Wisconsin Insurers Must Defend USEPA/DNR Claims under CERCLA

In July, 2003, the Wisconsin Supreme Court issued its opinion in ***Johnson Controls Inc. v. Employers Insurance of Wausau***, (***JCI***) 2003 WI 108, 665 N.W.2d 257, in which it reversed ***City of Edgerton v. General Casualty Company of Wisconsin***, 184 Wis. 2d 750, 517 N.W.2d 463 (1994), decided nine years earlier. The court held that the "costs incurred to clean up damaged property as a result of an insured's liability under CERCLA or equivalent state statutes are sums that an insured is legally obligated to pay as damages and must be indemnified under a CGL policy, unless coverage is excluded by other provisions in the policies." The court also held that "a government-issued notice alleging an insured's liability for environmental response costs under CERCLA or equivalent state statutes constitutes the commencement of a legal proceeding that, in the CERCLA context, is the functional equivalent of a suit and triggers the insurer's defense obligation." ***Johnson Controls***, 2003 WI at ¶ 120. The decision left unanswered numerous questions including retroactive/prospective application of the decision, application of issue and claim preclusion to previously-litigated claims under ***Edgerton*** and its impact on settlements and releases. This article focuses on some of the practical issues left unanswered by the court's holding that a government-issued notice triggers an insurer's defense obligation that will be faced by policyholders and insurers in litigation which is certain to follow the ***JCI*** decision.

An initial issue is what rules will determine the insurer's defense obligation. The rules controlling when an insurer has a duty to defend a lawsuit are well established. An insurer's duty to defend an insured is determined by comparing the allegations of the complaint to the terms of the insurance policy. ***Fireman's Fund Insurance Company v. Bradley Corp***., 2003 WI 33 ¶ 19, 261 Wis. 2d 4. If the allegations of a complaint, if proven, would give rise to the possibility of recovery that falls under the terms and conditions of the insurance policy, a duty to defend exists. ***Id***. The duty to defend is based solely on the allegations contained within the four corners of the complaint without resort to extrinsic facts or evidence. ***Id***.

Unlike a formal complaint which must contain a short and plain statement of the claim and identify the transaction, occurrence or series of transactions or occurrences out of which the claim arises, a PRP letter may only identify the site, assert the insured's involvement and require the insured's response. The underlying facts essential to a determination of the defense obligation may not be provided. The policyholder in receipt of a PRP letter should send the letter to its liability insurers and request a defense. The insurer considering the request must construe the allegations liberally and any doubt must be resolved in favor of the insured. ***Id***., at ¶ 20.Facts extrinsic to the letter may not be considered. Thus, in most instances, the insurer will be required to accept the defense, subject to its reservation of rights.

A related question concerns responsibility for defense costs incurred prior to the ***JCI*** decision. In some instances, the policyholder may have provided notice and tendered the defense of a PRP letter to an insurer. The insurer, pursuant to ***Edgerton***, probably declined to defend. In other instances, the policyholder, realizing the futility of a tender of a PRP letter under ***Edgerton***, may have decided not to tender. The law in Wisconsin has been that an insurer is not responsible for defense costs incurred by an insured prior to notification and tender of the defense. *See* ***Towne Realty, Inc. v. Zurich Insurance Company***, 201 Wis. 2d 260 (1996). If this precedent is applied, the policyholder who did not notify or tender its PRP letter until after the ***JCI*** decision, should not recover pretender defense costs. Those who provided notice and tendered the defense, but were declined coverage, will have a basis to claim recovery of pre-***JCI*** defense costs and expenses. Any determinative answer must await further development of case law under the ***JCI*** precedent.

The court in ***JCI*** recognized that while CERCLA response costs are covered under the insuring agreement, they may be excluded by the policy terms or exclusions. ***Id***. at 92. Left unanswered is whether an insurer may rely upon policy exclusions to outright decline a defense to a PRP letter. An insurer that is considering this option should be aware there is an unresolved conflict in the Wisconsin appellate courts on this issue. Some courts have held that absent a judicial determination, an insurer may not rely solely on a policy exclusion to outright deny an insured a defense. For example, in ***Radke v. Fireman's Fund Insurance Company***, 217 Wis. 2d 39, 44 (Ct. App. 1998), the court held that when an insurer outright declines to defend its insured, a court subsequently determining whether the insurer breached its duty to defend must ignore "both the merits of the claim and any exclusionary or limiting terms or conditions of the policies." Two years later a panel from a different district held that an insured did not breach its duty to defend by outright declining to defend its insured because the claims against the insured, even if proven, would have been excluded under the insured's policy. ***Last v. American Family Mutual Insurance Company***, 2000

WI App. 1969, 238 Wis. 2d 140 Since an insurer's breach of a defense obligation results in the waiver of all coverage defenses and exposes the insurer to damages in excess of the policy limits, an insurer is best advised not to outright decline to defend a PRP letter. This caution extends to circumstances where an exclusion clearly precludes coverage or where extrinsic facts establish a coverage defense.

