

Contributing Authors

Joseph A. Hinkhouse
(312) 784-5454
jhinkhouse@hww-law.com

Richard McDermott
(312) 784-5413
rmcdermott@hww-law.com

Joe Hinkhouse and Rich McDermott are partners at Hinkhouse Williams Walsh LLP, a specialty law firm of trial lawyers experienced in complex and varied litigation on behalf of insurers and reinsurers. Founded in 2008, and backed by over 100 years of relevant litigation experience, HWW's trial practice focuses on insurance coverage, insurance bad faith and punitive damages actions, advertising injury and intellectual property, reinsurance disputes, and products liability.

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The Harsh Consequences of Default: Wisconsin Supreme Court Orders Professional Liability Insurer to Pay Damages Despite No Finding of Insureds' Negligence

In recent years, the Wisconsin Supreme Court has fostered a legal climate increasingly unfavorable to business. The court has struck down a cap on pain and suffering damages (*Ferdon v. Wis. Patients Comp. Fund*), greatly expanded product liability (*Thomas v. Mallett*), and made it easier to award punitive damages (*Strenke v. Hogner* and *Wischer v. Mitsubishi Heavy Indus.*). A July 3, 2008 ruling directed against the insurance industry continues this trend.

In *Estate of Dale Otto, et al. v. Physicians Insurance Company of Wisconsin, Inc. et al.*, the court, in a 4-3 split, held that a professional liability insurer was required to pay damages for the alleged conduct of its insured, despite no finding that the insured was liable. Specifically, it ordered Physicians Insurance Company of Wisconsin, Inc. ("PIC") to pay nearly \$1 million in a medical malpractice case even though its insureds - two doctors and a clinic - were never adjudged to be negligent, and without a finding that the alleged negligence caused injury. Authored by Chief Justice Shirley Abrahamson, the opinion provides a cautionary lesson about the importance of meeting litigation deadlines and the peculiar risks of coverage in states that allow "direct actions."

BACKGROUND

Dale Otto filed a suit against doctors, their clinic, and their unnamed insurer. Claiming that the doctors failed to diagnose his cancer, Otto alleged, pursuant to Wisconsin's "direct action" statute, that PIC was "directly liable" for the damages caused by its insureds' negligence.

The attorney for the doctors and clinic answered the amended complaint, denying negligence and denying they caused damages to the plaintiffs. Although the insureds' answer was not filed on behalf of PIC, it also denied PIC's liability to the plaintiffs. Pursuant to Wisconsin rules, PIC had 45 days after being served to respond to the complaint. It failed to do so. Meanwhile, the case progressed against PIC's insureds, and in none of the subsequent pleadings or hearings did counsel for the insureds suggest they were also representing PIC. Finally, about eight months after being sued, PIC -- now represented by the same attorney who represented PIC's insureds -- answered the amended complaint, denying liability.

The plaintiff then moved for a default judgment

against PIC, while PIC asked for retroactive enlargement of time to answer. PIC argued that its earlier failure was inadvertent, that it immediately filed an answer when the omission was pointed out, and that its failure did not prejudice the plaintiffs. The trial court rejected PIC's arguments, finding PIC's neglect inexcusable, and granted a default judgment.

PIC then argued that the sole consequence of the default should be barring PIC from raising coverage defenses, but that it should still be allowed to defend the allegation that its insureds negligently caused damages to the plaintiffs. The trial court again disagreed, ruling that PIC's neglect made it subject to a judgment by default for the plaintiffs' damages. After a hearing the court found PIC liable to the plaintiffs for approximately \$972,000. The trial court then dismissed without prejudice the claims against the doctors and clinic, upon a stipulation with the plaintiffs. The dismissal order provided that no finding would be made as to whether the doctors had been negligent.

The Court of Appeals affirmed the judgment, finding that PIC failed to show excusable neglect for its untimely answer, and that its insureds' timely answer was not sufficient to cover its own response obligation. The Wisconsin Supreme Court granted review and affirmed.

MAJORITY OPINION

In presenting its case to the Wisconsin Supreme Court, PIC did not challenge its default status, but rather focused on the consequences of default. The specific issue considered by the court was whether the timely answer served by PIC's insureds, denying the liability of *all* defendants, precluded a judgment by default against PIC for the plaintiff's damages. The *Otto* court rejected each of PIC's arguments for its position that its insureds' timely answer worked to its benefit.

