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Wisconsin Supreme Court Clarifies Insurer Obligations When Disputing A Duty To Defend

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Wisconsin is a direct-action state, meaning insurers can be (and often are) parties to tort and contract disputes between third-party claimants and their insureds. When coverage is disputed, Wisconsin courts require insurers to take the following steps to determine rights and obligations under their policies without running the risk of breaching the duty to defend: (1) defend under a reservation of rights, (2) defend under a reservation of rights but seek a declaratory judgment on coverage, (3) enter into a nonwaiver agreement under which the insurer defends the insured but the insured acknowledges that the insurer has the right to contest coverage, and (4) file a motion with the circuit court requesting a bifurcated trial on coverage and liability and a stay of the proceedings on liability until coverage is determined. *Water Well Sols. Serv. Grp., Inc. v. Consol. Ins. Co.*, 2016 WI 54, ¶ 27.

Under the fourth option, an insurer is not required to defend its insured pending resolution of the coverage issue, because a successful motion to stay halts the liability case so that the insured does not incur attorneys' fees litigating liability until a coverage determination is made by the circuit court. In *Choinsky v. Employers Ins. Co. of Wausau*, 2020 WI 13, ¶ 19, decided February 13, 2020, the insurer elected to take this fourth option, but the circuit court denied the insurer's motion to stay the liability proceedings, such that the insured was forced to simultaneously incur attorneys' fees for establishing coverage and defending the tort lawsuit.

Six retired employees of the Germantown School District ("the District") sued the District for the District's decision to discontinue group long-term care insurance for its current employees, causing the retired employees to also lose that benefit. The lawsuit against the District alleged four causes of action: breach of contract, breach of implied contract, breach of the duty of good faith and fair dealing, and promissory estoppel.

The District tendered the defense of the lawsuit to its insurance companies ("the Insurers"). The Insurers rejected the tender on the basis that their policies only provide coverage to the District for negligent acts, not deliberate acts such as the "unilateral action" to terminate an insurance benefit. The Insurers' rejection letter explained that, if the District did not withdraw its tender, the Insurers would file a motion in the pending litigation to obtain a coverage determination. The District refused to withdraw its tender.

The Insurers filed a motion in the liability dispute asking the circuit court to allow it to intervene in that lawsuit, and it also requested that the circuit court bifurcate the liability and coverage issues and stay the liability lawsuit until coverage could be resolved (the fourth prescribed method above). The court granted the Insurers' motion to intervene and bifurcate, but it denied the motion to stay the liability proceedings. The Insurers thereafter filed their own complaint for declaratory judgment in the pending litigation asking the court for a declaration that it owed no duty to defend or indemnify the District. The Insurers initially refused to pay for the District's defense, but a year later agreed to pay the District's attorneys' fees incurred in the defense of the liability lawsuit, including retroactively, while the coverage dispute was ongoing.

At the coverage trial (which took place before the liability trial), the jury found that the District decisionmakers acted negligently; after that finding, the circuit court concluded the Insurers had a duty to defend based on the complaint's allegation that the District "should have known" the adverse effect its decision to eliminate long-term care insurance for current employees would have on its retired employees. The District then sought recovery of its attorneys' fees incurred in establishing coverage, based on Wisconsin precedent that an insurer must pay its insured's attorneys' fees relating to coverage if there is a breach of the duty to defend (a breach of the duty to defend results in damages naturally flowing from that breach).

The court first recognized, this "case presents a problem with the fourth option when the circuit court denies the bifurcation or stay motion, resulting in the insured defending itself for a period of time on both liability and coverage. We remedy that problem by clarifying the bifurcation/stay procedure: if a circuit court denies bifurcation or a stay of the liability case, in order to protect itself from being found in breach of its duty to defend, the insurer must defend its insured under a reservation of rights so that the insured does not have to pay to defend itself on liability and coverage at the same time. Additionally, the insurer must reimburse its insured for reasonable attorney fees expended on a liability defense, retroactive to the date of tender." The Wisconsin Supreme Court expressly encouraged "circuit courts to decide bifurcation and stay motions expeditiously and to grant the requested stay unless case-specific factors weigh against it."

With respect to the request for attorneys' fees associated with establishing coverage, the court held that the Insurers did not breach their duty to defend because they followed a judicially preferred method for having coverage decided before liability. When the circuit court denied the Insurers' motion to stay the liability proceedings, the Insurers provided a full defense, retroactive to the date of tender. By doing so, the Insurers complied with their contractual responsibilities to the District and were not responsible for the District's coverage-related attorneys' fees.