The majority recognized two exceptions to the general rule. One was when an insurance company breached its duty to defend. If there was a breach of that duty then, as a result of that breach, the insured would be entitled to recover any damages which "naturally flow from the insurer's breach of its duty to defend." (*10) Those damages could include the amount of the judgment, attorneys' fees and costs, and any additional costs which the insured can "show naturally resulted from the breach." (*10) Another recognized exception to the general rule is whenever the insured can prove in the third party context that the insurer breached its duty to act in good faith toward the insured. Whenever that happens, the insurer is liable in tort for any damages which the insurer caused. Nevertheless, the majority stated that those "damages are not an expansion of the coverage under the insurance policy as a result of waiver or estoppel. They are a reflection of the insurer's tortious conduct." (*10) The majority concluded that "bad faith and breach of the duty to defend are not situations in which an insurer becomes liable for insurance coverage not included in the insurance contract; in these cases insurer's are liable for the damages they caused by breach of contract or by tortious breach of duties arising from the contract. While at times these cases have been explained in terms of 'estoppel' the cases do not refer to estoppel in the traditional sense and the estoppel referred to does not expand or create coverage." (*11)

After ruling in favor of the insurance company the majority spoke directly to the insurance industry in Wisconsin "to emphasize the importance of insurer's communicating with their insureds." The court emphasized that its majority ruling should not "be interpreted as a license for insurers not to communicate forthrightly with their insureds—especially when insurers dispute coverage. It certainly would have been better practice for [the insurer] to send a reservation of rights letter in this case. Its failure to do so has created ill will and completely overshadowed [the insurer's] extensive costs in providing a defense." The majority noted that at oral argument the insurer's attorney conceded as much.

The majority then continued by stating that "[t]he lesson here is that [the insurer] could have avoided the costs of this appeal by issuing a reservation of rights letter. A reservation of rights letter cannot only head off litigation, but also preserve forfeiture defenses at a time when an insurer may not know whether such a defense exists. As we have clearly stated, forfeiture defenses can be waived, because the insured had purchased the coverage the insurer seeks to deny. Communications between the insurer and the insured, whether in the form of a reservation of rights letter or other form, demonstrates good faith, prevents surprises and hard feelings, and tends to avoid litigation between insurers and their insureds." (*11) The majority opinion contains similar statements at the beginning of its opinion stating that "[w]e strongly urge insurers to communicate with their insureds about their potential coverage defenses, but we do not see the failure to issue a reservation of rights letter as grounds to require an insurer to provide insurance coverage that does not otherwise exist in the insurance contract." (*1)

We have noted in other blog posts that in other states there are sometimes risks in sending reservation of right letters. The Supreme Court of Wisconsin sets out the law in Wisconsin in detail in the *Maxwell* case. All insurers writing in Wisconsin are encouraged to study the *Maxwell* opinion both to help ensure that they do not find themselves providing coverage by way of waiver or estoppel when a simple reservation of rights letter would have prevented coverage. In a different case it is easy to see that the failure to send a reservation of rights letter, defending a case, and then denying any duty to indemnify could easily be the grounds for a common law bad faith claim in Wisconsin. Beware!

By Anthony Martin

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