Imagine being sued in a complex, multicount lawsuit in which the plaintiff seeks significant monetary damages. Knowing you have liability insurance, you tender the suit to your insurance carrier. The insurer agrees to defend you without qualification. You rest easier knowing the insurer and its lawyers are handling the case. Unfortunately, after years of discovery and a jury trial, the lawsuit concludes in the plaintiff’s favor and the court enters a substantial monetary judgment against you on one of the claims. You are once again thankful for your insurance coverage. However, your carrier then delivers some unexpected news: it is denying coverage because your insurance policy does not cover the particular claim on which the judgment is based. You now face personal liability.

Could this nightmarish scenario really happen, especially after the insurer defended the entire lawsuit through final judgment? Unfortunately, the answer for Wisconsin policyholders could be yes in light of the Wisconsin Supreme Court’s 2012 decision in Maxwell v. Hartford Union High School District.¹

Insurance Reservation-of-rights Letters

In Maxwell, the Wisconsin Supreme Court clarified Wisconsin’s law on insurance reservation-of-rights letters, which are the primary means insurers use to notify policyholders about potential coverage disputes.² An insurer typically issues a reservation-of-rights letter shortly after the policyholder tenders a lawsuit and asks the insurer to defend the claim.

The letter often communicates a middle-ground
Coverage Delayed, Coverage Denied

Does an insurer that provides a defense to an insured lose its right to later deny coverage if it does not timely issue a reservation-of-rights letter? The Wisconsin Supreme Court recently said no, insurers have a right to delay in denying coverage. Policyholders should scrutinize their insurance coverage, even after an insurer agrees to defend, particularly with suits alleging possible uncovered claims.

coverage position in which the insurer neither completely accepts nor completely denies coverage for the lawsuit. Instead, the insurer indicates that certain claims may not be covered under its policy terms, even though the insurer has agreed to defend the lawsuit.

To better appreciate the role of reservation-of-rights letters, it is important to understand them in the context of how liability insurance policies work. The typical liability policy obligates a carrier to both defend a lawsuit on a policyholder’s behalf and pay any judgment that may eventually be entered against the policyholder. Stated another way, a liability policy imposes twin duties on the insurer: to defend the policyholder and to indemnify the policyholder.¹

An insurer’s duty to defend is broader than its duty to indemnify.² An insurer has a duty to defend all claims in a lawsuit even when only one of the claims in the complaint
Reservation-of-Rights Letters

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would be covered under its policy terms.2 Under Wisconsin law, an insurer that wrongfully refuses to defend a lawsuit that might trigger coverage waives all coverage defenses under its policy.3 If a court determines the insurer breached its duty to defend, the insurer will be responsible for any judgment entered against the insured as well as the insured’s defense costs.4

Because insurers have strong incentives to defend lawsuits that might result in coverage, the Maxwell decision has implications for insurers and policyholders alike. Maxwell eliminates the need for insurers to reserve rights in many lawsuits in which they might still have a duty to defend. As such, policyholders can no longer early on to avoid complications posed by the doctrines of waiver and estoppel. The law often treats the concepts similarly.5 Wisconsin law defines waiver to mean the voluntary and intentional relinquishment of a known right.6 Estoppel occurs when a party, by its acts, representations, admissions, or even silence, induces another person or entity to act to its detriment.7 In the insurance context, the policyholder asserting estoppel must show that it rightfully relied and acted on a belief it had coverage and would be prejudiced by the insurer’s later denial of such coverage.8 Citing either waiver or estoppel, some Wisconsin courts have suggested an insurer’s failure to reserve rights

The most significant danger for policyholders arises when the insurer remains silent about potential coverage gaps posed by a lawsuit.9

rest easy even after their insurer agrees to defend. Because insurers might never issue a reservation-of-rights letter or communicate about coverage, policyholders must now closely evaluate their insurance coverage on their own, particularly with suits alleging possible uncovered claims.

Historically, an insurer would issue a reservation-of-rights letter could result in coverage for otherwise uncovered claims. In a 1942 decision, Wisconsin Transportation Co. v. Great Lakes Casualty Co., the Wisconsin Supreme Court indicated that if an insurer planned to both defend a policyholder and later contest coverage, it must first send a reservation-of-rights letter to its insured to preserve the insurer’s coverage defenses.12 And in 1949, in Pouwels v. Cheese Makers Mutual Casualty Co., the supreme court suggested that an insurer, by defending a policyholder without ever raising coverage defenses or reserving rights, waived all coverage defenses.13

In 1983, the U.S. District Court for the Eastern District of Wisconsin held in Koerhing Co. v. American Mutual Liability Insurance Co. that either waiver or estoppel could preclude an insurer from denying coverage after an adverse judgment when the carrier exercised complete control of the defense throughout the lawsuit.14 When the insurer controls the defense of a suit that results in an adverse judgment, prejudice is presumed for the policyholder.15 Based on these cases, waiver or estoppel could effectively expand coverage beyond an existing insurance contract and compel a carrier to cover claims that would not ordinarily be covered under the policy’s plain language.

