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Expert Analysis

'K2' Ruling on Insurer Refusal To Defend Fits Within Established Law

By **Charles A. Booth**

And **Michael L. Anania**

Did the Court of Appeals adopt a new draconian penalty regarding when an insurer wrongfully fails to defend, or is the decision issued by the court on June 11, 2013, in *K2 Investment Group v. American Guar. & Liab. Ins.* a logical application of established New York law to the particular facts of that case? In an article written about the case in the June 24, 2013, edition of this publication, the authors suggest the former is true, but that position appears premature. There is a strong case to be made that the New York Court of Appeals did not deviate from existing New York law in deciding the *K2* case.

The problem with the decision is that the court arguably reached the right result, but then unnecessarily may have overstated the grounds on which its decision is based—i.e., an insurer, which breaches its duty to defend, "must indemnify…, even if policy exclusions would otherwise have negated the duty to indemnify." (Slip op., at 7.) This is an inherent problem with dicta, especially when a court writes an opinion in broad terms and does not confine the ruling to the facts in dispute.

However, as discussed below, the opinion can be understood as an example of the court reacting very negatively to what it viewed as an insurer's unjustified breach of its duty to defend its policyholder. Thus, while the court may have reached a result consistent with existing New York law, in expressing its strong disapproval of the insurer's conduct and arguments, it used language that arguably appears to go beyond existing law. This gives rise to issues that will require later resolution, such as how to reconcile *K2* with earlier decisions of New York's highest court on point and not cited by it in *K2*, e.g., *Servidone Constr. v. Security Ins.*, 64 N.Y.2d 419, 423 (1985) (the insurer that wrongfully refused to defend could still challenge its liability for indemnity based on exclusion for contractual liabilities). As we explain further, there is no indication under the actual facts of this case that the court intended to overrule well-established New York law holding that the duty to indemnify turns on actual facts (at least where such facts are not resolved by an underlying judgment), as set forth in *Servidone*, or that a breach of the duty to defend does not in itself preclude an insurer from denying the duty to indemnify.

CHARLES A. BOOTH *and* MICHAEL L. ANANIA *are partners at Ford Marrin Esposito Witmeyer & Gleser.*

Crucial Factual Context of 'K2'

The plaintiffs in the coverage action were investor companies (collectively "K2") that loaned approximately $2.8 million to a real estate company that was part owned by Jeffrey Daniels, who was also a practicing lawyer. Oddly, Daniels was alleged to have represented K2 in connection with K2's loans to Daniels' own company. In his representation of K2, Daniels was alleged to have failed to record mortgages in K2's favor to secure the loans and failed to obtain title insurance. This rendered K2's investment unsecured. The real estate company subsequently became insolvent and defaulted on the loans.

K2 sued to recover the proceeds of the defaulted loans. Two counts in K2's complaint were for legal malpractice, based on allegations that Daniels' representation of K2 in connection with the loans was negligent. Daniels thereafter tendered the suit to his legal malpractice insurer.

The malpractice claims were facially suspect. They were after all based on allegations that Daniels represented K2 in connection with loans that K2 made to Daniels' own company. Therefore, there was reason to believe that Daniels never actually represented K2 in connection with the loans, and that the claims were "really" based on Daniels' actions in respect of his side business at his real estate company, not his law practice. If so, that would defeat the malpractice counts, and would lead to no coverage for the other counts, because of the typical exclusions in such policies for liabilities arising from side businesses.

Under these circumstances, the insurer certainly would have been entitled to reserve its rights. Instead, it disclaimed altogether on the basis of the exclusions for liabilities arising from the side businesses of the lawyer, and refused to defend Daniels, even against the malpractice counts. This disclaimer arguably was improper because, while it might well have turned out that Daniels never represented K2, and so the only valid counts (if any) would have been those unrelated to the alleged malpractice, K2 clearly was suing Daniels for covered, legal malpractice, which the insurer had to defend even if that claim was "false."

Without a defense funded by the insurer, Daniels defaulted. Ultimately, K2 obtained a default judgment for approximately $3 million against Daniels, based solely on the malpractice claims, and it discontinued the other counts. Then standing in Daniels' shoes, K2 sued the insurer to collect on the judgment.

Facts Applied to Existing Law

Under established New York law, an insurer is prohibited from re-litigating any issues determined by the underlying judgment, with regard to coverage of the suit in which the judgment was rendered. In *Lang v. Hanover Insurance*, 3 N.Y.3d 350, 356 (2004), the New York Court of Appeals held that:

> [A]n insurance company that disclaims in a situation where coverage may be arguable is well advised to seek a declaratory judgment concerning the duty to defend or indemnify

> the purported insured. If it disclaims and declines to defend in the underlying lawsuit without doing so, it takes the risk that the injured party will obtain a judgment against the purported insured and then seek payment… Under those circumstances, having chosen not to participate in the underlying lawsuit, *the insurance carrier may litigate only the validity of its disclaimer and cannot challenge the liability or damages determination underlying the judgment*. (Emphasis added.)

The underlying judgment against Daniels was based solely on the allegations in the counts for malpractice in the representation of K2. Therefore, absent collusion between K2 and Daniels (which was not alleged), the insurer owed coverage, and could no longer cite exclusions for liability arising from a lawyer's side business ventures. Predictably, the intermediate appellate court affirmed summary judgment in favor of K2, and held that the exclusions were "patently inapplicable" to the insurer's duty to pay the judgment. Yet, the insurer continued to make this argument before the Court of Appeals, but never squarely explained how it could rely on exclusions for Daniels' side businesses, since it was bound to the underlying judgment imposing liability based on professional, legal malpractice.

