Estoppel—Duty to Defend and Beyond

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The estoppel principle is commonly thought to apply solely in the context of liability policies, and then only to penalize an insurer for failing to honor its duty to defend.[1] Yet, two recent cases, *Uhlich Children's Advantage Network v. National Union Fire Company*,[2] and *Lumbermen's Mutual Casualty Company v. Sykes*,[3] demonstrate that Illinois courts have expanded the application of estoppel to bar the insurer from raising policy defenses to coverage in other contexts, namely with claims-made policies and first party policies.

The estoppel principle in the liability insurance context provides that an insurer that wrongfully denies coverage may not simply refuse to defend the insured. Such insurer must defend the suit under a reservation of rights or seek a declaratory judgment that there is no coverage. If the insurer fails to do this, and is subsequently found to have wrongfully denied coverage, it is estopped from later raising policy defenses to coverage.[4]

An insurer must defend under the following circumstances: 1) where potential coverage exists; 2) unless no possibility of coverage exists; 3) if facts known to the insurer outside the complaint trigger coverage; 4) without resort to extrinsic evidence on the same issue as must be adjudicated in the underlying suit; or 5) until adjudication of defense finally resolved based on extrinsic facts. In other words, when there is doubt as to coverage, that doubt is to be resolved in favor of the insured

Illinois rules on estoppel derive their power from the breadth of the duty to defend. Insurers have long been on notice in Illinois that the failure to defend a potentially covered suit has dire consequences, if the insurer gambles on denying coverage rather than defending under a reservation of rights or filing a declaratory judgment. The Illinois courts have had numerous opportunities to limit the estoppel rules, but have declined to do so. An insurer must defend in the following circumstances: 1) where potential coverage exists; 2) unless no possibility of coverage exists; 3) if facts known to the insurer outside the complaint trigger coverage; 4) without resort to extrinsic evidence on the same issue as must be adjudicated in the underlying suit; or 5) until adjudication of defense is finally resolved based on extrinsic facts. In other words, when there is doubt as to coverage, that doubt is to be resolved in favor of the insured.[5]

One of the last battles in the insurer estoppel wars was fought before the Illinois Supreme Court in *Employers Insurance of Wausau v. Ehlco Liquidating Trust*.[6] Insurers were insistent that estoppel should not apply where the coverage defense of late notice was raised because it was a "condition precedent." They argued no potential coverage existed because the insured did not comply with the policy's

provisions. Therefore, there was no duty to defend.[7] The Illinois Supreme Court soundly rejected the distinction. If an insurer denies coverage based on facts extrinsic to the complaint, the insurer must obtain an adjudication terminating coverage before it can allege there is no duty to defend.[8]

It should come as no surprise, then, that the same argument rejected by the court in *Ehlco* should also be rejected under a claims-made policy. Insurers have asserted that giving notice in a claims-made policy is a "trigger of coverage," not merely a condition. No notice during the policy period means that the policy does not potentially apply. Therefore, the insurers argue, there is no duty to defend.

In *Uhlich Children's Advantage Network v. National Union Fire Company*, the Illinois Appellate Court applied the rule of estoppel to prevent a claims-made insurer from denying coverage based on the insured's failure to report the claim during the policy period.[9] Although the Northern District of Illinois had applied the estoppel rule to a claims-made policy,[10] *Uhlich* is the first case in which an Illinois state court found that "there is nothing in *Ehlco* limiting the estoppel doctrine to occurrence-based policies."[11]

In January 2005, a former employee of Uhlich Children's Advantage Network (UCAN) filed a charge with the EEOC alleging discrimination under the ADA. He amended his charge on July 2005 to name UCAN's executive vice president of human resources. In September 2005, he filed a complaint in the U.S. District Court against UCAN and its EVP alleging discrimination under the ADA and seeking damages under the Family and Medical Leave Act. UCAN gave notice to National Union, its Employment Practices Liability insurer, the same day it received the federal complaint. National Union denied coverage arguing that the claim was first made in January 2005 during the first National Union policy, but was not reported until the policy period for the subsequent policy. In February 2008, UCAN filed a complaint against National Union contending that National Union had a duty to defend. National Union filed a motion to dismiss based on its "late notice" argument. Because both policies provided that only a claim made and reported during the first policy period was covered, it argued there was no coverage. The trial court agreed and dismissed UCAN's complaint.[12]