On other occasions, Wisconsin courts have retreated from using either waiver or estoppel to create insurance coverage beyond an insurance policy’s original terms. In 1967, in Ahnapee & Western Railway Co. v. Challoner, the supreme court rejected the use of estoppel to expand a policy’s terms in a situation in which a carrier’s agent provided the policyholder with an assurance of coverage before a loss.16 In 1989, the supreme court held in Shannon v. Shannon that a policyholder could not argue waiver to avoid a policy exclusion even though the insurer failed to raise the specific exclusion in a reservation-of-rights letter.17

Pre-Maxwell cases produced uncertainty about whether an insurer’s failure to reserve rights could result in coverage based on waiver or estoppel. Besides the hazards of waiver or estoppel, however, reserving rights often creates other complications for an insurer. For example, a reservation-of-rights letter could trigger, early in
the process, coverage litigation with the policyholder that the insurer may want to avoid.18

Also, by reserving rights, a carrier can lose the right to hire and control defense counsel because a reservation-of-rights letter creates a conflict of interest between the policyholder and insurer and thus entitles the policyholder to use independent defense counsel paid for by the insurer.19 For these reasons, insurers have incentives to avoid the complications posed by a reservation-of-rights letter and may benefit from not issuing one at all.

**The Maxwell Decision**

The Maxwell holding illustrates the issues that arise for a policyholder when an insurer fails to provide a reservation-of-rights letter or to otherwise communicate about coverage. In Maxwell, the policyholders were the Hartford Union High School District and the Hartford Union High School Board of Education. They were defendants in a multicity lawsuit, which included a wrongful-termination claim, filed by an administrative employee who alleged that the district engaged in misconduct when it discharged her.

The district promptly tendered the lawsuit to its liability insurer, and the insurer provided an unqualified defense without issuing a reservation-of-rights letter or suggesting it would eventually contest coverage. The insurer’s retained counsel defended the district for months but ultimately lost the wrongful-termination claim, resulting in a significant judgment against the district. The insurer then invoked an exclusion in its policy for wrongful-termination claims and declined to satisfy the judgment, leaving the district liable.

In response to the coverage denial, the district argued the insurer should cover the judgment because it had controlled the defense through judgment before it ever reserved rights or raised a coverage issue. The district asserted that the insurer waived its right to deny coverage by its delayed actions.

The circuit and appellate courts deciding Maxwell were sharply divided. The circuit court decided that the insurer could deny coverage without ever issuing a reservation-of-rights letter. The Wisconsin Court of Appeals reversed, rejecting the insurer’s right to deny coverage, particularly after it had retained counsel and actively controlled the defense of the underlying suit through final judgment.20 The court of appeals decided that under such circumstances, coverage existed based on an exception to the general rule that use of waiver or estoppel to expand coverage beyond the original policy terms usually is not allowed.21

The dissent further suggested that prejudice to the policyholder would be presumed under such a scenario.22 The Maxwell majority did limit its holding somewhat by reaffirming that waiver or estoppel would continue to prevent an insurer from denying coverage based on insurance policy forfeiture clauses if not timely raised.23 Forfeiture clauses – like notice or cooperation provisions – impose conditions that a policyholder must satisfy to maintain coverage that already exists under a policy; coverage clauses address the scope of coverage or the risks that the policy covers.24

The Maxwell court held that an insurer can never be held to have waived the limits on policyholders imposed by coverage clauses but may be held to have waived forfeiture clauses by not timely reserving rights after agreeing to defend.

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After Maxwell, Wisconsin now stands apart from what one court has characterized as an “emerging trend” in decisions holding that in situations in which the insurer exclusively controls a policyholder’s defense without reserving rights, the insurer will be responsible for covering any adverse judgment.27 Certain courts weighing the issue have held that the insurer’s failure to timely reserve rights after defending the uncovered claim leads to coverage based on waiver.28 Other courts have applied estoppel to prevent an insurer from denying coverage if the policyholder can show reliance and prejudice from the insurer’s defense of the underlying suit.29 One such situation occurred in an Illinois case, Nationwide Mutual Insurance Co. v. Filos. 30 In Filos, an insurer defended a manufacturer in a product-liability lawsuit for more than four years without ever reserving rights. On the eve of trial, the insurer realized that the plaintiff’s injury had not occurred during the policy period. Under these facts, the Illinois appellate court held that an insurer may be estopped from denying coverage if the policyholder can show the insurer had knowledge of a valid coverage defense and the policyholder was misled by an act or statement of the insurer, or estoppel from expanding coverage beyond a policy’s terms, the Filos court looked to the law of several other jurisdictions, including Oklahoma, Texas, Florida, New York, and New Jersey, all of which have adopted the exception when the insurer controls the defense without reserving rights.32 Although in Maxwell, the Wisconsin Supreme Court acknowledged the existence of this coverage exception in other states, the court has now explicitly rejected it for Wisconsin.

