By David Wentzel and Mike Kozlowski

Insurer's Refusal to Defend

Seventh Circuit Confirms Stringent Penalties

This past year, the Seventh Circuit "provided a warning for insurance companies who refuse to defend their insureds," reaffirming long-standing Illinois law confirming stringent penalties for insurers that breach the duty to defend. *National American Insurance Company v. Artisan and Truckers Casualty Company*, No. 14-2694 (7th Cir. Aug. 6, 2015).

For attorneys unfamiliar with insurance law, even the simplest case involves at least three parties–the plaintiff, the defendant, and the insurance carrier–and usually at least two separate lawsuits: (1) underlying action (plaintiff v. defendant, to determine defendant's liability); and (2) the coverage dispute (insurance carrier v. defendant, to determine whether defendant's loss is covered under the policy). *National American* involves the second type of dispute and the relationship between the insurance company and the policyholder-defendant.

Basis of the Lawsuit

The underlying case arose from an accident between an 18-wheeler and a pickup truck. The pickup-truck-driving plaintiffs sued "everyone," including the driver of the semi, his passenger, the owner of the truck and "Unlimited Carrier," the company

whose placard appeared on the cab of the truck. The plaintiff's eight-count complaint alleged various theories of direct and vicarious liability, including multiple counts that the driver acted as an agent on behalf of Unlimited Carrier and other counts that the driver was the owner's agent. The defendant-driver tendered the defense to his owner's insurer, Artisan, which refused to defend based on an exclusion in the policy denying coverage if the vehicle is being operated on behalf of another organization, presumably, Unlimited Carrier; however, no contract was signed between the defendant or the owner and Unlimited Carrier at the time of the accident.

Enter National American Insurance Company (NAICO), Unlimited Carrier's insurer. NAICO defended all of the potentially liable parties in the underlying action under a reservation a rights. The underlying case was settled, and the defendants assigned their rights under the Artisan Policy to NAICO.

NAICO then sued Artisan, contending that Artisan breached the duty to defend and reimbursement of the settlement cost attributable to Artisan's insureds, through theories of subrogation and equitable contribution. NAICO successfully maintained that Artisan had a duty to defend because some of the claims, namely those where its insured was the alleged principal, fall within coverage.

Artisan appealed, contending that the underlying complaint did not allege any claims that potentially fall within coverage, and thus its duty to defend was not triggered. Artisan continued to rely on its policy language excluding coverage where the vehicle is operated "on behalf of another." Artisan argued that Unlimited Carrier exerted "authority and control" over the tractor through theories of federal logo and placard liability, and that because of Unlimited Carrier's potential liability, the vehicle was being operated "on behalf of" a non-covered entity.

Consequences of Breaching the Duty to Defend

The Seventh Circuit disagreed, finding that the counts alleging vicarious liability against Artisan's insured triggered the duty to defend, because Artisan's insured was potentially liable for those claims. That other counts alleging vicarious liability against Unlimited Carrier were almost certainly outside the scope of coverage was irrelevant to determine whether Artisan had a duty to defend.

Having found that Artisan breached the duty to defend, the Seventh Circuit held that it was estopped from asserting "any coverage defenses." As a result, Artisan was required to pay NAICO every penny authorized by the settlement agreement, including costs for NAICO's efforts in defending and indemnifying Artisan's insureds.

The Seventh Circuit relied almost exclusively on the Illinois Supreme Court case *Maryland Casualty Co. v. Peppers*, 64 Ill. 2d 187 (1976), a watershed case for insurance coverage in Illinois. While *Peppers* addresses much more than just the duty to defend, it does make clear that an insurer may only refuse to defend when *all* of the claims are clearly *excluded* from coverage.

Refusing to defend makes rational economic sense if the damages for breach of the duty to defend stay within the policy limits and are reasonably equivalent to what the insured-defendant would have to pay with a defense, with the added benefit that the insured may never pursue the insurer. Thus, by refusing to defend, the insurer can reap the best reward–no liability–without incurring defense costs either on behalf of its insured in the underlying action, or for itself in the coverage dispute. The possibility of the best result in exchange for the least effort can make refusing to defend, even wrongfully, an attractive position where possible damages have often been capped at the policy limits. However, recent Illinois case law has upheld damage awards *in excess of the policy limits* against an insurer for failing to defend. *Delatorre v. Safeway Ins. Co.*, 2013 IL App (1st) 120852.

DAILY PRACTICE AREA UPDATES

The CBA is pleased to introduce the second year of CBA Newsstand by Lexology, a daily email that provides valuable and free practical know-how. Learn more at www.chicagobar.org/newsstand.

The duty to defend is so fundamental that breach of the obligation constitutes repudiation of the contract. *Margulis v. BCS Ins. Co.*, 2014 IL App (1st) 140286. This repudiation results in the insurer being estopped from raising policy defenses to coverage. This means that an insurer cannot deny coverage based on the terms of the insurance policy once it has breached the duty to defend. *Mt. Hawley Ins. Co. v. Certain Underwriters at Lloyd's*, 2014 IL App (1st) 133931. Estoppel even bars otherwise meritorious defenses under the rationale that an insurer cannot rely on the policy for a defense while simultaneously breaching the defense provisions. Thus, by breaching the duty to defend, an insurer can create liability where none existed before.

Although these recent cases do not depart from long-standing Illinois precedent, they do show that courts are unwilling to minimize the strict laws governing insurers' duties to the insured. Clearly, insurers are breaching the duty to defend, even where their duty is obvious. In this scenario, one might think that insurers would have gained some ground, but Illinois courts are holding the line and taking insurers to task when they breach the duties owed to their policyholders. ■

David Wentzel is a former equity partner of McDermott, Will, & Emery and the founder of Wentzel Law Offices, where he practices complex civil litigation throughout the United States. Michael Kozlowski is an associate with Wentzel Law Offices and is a member of the Insurance Law Committee of the Chicago Bar Association.