On appeal, UCAN argued that because there was potential for coverage under the policy and since the defendant failed to defend under a reservation of rights or to seek declaratory judgment, it was estopped from denying coverage.[13] National Union relied on the holding in *Graman v. Continental Casualty Co.*[14] that when notice is not given during the policy period of a claims-made policy, there is no potential coverage.[15]

> ***Ehlco concluded that there is no exception to the estoppel doctrine for late notice defenses, and the Uhlich court concluded that is nothing in Ehlco limiting the estoppel doctrine to occurrence-based policies***

The appellate court noted that the Illinois Supreme Court in *Ehlco*, 19 years after *Graman*, expressly rejected National Union's argument. *Ehlco* concluded that there is no exception to the estoppel doctrine for late notice defenses, and the *Uhlich* court concluded that is nothing in *Ehlco* limiting the estoppel doctrine to occurrence-based policies.[16] Therefore, the court held that National Union, having failed to defend under a reservation of rights, and having failed to seek a declaratory judgment in a timely manner (rejecting National Union's argument that its request for a judicial determination after plaintiffs filed their own declaratory judgment was "timely"), was estopped to raise its coverage defense and owed UCAN coverage under the policy.[17]

Insurers have long recognized the danger that their late notice coverage defenses could be subject to estoppel, even in the context of claims-made policies. In *National Union v. Baker & McKenzie*,[18] the insurer (the same one as in *Uhlich*) filed a declaratory judgment to adjudicate the insured's claim for coverage under a claims-made policy under circumstances very similar to *Uhlich*. In May 1989, Baker & McKenzie sent notice to National Union of a potential claim against several of its partners. In January 1990, even before the malpractice case was filed against Baker & McKenzie, National Union filed a declaratory judgment seeking a declaration that National Union's insurance policy did not cover the claim against the lawyers because it was first made but not reported during the first policy year. The court held that there was no coverage for Baker & McKenzie under National Union's policy, because Baker & McKenzie failed to report the potential claim in the policy year the claim was first made. *Uhlich* does not distinguish *National Union v. Baker & McKenzie*, but, citing *Ehlco*, simply notes that "once the insurer breaches its duty to defend, the estoppel doctrine 'has broad application and operates to bar the insurer from raising policy defenses to coverage, even those defenses that may have been successful had the insurer not breached its duty to defend.' "[19]

There are two Illinois cases that distinguish *Ehlco* where the insurer was raising late notice as a coverage defense, but neither of them arises in the

claims-made context. In *Northern Insurance Company of New York v. City of Chicago*,[20] and *American National Fire Insurance Company v. National Union Fire Insurance Company of Pittsburgh, PA*,[21] the courts refused to apply estoppel even though the insurer failed to file a declaratory judgment or defend under a reservation of rights. The facts in those cases revealed that neither insurer was given an opportunity to defend. The courts believed that it was obvious from the face of the underlying suits that the insured had had notice of the occurrences and the suits for more than two years before the insurers were notified.[22]

Illinois insurers have been forewarned in many other contexts to obtain an adjudication of the duty to defend, including where the facts do not suggest the answer to coverage, but where there is no "policy" in existence. For instance, in *American Standard Insurance Company of Wisconsin v. Gnojewski*,[23] the court held that the insurer breached its duty to defend under an automobile liability insurance policy, and was estopped from asserting policy defenses based on notice of cancellation to a lien holder. The appellate court cited the estoppel doctrine, stating that a complaint alleging facts that potentially could give rise to coverage under a policy triggers a duty to defend that the insurer cannot simply deny. The estoppel doctrine was not applicable, however, where there was no duty to defend or the duty was not properly triggered. The court noted that since there was a dispute regarding whether or not the cancellation was proper, Gallant should have either defended the underlying lawsuit under a reservation of rights or sought a declaratory judgment.[24]