Policyholder Strategies after Maxwell

The Maxwell decision poses a new challenge for Wisconsin policyholders facing lawsuits that allege both covered and uncovered claims. In light of Maxwell, the most significant danger for policyholders arises when the insurer remains silent about potential coverage gaps posed by a lawsuit. The risk for policyholders is that the insurer will defend the case until judgment is entered and only then notify the policyholder of the absence of coverage. The Maxwell holding obviously raises the question of what a Wisconsin policyholder can do to protect itself from surprise and avoid facing an uncovered judgment at the end of the case, when it might be too late. For starters, because of Maxwell’s instruction against creating after-the-fact coverage beyond the insurance contract terms, the policyholder needs to act early.

Because Maxwell has now shifted the burden of assessing insurance coverage onto the policyholder, this means the policyholder should inquire about coverage at the very outset of litigation. The policyholder should send what now might be called a “Maxwell letter,” requesting the insurer’s position on coverage and advising the insurer that if no such opinion is conveyed, the policyholder will rely on its insurance policy to provide full protection. If the insurer provides no clear response, the policyholder should strongly consider obtaining an independent legal opinion about the existence of covered and uncovered claims.

The Maxwell court did suggest that the tort remedy of bad faith might be available to a policyholder if the insurer controls the entire defense but fails to communicate with the insured about uncovered claims.33 Even so, the court indicated that an insurer’s failure to issue a reservation-of-rights letter is not by itself evidence of bad faith.34 To set the stage for a potential bad-faith claim, a policyholder likely must make a written request for a coverage position from the insurer. Indeed, the Maxwell court suggested that a response from the insurer to such an inquiry would be appropriate and would constitute evidence of good faith.35 An insurer’s failure to respond would also likely violate Wisconsin’s claim-handling regulations mandating prompt communications and, in turn, further support a bad-faith claim.36 Maxwell also reinforces the need for a policyholder to hire independent defense counsel when the policyholder faces both covered and uncovered

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claims. With uncovered claims, the policyholder should strongly consider asserting control over the defense by having independent counsel defend the case. Under these circumstances, the policyholder may rightfully argue that the insurer should pay for such legal expenses because a lawsuit having both covered and uncovered claims creates a conflict of interest for the insurer’s retained counsel.37 Wisconsin case law has previously indicated such a conflict of interest gives policyholders the right to independent counsel paid for by the insurer.38

Although the Maxwell decision is not friendly to Wisconsin policyholders, they are not without protection. Upon tendering a new lawsuit, a policyholder should ask its insurer about the existence of any potential coverage issues. Absent an adequate response, the policyholder should consider hiring an independent attorney to thoroughly analyze potential coverage gaps. If potentially uncovered claims exist, the policyholder, to fully protect itself, should assert the right to control the defense at the insurer’s expense.

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Endnotes

1Maxwell v. Hartford Union High Sch. Dist., 2012 WI 58, 341 Wis. 2d 238, 814 N.W.2d 484.
2Id.
3See Johnson Controls Inc. v. London Market, 2010 WI 52, ¶¶ 28-29, 323 Wis. 2d 176, 784 N.W.2d 579.
4Id.
9Id.
10Id.
15Id. at 313.
16See Alnappee, 34 Wis. 2d at 140-41.
21Id.
22See Maxwell, 2012 WI 58, ¶ 34, 341 Wis. 2d 238.
23Id. ¶ 92.
24Id. ¶ 93.
25Id. ¶ 40-41.
26See Alnappee & W. Ry. Co., 34 Wis. 2d at 134; Shannon, 150 Wis. 2d at 454-55.
30See Filos, 673 N.E.2d at 1103-04.
31See id. at 1104-05.
33See Maxwell, 2012 WI 58, ¶¶ 58-62, 341 Wis. 2d 238.
34Id. ¶ 59.
35Id. ¶ 58.
36See Wis. Admin. Code § Ins. 6.11(3).
38See supra note 19.