The Storm Has Passed For NY Insurance Law

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Law360, New York (February 21, 2014, 4:50 PM ET) -- This article addresses the background and impact of the extraordinary ruling on Feb. 19 by the New York Court of Appeals, vacating its own prior decision in the K2 action from last June. See K2 Investment Group LLC v. American Guarantee & Liability Insurance Co., 21 N.Y.3d 384 (2013).

As described in detail below, on reargument, the Court of Appeals found that its prior K2 decision conflicted with its own precedent, and that there was no rational reason for departing from a well-established rule of New York insurance law. The court therefore reversed its holding from last year and reaffirmed the principle that an insurer that makes a mistake and wrongfully denies a defense is not precluded from asserting its defenses to coverage for indemnity.

Impact of the Ruling on Reargument

Since last June, New York's insurance law has been roiled by the court's initial ruling in this case. That ruling appeared to hold that when an insurer breaches a duty to defend, the insurer henceforth would automatically owe indemnity coverage for which it had never charged a premium, and which the policy never actually covered.

However, if the court had actually intended to do this, that meant it consciously abandoned 30 years of firmly established New York precedent without even mentioning the existence of it. See, e.g., Servidone Const. Corp. v. Security Ins. Co., 64 N.Y.2d 419, 423-24 (1985) (cited 350-plus times in the intervening 29 years).

We did not believe the court had intended to do this. A few other states (most notably Illinois) had adopted such a rule, but applying it in New York would have been contrary to the underlying philosophy of New York jurisprudence.

The problem, we argued, arose from the following:

- The court was clearly offended by the insurer's wrongful refusal to defend its policyholder, which the insurer did not and could not even try to defend or explain on appeal;

- The judges therefore raised a new issue at oral argument, not raised in the lower courts or in the briefs, as to whether they should penalize the insurer by holding it could no longer challenge the existence of a duty to indemnify; and

- Because the case had not concerned such an issue up until that moment at oral argument, neither the court nor counsel identified or discussed the direct precedent to the contrary.

Then, in its ruling in June, the court held that the insurer could no longer deny a duty to indemnify where it incorrectly refused to defend. The opinion had language that appeared to adopt the "Illinois estoppel" rule, and legal commentators concluded that New York law had been turned on its head, in a radically anti-insurer way.

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We pointed out at the time that this ruling could be read in a much more limited way consistent with prior precedent, and that the broad language could be viewed as nonbinding dicta, resulting simply from disapproval of this particular insurer's actions. (See, e.g., "Another View on K2 Investment v. American Insurance," Law360, Sept. 10, 2013.)

We also anticipated that this court would not let the broad view of its ruling stand, and would correct the perceived departure from New York precedent.

In September 2013, the court saw the opportunity to quell the firestorm and return to long-established New York law. It granted a motion for reargument. Such action by the court is extremely rare. Then on Feb. 19, having considered reargument, the court in fact held the prior ruling was a mistake, and it vacated the ruling.

New York law now reverts to what it was before all the confusion and consternation began last June. An insurer that makes a mistake and wrongfully denies a defense still may assert its defenses to coverage for indemnity.

Context for These Events

To appreciate the impact of the Feb. 19 ruling, it is not necessary to know more than that about the background of the K2 case. But we offer here an overview of that background, in order to put these recent issues and events in context.

The K2 case arose from a facially bizarre legal malpractice claim brought against a New York attorney named Jeffrey Daniels. Certain investor companies (collectively "K2") had loaned $2.8 million to a real estate company named Goldan LLC, which Daniels partly owned. Goldan then became insolvent and failed to repay the loans. It turned out that K2's mortgages on the property had not been recorded and secured, and K2's loans were thus uncollectible.

Oddly though, K2 claimed that Daniels had represented K2 itself in the transactions and so was responsible for failing to protect K2's interests, even though Daniels was part owner of the other party to those very transactions. Zurich, as Daniels' malpractice insurer, understandably concluded that Daniels had not acted as counsel to K2 and so had not committed malpractice. But Zurich nevertheless owed Daniels a defense.

Instead of doing so, Zurich refused to defend. Daniels defaulted, and K2 obtained a default judgment, for which it then sued Zurich directly. Zurich essentially admitted it had breached its duty to defend, but claimed to owe no indemnity because of exclusions for legal malpractice claims arising out of the insured's (Daniels') status as owner, director or officer of a business enterprise.

New York law had long held that an insurer that breached a duty to defend was bound to any fact finding that occurred in the underlying action. Here, K2's default judgment against Daniels was necessarily based on findings of fact that Daniels had indeed acted as K2's counsel and had committed malpractice.

But Zurich argued that, even though it was bound to those facts, the exclusions could still apply, because the malpractice in a broad sense could still have "arisen out of" Daniels' ownership of the company to which K2 made its loans (i.e., Goldan). K2 argued to the contrary that the exclusions could no longer apply, because they only applied to malpractice claims by Daniels' own companies, not to malpractice claims by a third party.

The lower court rulings, and the briefing to the Court of Appeals, all focused on whether the exclusions could still apply, even now that a court had necessarily found that Daniels indeed had represented K2 and had committed malpractice in doing so.

The Court of Appeals could have undone the confusion of its prior ruling by clarifying that, given those underlying findings of fact, the exclusions could no longer apply, and so Zurich inevitably owed indemnity coverage for that reason. The language that had caused all the concern, about Zurich no longer being able to deny coverage, could then be explained as perhaps an inartfully broad way of simply applying the facts to established precedent.

On reargument though, the court could not resolve the case this way because it took a broad view of the exclusions. (See slip op. of 2/19/14, at pages 6-8.) That is, even though Zurich was bound to the facts about Daniels representing K2 and committing malpractice, the exclusions might still apply, the court held, if his malpractice toward K2 is found to have "arisen" from his ownership of Goldan.

The court instead resolved the crisis in a different way. It stated that it had in fact intended to hold that after breaching the duty to defend, an insurer is barred from denying coverage. (Id., at p. 2.) But the court acknowledged that this holding "cannot be reconciled" with prior New York law (id., at pages 3-4), and that there is no valid reason to change that contrary, prior precedent. (Id., at pages 5-6.)

Conclusion

In sum, it now appears clear that this episode was the result of the court being offended by the actions of the insurer, and coming up with a possible response sua sponte at oral argument, with the result that counsel and the court did not identify or consider the specific reasons and precedent against imposing such a response. In any event, the storm has now passed, and New York law with respect to insurer claim handling again stands as it did before any of this occurred.

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