The Illinois courts have not only applied estoppel in the liability insurance context; they have also held estoppel applicable in other instances in order to protect the rights of the insured. For example, in the context of life insurance, traditional estoppel principles have been applied to prevent an insurance company from raising a defense brought about by its own conduct. As early as 1871, in *Insurance Company v. Wilkinson*,[25] the United States Supreme Court ruled that where the insured died of a fever, the insurer was estopped from claiming an error in the mother's age on the insurance application as a reason to deny payment, because the agent's act in filling in the incorrect answer was attributable to the insurer. In so ruling, the Court found:

> It is in precisely such cases as this that courts of law in modern times have introduced the doctrine of equitable estoppels, or, as it is sometimes called, estoppels *in pais*. The principle is that where one party has by his representations or his conduct induced the other party to a transaction to give him an advantage which it would be against equity and good conscience for him to assert, he would not in a court of justice be permitted to avail himself of that advantage.[26]

Courts have long upheld this principle in the insurance context.[27]

The principle was discussed more recently in *Sponemann v. Country Mutual Insurance Company*,[28] a case typical of those arising in the first party context where an insurance company is estopped from raising a limitations defense by conduct which induces its insured to reasonably believe that his claim will be settled without suit.[29] There the court held that where the insurer gave no indication, prior to the running of the limitation period, that a question existed as to the insured's coverage under the uninsured motorist provision of an automobile liability policy, the insurer was barred from raising the limitations period as a defense to coverage.[30] Unlike the estoppel principle arising in the context of a duty to defend, this first party application of estoppel is based upon an assessment of whether the insured was prejudiced by the conduct of the insurer. In that regard the court stated that an insured has a right to know with reasonable promptness the attitude of an insurer, so that he might take such actions as would save him from loss and damage.[31] Thus, estoppel here is based on the principle that one may not act in a particular manner and then assume a position inconsistent with that conduct to the prejudice of one who has relied upon it.[32]

While the mere pendency of negotiations between the parties will not, of itself, give rise to an estoppel, estoppel may be found where negotiations are such as to lull the insured into a false security, thereby causing him to delay the assertion of his rights.[33] Since estoppel is recognized in order to protect from harm a party who has relied to his prejudice upon the acts of another, it is immaterial that the insurer intended neither to mislead the insured nor to relinquish its own rights under the policy.[34]

> ***[E]stoppel, in this [first party] context, requires the insured to establish the following: (1) that he was misled by the acts or statements of the insurer or its agent; (2) reliance by the insured on those representations; (3) that such reliance was reasonable; and (4) detriment or prejudice suffered by the insured based on the reliance***

This estoppel principle was reaffirmed and expanded recently in *Lumbermen's Mutual Casualty Company v. Sykes*.[35] In *Sykes*, the insured reported toxic mold growth in her home that allegedly was a result of prior water damage from ice dams that had

formed on the roof of her house. Due to this mold growth, her home became uninhabitable and she was forced to move out. The insurer, which had paid for repair of the water damage, denied coverage for the mold.[36] The insured asserted that the insurer was estopped from raising noncoverage as a defense. The court found that estoppel, in this context, required the insured to establish the following: (1) that she was misled by the acts or statements of the insurer or its agent; (2) that she relied on those representations; (3) that her reliance was reasonable; and (4) that she suffered detriment or prejudice as a result of her reliance. The court found that while there was a material issue of fact as to certain aspects of the insured's claim, the insurer was estopped from raising the defense of noncoverage where it had assured the insured that the mold damage resulted from a covered cause under the policy.[37] Significantly, the court made such a finding despite the insurer's having previously sent the insured a letter stating it would not pay for anything not covered under the terms of the policy.[38]

This line of estoppel cases in the first party context is akin to those cases in the liability realm in which the insurer "lulls the insured" into a sense that no coverage defenses will be raised. Those cases apply a form of equitable estoppel that arises when an insurer assumes an insured's defense without reserving its rights

