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ALERT

Insurer Not Estopped from Denying Coverage after Defending Without a Reservation of Rights

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Applying Wisconsin law, the Supreme Court of Wisconsin has held that an insurer that provides a defense to its insured without a reservation of rights is permitted to deny coverage based on a policy exclusion, even after a detrimental judgment is issued, because the doctrines of waiver and estoppel cannot create coverage that does not otherwise exist. *Maxwell v. Hartford Union High Sch. Dist.*, No. 2009AP2176, 2012 WL 1937109 (Wis. May 30, 2012).

The underlying claimant was an administrative employee of a state school district who had an employment contract that covered the time period from July 2005 to June 2008 but whose position was eliminated at the end of the 2006-2007 school year. The employee sued the school district for breach of contract, and the district's public entity liability insurer provided a defense to the insured without issuing a reservation of rights letter. After the court awarded the employee approximately $100,000 in compensatory damages, the insurer denied coverage based on a policy exclusion for awards constituting "compensation for loss of salary." The district then filed a third-party complaint against its insurer seeking a declaration of coverage. Because the exclusion clearly applied, the trial court granted the insurer's motion to dismiss. The intermediate appellate court reversed, holding that although the general rule is that coverage cannot be created by waiver or estoppel, there is an exception where a carrier provides a defense to its insured without a reservation of rights and denies coverage only after defending to a detrimental judgment.

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In a split ruling, the state's highest court held that under well-settled Wisconsin law, waiver and estoppel cannot be used to create coverage that is not otherwise available under the policy. The court explained that although unconditionally assuming the defense of an insured can be grounds for establishing estoppel or waiver of a forfeiture clause (*e.g.*, a notice provision), the doctrines cannot be used to enlarge the coverage provided by a policy. The court distinguished a line of Wisconsin cases holding that an insurer that breaches its duty to defend can be liable for extra-contractual damages. The court noted that although such cases have sometimes been explained in terms of the insurer being "estopped from denying coverage," it is not estoppel "in the traditional sense" because the scope of coverage is not actually expanded. In announcing its holding, the court cautioned that its opinion should "not be interpreted as a license for insurers not to communicate forthrightly with their insureds."

In dissent, three justices of the court contended that the majority's decision "wrongly concludes that the only penalty for an insurer's failure to follow [the state's procedure for reserving rights and contesting coverage] is that it waives any *forfeiture* clauses." The dissent argued that the situation presented by this case—where an insurer controls its insured's defense only to deny coverage after an adverse judgment—results in clear prejudice to the insured that can only be remedied by precluding the carrier from asserting defenses to coverage.

The opinion is available here.