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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

The Risks Of Not Defending Your Insured

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Bradley J. Lorden

The first line of the Seventh Circuit's opinion says it all: "This case provides a warning for insurance companies who refuse to defend their insureds." As the court's admonishment suggests, insurers that improperly refuse to defend an insured do so at their own risk and may waive their coverage defenses in the process. Insurers' options remain to either defend under a reservation of rights or initiate a declaratory judgment action.

National American Insurance Co. v. Artisan and Truckers Casualty Co.

The case, National American Insurance Co. v. Artisan and Truckers Casualty Co., stemmed from a semitruck accident and the resulting personal injury suit.[1] The plaintiffs in that case, who were seriously injured in the accident, filed suit against: the driver of the truck; the driver's father, who owned the truck; and Unlimited Carrier, the trucking company whose placards were on the side of the truck.

When the driver of the truck learned of the lawsuit, he contacted his insurer, Artisan, which promptly denied coverage. Artisan asserted that its policy excluded coverage because it covered only the driver of the truck and his father, and, at the time of the accident, the driver was operating the truck on behalf of Unlimited Carrier, which was not named as an insured on the Artisan policy. The Artisan policy also explicitly excluded claims when the truck was being "operated, maintained or used for or on behalf of anyone else or any organization." Because the driver's truck displayed placards for Unlimited Carrier at the time of the accident and since the plaintiffs' complaint alleged that "Unlimited Carrier exercised authority and control" over the truck, Artisan asserted that its policy excluded coverage.

Meanwhile, Unlimited Carrier's insurer, National American Insurance Co. (NAICO) defended the driver's suit subject to a reservation of rights. NAICO and the plaintiffs settled, then NAICO filed a declaratory judgment action against Artisan to recover what it paid in defending and settling the underlying suit. The U.S. District Court for the Northern District of Illinois held that Artisan breached its duty to defend and granted summary judgment in favor of NAICO. Artisan then appealed to the Seventh Circuit, which affirmed.

The Seventh Circuit found three facts particularly persuasive. *First*, despite the Unlimited Carrier placards on the truck, the driver was not actually in the process of picking up a load for Unlimited Carrier. *Second*, the driver did not sign a lease with Unlimited Carrier until eight days *after* the accident, meaning that the driver did not have authority to display Unlimited Carrier's placards. *Third*, the plaintiffs in the underlying action alleged vicarious liability not just against Unlimited Carrier, but also against the driver's father, who was named as an insured under Artisan's policy.

This third point was particularly important. Artisan argued that Unlimited Carrier was ultimately liable in the underlying case since plaintiffs there alleged that it exercised authority and control over the truck. This allegation, according to Artisan, trumped any liability of the driver's father as it implicated the federal doctrine of placard liability, which provides that a plaintiff can sue the company whose placard appeared on the truck that struck him.

The Seventh Circuit rejected this argument. While Artisan's "ultimate liability" argument might apply to its duty to *indemnify* the driver, the court said, it has no application to its broader *duty to defend* which is triggered when a cause of action against the insured "potentially fall[s] within the scope of coverage," even if other causes of action do not. Just because one theory of liability — placard liability — may not trigger coverage, plaintiffs' claim that the driver's father was also vicariously liable did trigger Artisan's duty to defend. Since Artisan breached that duty, it was estopped from raising policy defenses to coverage and was ordered to reimburse NAICO for the money NAICO spent defending and settling the underlying suit. As the court explained, "[i]f the insurer does not defend under a reservation of rights or seek a declaratory judgment, then 'it will be estopped from later raising policy defenses to coverage.'"[2]

The Risk to Insurers That Improperly Refuse Their Duty to Defend

While the Artisan decision is limited to the facts at hand in that case, the warning given by the Seventh Circuit should reverberate with all liability insurers. Indeed, longstanding Illinois case law dictates that an insurer faces only three courses of action: (1) defend the lawsuit under a reservation of rights; (2) seek a declaratory judgment excluding coverage; or (3) do nothing and refuse to defend.[3] The third option is done at the insurer's risk — a risk that did not pay off in Artisan as the Seventh Circuit noted that Artisan "gambled and lost."