Sykes is also significant because, prior to *Sykes*, most cases applying estoppel in the first party context determined whether, as in *Sponemann*, the insurer was estopped from raising the limitations period as a defense to a suit by the insured to enforce the terms of the policy. In *Sykes*, however, the court applied estoppel to bar the raising of *any* policy defense. Thus, the *Sykes* court makes clear that, although the insured must demonstrate a prejudicial reliance not required in the liability insurance context, estoppel applies equally in the first party insurance arena to protect the rights of the insured. In that sense *Sykes* broadened the application of estoppel in the first party insurance context in the same fashion *Uhlich* broadened it in the liability context.

This line of estoppel cases in the first party context is akin to those cases in the liability realm in which the insurer "lulls the insured" into a sense that no coverage defenses will be raised. Those cases apply a form of equitable estoppel that arises when an insurer assumes an insured's defense without reserving its rights.[39] In *Ehlco*, the court recognized the difference between this form of equitable estoppel, which requires a showing of prejudice, and the contractual estoppel that applies when the insurer breaches its duty to defend, which does not require prejudice:

> Wausau's argument presumes that prejudice is an element of the estoppel doctrine that must be pleaded and proved by the insured before estoppel applies. None of this court's cases applying this form of estoppel, however, even discuss prejudice.... Moreover, several appellate court cases have expressly rejected the requirement of prejudice in this context.... The few cases that Wausau offers in support of a prejudice requirement are inapplicable. Those cases concern a different form of equitable estoppel that arises once an insurer actually assumes an insured's defense without reserving its rights.... Therefore, Wausau's argument that Ehlco was required to plead and prove prejudice fails.[40]

CONCLUSION

The estoppel principle is a valuable weapon in the policyholder's arsenal when an insurer wrongfully refuses to defend the insured. The insurer must act promptly in notifying the insured of its coverage position and in preserving its rights to deny coverage. It acts at its own peril if it abandons the insured. Estoppel will apply to the insurer's coverage defense based on conditions, exclusions, or the existence of the policy. In the liability insurance context, it will apply regardless of whether the policy is an occurrence or claims-made policy. The insurer who fails to defend under a reservation of rights, to reimburse independent counsel fees as incurred, or to file a timely declaratory judgment should beware. The only time estoppel is guaranteed not to apply is if the insurer is correct in concluding that no potential duty to defend exists based on the face of the pleadings. In the first party context, it does apply where the insurer "lulls the insured" into a sense that no coverage defenses will be raised, resulting in the barring of *any* policy defense.

[1] Stanley C. Nardoni and John S. Vishneski, III, *The Illinois Estoppel Doctrine: How Promptly Must an Insurer Act?*, 24 N. ILL. U. L. REV. 211, 231 (Spring 2004).

[2] Uhlich Children's Advantage Network v. Nat'l Union Fire Co. of Pittsburgh, *PA*, 398 Ill. App. 3d 710 (Ill. App. Ct. 2010).

[3] Lumbermen's Mut. Cas. Co. v. Sykes, 890 N.E.2d 1086 (Ill. App. Ct. 2008).

[4] Murphy v. Urso, 430 N.E.2d 1079, 1082 (Ill. 1981); *Sims v. Illinois Nat'l Cas. Co.*, 193 N.E.2d 123, 129 (Ill. App. Ct. 1963).

[5] Berkeley, J. and Reagan, M., "Duty to Defend,"§ 16.23, *Commercial and Professional Insurance*, Illinois Institute for Continuing Legal Education, 2008.

[6] Employers Ins. of Wausau v. Ehlco Liquidating Trust, 708 N.E.2d 1122 (Ill. 1999).

[7] *Ehlco*, 708 N.E.2d at 1134.

[8] *Ehlco*, 708 N.E.3d at 1136.

[9] *Uhlich*, 398 Ill. App. 3d at *8.