The court has recognized four options available to insurers faced with a debatable tender of defense: (1) the insurer and insured can enter into a non-waiver agreement under which the insurer agrees to defend, and the insured acknowledges the insurer's right to contest coverage;(2) the insurer can request a bifurcated trial or declaratory judgment in order to resolve the coverage issues before the liability and damage issues are litigated; (3) the insurer can file a reservation of rights that allows the insured a defense free from the insurer's control, but paid for by the insurer; or (4) the insurer can outright decline to defend. The supreme court has stated the preferred method is option (2) which allows the insurer to seek a stay of the underlying liability and damage issues pending resolution of the coverage dispute. ***Newhouse v. Citizens Security Mutual Insurance Co***., 176 Wis. 2d 824, 836 (1993).

Although this procedure works reasonably well in the context of a lawsuit it has its limitations when applied to a PRP letter. The policy behind the environmental cleanup statutes is to remediate or prevent pollution which is a current or imminent threat to public safety, health and the environment. Consequently, both legally and practically, it is unlikely a stay of the cleanup process will be granted pending resolution of the coverage dispute particularly where resolution of those issues may take years. Thus, an insurer will be required to provide a defense to the cleanup action under a reservation of rights pending final resolution of the coverage issues.

In the context of a lawsuit, an insurer seeking to have its defense obligation judicially determined is advised to intervene in the underlying liability lawsuit and seek declaratory judgment of its coverage and defense obligations. With a PRP letter no lawsuit exists. The courts recognize that a declaratory judgment action is an acceptable alternative to resolve issues concerning an insurer's defense obligation. *See* ***Fire Insurance Exchange v. Basten***, 202 Wis. 2d 74, 90 (1996). An insurer contemplating declaratory judgment under these circumstances must determine who must be joined as parties. The uniform declaratory judgment statute, Wis. Stat. § 804.04(11) mandates that all persons who have or claim any interest which could be affected by the grant of declaratory relief must be made parties to the declaratory judgment action. In ***Basten***, the Wisconsin Supreme Court held that interested parties for the purpose of a separate declaratory relief proceeding included the plaintiff and the co-defendants in the underlying personal injury lawsuit. The court reasoned that each of those parties' actual recovery from the insured in the underlying lawsuit could be affected by a separate coverage determination. Consequently, those persons were required to be made parties to the declaratory judgment action. ***Id***., at 93. Extension of this requirement in the context of a government-initiated cleanup is impractical and potentially impossible to satisfy. The parties who could be impacted by a coverage determination include the USEPA/WDNR, all of the PRP's and adjoining landowners. At a large site, the list of "interested parties" as defined by the court could involve 100 or more potential parties, an expensive and unmanageable proposition. Common practice has been to ignore ***Basten*** and join only the insured and insurers in an environmental coverage declaratory judgment action. The risk, primarily to the insurer, is that any declaration of coverage may be unenforceable against parties who were not joined in the lawsuit. ***Id.,*** at 96. The ***Basten*** court did not examine whether the doctrines of issue or claim preclusion would apply to prevent re-litigation of the coverage issues. Application of these doctrines is the logical and practical means of resolving the joinder issue in these types of declaratory judgment actions.

Also left unanswered by ***JCI*** are the duties and responsibilities of the insurer and insured while the declaratory judgment action is pending. Selection of counsel and the right to control the defense are issues which are of concern at the outset of the insurer’s agreement to defend under a reservation of rights. An insurer’s right to select defense counsel when defending under a reservation of rights has not been definitively decided in Wisconsin. In an unpublished decision, ***State v. City of Rhinelander***, Ct. App. Case No. 00-2666 (2001), the court approved the insurer's selection of independent defense counsel. Case law also suggests that an insurer who defends under a reservation of rights cannot control the defense. ***Jacob v. West Bend Mut. Ins. Co.***, 203 Wis. 2d 524, (Ct. App. 1996).

Closely related to the right to control the defense, is the insurer’s duty to settle within the policy limits. An environmental enforcement action involves numerous interim decisions by a PRP, all of which may require the insured’s financial commitment. Those decisions may have to be made before coverage is decided. If coverage is fairly debatable, an insurer does not have a good faith obligation to settle until the coverage issue is finally decided.

It must, however do the following: undertake a reasonably diligent investigation of the facts and circumstances underlying the claim; investigate any new facts coming to its attention which would affect a reasonable settlement decision or effect a coverage determination; determine and fully disclose to the insured any likelihood of recovery beyond the policy limits; and keep the insured informed of any settlement offers from the claimant and the progress of any negotiations, even though it has denied coverage. *See* ***Mowry v. Badger State Mutual Casualty Company***, 129 Wis. 2d 496, 524 (1986); ***Prosser v. Leuck***, 225 Wis. 2d 126 (1999).

The policyholder engaged in a coverage dispute may also have an interest in settling the clean-up action before coverage is finally decided. Policy conditions and the contractual liability exclusions generally preclude coverage for payments or settlements made without the insurer's consent. *See* ***Shorewood School Dist. v. Wausau Ins***., 170 Wis. 2d 347, 379 (1992). A policyholder desiring to settle is advised to notify its insurers and seek their consent to settle. The insurer should review the proposal, and unless it is patently unreasonable, consent to the settlement with the understanding that its consent is not an admission of coverage. Ultimate responsibility for payment is determined by the coverage litigation.

It is certain that the rules controlling the defense obligation will continue to be refined as coverage cases reach the appellate courts. The existing legal framework and procedures will allow both sides to resolve coverage issues without jeopardizing their rights under the ***JCI*** decision.