At oral argument before the Court of Appeals, three different judges, at three separate points in time, asked the insurer's counsel to name one case that would allow it, as a wrongfully non-defending insurer, to deny its duty to indemnify, based on an effort to re-litigate facts that had been determined by an underlying judgment against the insured. The last time, one case was identified, *Hough v. USAA Cas. Ins.*, 93 A.D.3d 405 (1st Dept. 2012).

While the *Hough* opinion itself set forth almost no facts, we know, from an opinion in a related action, that the insured there had struck the tort claimant with a car, and that there was reason to believe his action was intentional. *In re Margulies*, 476 B.R. 393, 396-97 (Bankr. S.D.N.Y. 2012). The insurer in *Hough* refused to defend and a default judgment resulted, but the court allowed the insurer to contest its duty to indemnify, because the issue of whether the policyholder's tortious conduct was negligent or intentional had not been litigated and resolved in the underlying case. In that critical respect, the facts of *Hough* were opposite to those presented in *K2*.

In *K2*, there is little doubt that, notwithstanding the suspect facts, the Court of Appeals viewed the insurer's initial refusal to defend as itself an indefensible breach of its policy obligations. At least two justices pressed the insurer's counsel to concede that point, and though counsel did not do so, no real explanation was offered as to how the refusal to defend could possibly have been justified. Picking up on that point, the Court of Appeals was able to say in its opinion that:

> It is quite clear that [the insurance company] breached its duty to defend—indeed, it does not seem to contend otherwise now. (Slip op., at 5.)

In the opposing argument, K2's counsel repeatedly stated, with no real dispute from the panel, that the insurer had "walked away" from its policyholder, right at the moment in his career when he was "most vulnerable," and had blatantly refused to provide the defense it was unquestionably obligated to provide, and now is bound to the result.

In light of this essentially uncontroverted scenario, and following the court's holding in *Lang*, the Court of Appeals then stated as follows:

> [W]hen an insurer has breached its duty to defend and is called upon to indemnify its insured for a judgment entered against it, the insurer may not assert in its defense grounds that would have defeated the underlying claim against the insured…. A default judgment on the issue of liability in a legal malpractice action disposes of the issue of the lawyer's negligence and the validity of the underlying claim. (Slip op., at 6, citations & internal quotation marks omitted.)

The problem with the decision is that the court arguably reached the right result, but then unnecessarily may have overstated the grounds on which its decision is based.

The Court of Appeals could have ended there and reached the result that it ultimately reached. However, plainly disapproving of what was viewed as a case of indefensible breach by the insurer and the subsequent weak arguments it presented as justifying its handling of the claim, the Court of Appeals in dictum, stated as follows:

> [A]n insurance company that has disclaimed its duty to defend may litigate only the validity of its disclaimer. If the disclaimer is found bad, the insurance company must indemnify its insured for the resulting judgment, even if policy exclusions would otherwise have negated the duty to indemnify. This rule will give insurers an incentive to defend the cases they are bound by law to defend…. (Slip op., at 7, internal quotation marks omitted.)

It was the Court of Appeals' view that the insurer had acted badly, which apparently led the court to believe it had to create an "incentive" for insurers to live up to their duty to defend.

It is by no means certain, however, that by making this further statement, the court intended to overrule well-established New York law holding that the duty to indemnify turns on actual facts (at least where such facts are not resolved by an underlying judgment), or that a breach of the duty to defend does not in itself preclude an insurer from denying the duty to indemnify. See, e.g., *Servidone Constr. v. Security Ins.*, 64 N.Y.2d 419, 423 (1985). In fact, the court never mentioned *Servidone*, which one would have expected it to do if it were rewriting New York law on the consequences of an insurer's wrongful failure to defend. One might argue for example, that the "*Servidone* rule" and "*K2* rule" are reconcilable, such that an insurer that wrongly fails to defend may nevertheless contest indemnity coverage if the insured settles without entry of a judgment, or if the coverage defense is based on facts not resolved by the judgment. Moreover, under the facts of *K2*, the statement was entirely consistent with both *Servidone* and *Lang*.

It is also possible that, even if the above quote from *K2* is taken at face value, it will be limited to the arguably extreme facts presented in *K2*. For example, it could be limited to situations where the breach of the duty to defend was not and could not be seriously justified, or where even the refusal to indemnify is indefensible because it is based on facts that were resolved in the underlying case. Note as well that the above quote (the broadest statement by the court) refers to a breaching insurer not being entitled to deny indemnity based on "policy exclusions." Even under a broad reading, this could be limited to a holding that the breaching insurance company forfeits "exclusions," but not "coverage agreement" defenses such as named insured, trigger of coverage, or whether there was an occurrence, or "conditions" such as late notice. (None of those other coverage defenses would normally be litigated and resolved in the underlying case anyway.)

Conclusion

Based on the foregoing, there is uncertainty as to how this ruling will be applied. However, there is strong reason to expect that it will not preclude an insurer from challenging indemnity coverage if, in so doing, the insurer does not need to re-litigate facts resolved in the underlying case, even if the insurer wrongfully refused to defend the policyholder in that case. This is particularly so if the insurer's arguments are grounded in coverage defenses that are altogether irrelevant to the underlying case, and do not arise in an exclusion.