[10] Sullivan House, Inc. v. Federal Ins. Co., 2008 U.S. Dist. LEXIS 10438 (N.D. Ill. 2008).

[11] *Uhlich*, 398 Ill. App. 3d at *7.

[12] *Uhlich*, 398 Ill. App. 3d at *2–3.

[13] *Uhlich*, 398 Ill. App. 3d at *4.

[14] Graman v. Continental Cas. Co., 409 N.E.2d 387 (Ill. App. Ct. 1980).

[15] *Uhlich*, 398 Ill. App. 3d at *6.

[16] *Uhlich*, 398 Ill. App. 3d at *7.

[17] *Uhlich*, 398 Ill. App. 3d at *8.

[18] Nat'l Union Fire Ins. Co. of Pittsburgh v. Baker & McKenzie, 997 F.2d 305 (7th Cir. 1993).

[19] *Uhlich*, 398 Ill. App. 3d at *8.

[20] Northern Ins. Co. of New York v. Chicago, 759 N.E.2d 144 (Ill. App. Ct. 2001).

[21] American Nat'l Fire Ins. Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA, 796 N.E.2d 1133 (Ill. App. Ct. 2003).

[22] *American Nat'l*, 796 N.E.2d at 1142; *Northern Ins. Co.*, 759 N.E.2d at 150.

[23] American Standard Ins. Co. of Wisconsin v. Gnojewski, 747 N.E.2d 367 (Ill. App. Ct. 2001).

[24] *Gnojewski*, 747 N.E.2d at 374–75.

[25] Ins. Co. v. Wilkinson, 80 U.S. 222 (1871).

[26] *Wilkinson*, 80 U.S. at 234.

[27] *See, e.g.*, Frels v. Little Black Farmers' Mut. Ins. Co., 98 N.W. 522 (Wis. 1904); Phoenix Ins. Co. of Brooklyn v. Rad Bila Hora C.S.P.S., 59 N.W. 752 (Neb. 1904); Martin v. State Ins. Co., 44 N.J.L. 485, (N.J. 1882); Blanks v. Hibernia Ins. Co., 36 La. Ann. 599 (1884); St. Paul Fire & Mut. Ins. Co. v. McGregor, 63 Tex. 399 (1885); Bish v. Hawkeye Ins. Co., 28 N.W. 553 (Iowa 1886); Home Ins. and Banking Co. of Texas v. Myer, 93 Ill. 271 (1879).

[28] Sponemann v. Country Mut. Ins. Co., 457 N.E.2d 1031 (Ill. App. Ct. 1983).

[29] *See, e.g.*, Myers v. Centralia Cartage Co., 419 N.E.2d 465 (Ill. App. Ct. 1981); Florsheim v. Travelers Indemnity Co. of Illinois, 393 N.E.2d 1223 (Ill. App. Ct. 1979).

[30] *Sponemann*, 457 N.E.2d at 1037–38.

[31] *Sponemann*, 457 N.E.2d at 1039.

[32] *Sponemann*, 457 N.E.2d at 1039.

[33] *Sponemann*, 457 N.E.2d at 1038.

[34] *Sponemann*, 457 N.E.2d at 1038.

[35] *Sykes*, 890 N.E.2d at 1102.

[36] *Sykes*, 890 N.E.2d at 1090–92.

[37] *Sykes*, 890 N.E.2d at 1102–3.

[38] *Sykes*, *890 N.E.2d at 1103*.

[39] *See* Crum & Forster Managers Corp. v. Resolution Trust Corp., 620 N.E.2d 1073 (Ill. 1993); Maryland Cas. Co. v. Peppers, 355 N.E.2d 24, 29–30 (Ill. 1976); American States Ins. Co. v. Nat'l Cycle, Inc., 631 N.E.2d 1292, 1297–98 (Ill. App. Ct. 1994); Mid-State Savings & Loan Association v. Illinois Ins. Exchange, Inc., 529 N.E.2d 696, 699 (Ill. App. Ct. 1988).

[40] *Ehlco*, 890 N.E.2d at 1138 (citations omitted).