What are the stakes at issue? As illustrated by Artisan, under some state's laws, an improper denial will result in the insurer waiving its right to deny coverage in a subsequent lawsuit. Therefore, even if an insurer has policy defenses like late notice or failure to cooperate, an insurer will be precluded from asserting them if it improperly refused to defend its insured. This result was illustrated in Artisan where the insurer was estopped from raising coverage defenses and, thus, was forced to reimburse NAICO for the amounts it paid in settling and defending the underlying lawsuit. As the Seventh Circuit explained, this principal "incentivizes action over inaction, which ultimately inures to the benefit of the insured."[4]

An insurer that improperly refuses to defend not only risks waiving its coverage defenses, but faces other consequences as well. For instance, the insurer loses the right to control the defense and an insured can settle its underlying claim without obtaining the insurer's approval — potential rights surrendered by the insurer when it improperly refuses its duty to defend.[5] And, assuming it was reasonable, the insurer will be bound by the settlement. In addition to reimbursing the insured for the defense and settlement of the underlying claim, an insurer that breaches its duty to defend may also be liable for compensatory damages resulting from its breach. In some states, this includes consequential damages and attorneys' fees incurred in a declaratory judgment action to enforce the insurer's defense obligations.[6]

The Artisan decision is not an isolated incident of a court coming down hard on an insurer that breached its duty to defend, nor is it limited to Illinois law. For instance, in Pulte Home Corp. v. American Southern Insurance Co., the court warned that "an insurer undertakes a substantial risk when it chooses not to provide a defense."[7] In that case, the court found that the underlying complaint alleged facts that potentially fell within coverage, triggering the insurer's duty to defend. Since the insurer improperly refused to defend the underlying suit, it was required to reimburse the insured for the amounts spent in defending and settling the underlying case. The court reasoned that "[w]hen an insurer without justification refuses to defend its insured, the insurer is estopped from denying coverage and is obligated to pay the amount of any reasonable settlement made in good faith by the insured of the action brought against him by the injured party."[8]

As illustrated by Artisan, Pulte Home and similar decisions from several other states,[9] insurers face considerable risk when refusing to defend an insured in an underlying case that may potentially fall within coverage.

—Bradley J. Lorden, Proskauer Rose LLP

Brad Lorden is an associate in Proskauer's Chicago office.

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[1] National American Insurance Co. v. Artisan & Truckers Casualty Co., No. 14-2694, --- F.3d --- (7th Cir. Aug. 6, 2015).

[2] Id. at *7 (citing State Farm Fire & Casualty Co. v. Martin, 710 N.E.2d 1228, 1231 (Ill. 1999).

[3] Id. (citing Petersen Sand & Gravel Inc. v. Maryland Casualty Co., 881 F. Supp. 309, 313 (N.D. Ill. 1995)); see also Waste Management Inc. v. International Surplus Lines Insurance Co., 144 Ill. 2d 178, 207 (1991).

[4] Id.

[5] See, e.g., Am. Motorists Insurance Co. v. Trane Co., 544 F. Supp. 669, 689 (W.D. Wis. 1982) aff'd, 718 F.2d 842 (7th Cir. 1983) ("The insurer which wrongfully refuses to defend also loses the right to control the defense or the settlement of the action and is liable for defense costs, including attorneys' fees.")

[6] See Barry R. Ostrager & Thomas R. Newman, Handbook on Insurance Coverage Disputes § 506[a] (16th ed. 2013).

[7] Pulte Home Corp. v. American Southern Insurance Co., 647 S.E.2d 614, 616 (N.C. App. 2007) (emphasis added).

[8] Id. at 617.

[9] See, e.g., id. at 616 (citing Ames v. Continental Casualty Co., 79 N.C. App. 530, 538 (1986)); see also Truck Insurance Exchange v. Vanport Homes Inc., 58 P.3d 276, 281 (Wash. 2002); Conanicut Marine Services Inc. v. Insurance Co. of North America, 511 A.2d 967, 971 (R.I. 1986); Schurgast v. Schumann, 242 A.2d 695, 705 (Conn. 1968) (citations omitted); Gray v. Zurich Insurance Co., 419 P.2d 168 (Cal. 1966); St. Paul Fire & Marine Insurance Co. v. Vigilant Insurance Co., 919 F.2d 235, 240 (4th Cir. 1990).