First, PIC argued that its liability was dependent upon the liability of its insureds and that it could not admit their negligence by its default. The *Otto* court rejected PIC's argument as contrary to Wisconsin's "direct action" statute, which provides that any liability policy covering negligence can make the insurer directly liable to the plaintiff up to the policy limits. The court stated that an insurer's liability is derivative of the insured's *conduct*, and not the

insured's *liability*. Therefore, an insurer may be liable irrespective of whether there is a final judgment against the insured. The court concluded that by not filing an answer which denied the plaintiff's allegations, PIC in default admitted both the negligence of its insureds and its own consequent liability to the plaintiff.

Second, PIC argued that Wisconsin law permitted PIC to take advantage of its insureds' denial of negligence, despite its own default. The *Otto* court disagreed, citing Wisconsin law which provides that default judgment may be rendered if no issue of law or fact has been joined and if the time for joining has expired, both of which PIC conceded. The answer of its insureds was of no consequence.

Third, PIC argued that case law from other jurisdictions supported allowing PIC to take advantage of its insureds' answer. The cases cited involved the "common defense" doctrine, in which a codefendant's answer inures to the benefit of a defaulting defendant when a common defense exists as to both of them. In rejecting PIC's argument, the *Otto* court reasoned that none of the cases cited by PIC actually spoke to PIC's situation: "PIC concedes that it is in default and yet asserts that it is entitled to proceed indefinitely in the action as a party defendant on the issue of liability and damages."

PIC's final arguments involved the likelihood of inconsistent outcomes and public policy considerations. The *Otto* court rejected the first argument, reasoning that a judgment for damages against PIC was not inconsistent with dismissal of the action against PIC's insureds, because the direct action statute allows liability to be imposed upon an insurer even when there is no final judgment against the insured. The court also rejected the public policy argument, finding that PIC's lack of "excusable neglect" made a default judgment more appropriate than lesser sanctions. Essentially, the court concluded that PIC "caused its own problems" by such neglect.

DISSENT

Three court members disagreed with the majority. In a lengthy dissent, they argued that the case should be returned to the trial court where contested factual issues related to the insured's conduct should be litigated. The majority opinion was in error, the dissent said, because it "disconnected" PIC's liability from the insured's conduct, contrary to the purpose of Wisconsin's "direct action" statute.

The dissent emphasized that there was no allegation in the amended complaint that PIC provided negligent medical care, only that, by virtue of its insurance policy, it was "directly liable" for plaintiffs' damages. Therefore, the majority opinion ignored long-standing Wisconsin precedent that direct action liability must be conditioned on the conduct of the insured. The dissent did agree that if the insureds were found to have negligently provided medical care to Dale Otto, causing his injuries, then PIC's failure to answer in a timely manner would mean it had admitted coverage. But that was as far as the dissent would go. It forcefully rejected the notion that PIC's default conclusively established that its insureds were negligent and that the negligence caused plaintiffs' damages.

IMPLICATIONS FOR INSURERS AND THEIR COUNSEL

The obvious lesson to draw from *Otto* for any litigant or attorney is that pleadings deadlines must be carefully monitored and scrupulously met. Even under the circumstances here -- where PIC claimed inadvertence, plaintiffs' counsel could show no prejudice arising from PIC's neglect, and PIC's liability was denied through its codefendant insureds -- failure to answer within the statutory time frame was not excused. PIC chose not even to challenge that point before the Wisconsin Supreme Court, focusing instead on the consequences of such neglect. Indeed, even if the dissent had carried the day, at a minimum PIC would not have been permitted to assert any coverage defenses that may have been available if negligence and causation were proved.

The result in *Otto* was even more severe for the insurer because of Wisconsin's "direct action" statute and the court's refusal to look more closely at that law's fundamental purpose. While the statute can render an insurer "directly" liable to an injured plaintiff, such liability should be conditional. As the dissent stated, "an insurer is liable to all who are entitled to recover against the insured for the insured's negligence." That a majority of the Wisconsin Supreme Court choose to overlook the conditional aspect of an insurer's "direct" liability in a default judgment situation indicates that an insurer must show heightened sensitivity to all procedural requirements in any direct action, lest it find itself held responsible for negligence that has not even been proven. Moreover, an insurer must make sure that its own interests are properly defended in a direct action, whether by the attorney retained to defend its insured or through separate counsel.