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Another View On K2 Investment V. American Insurance

Law360, New York (September 10, 2013, 12:40 PM ET) -- There has been much commentary suggesting that there has been a radical change in New York insurance law based on the New York Court of Appeals' decision in K2 Inv. Group LLC v. American Guar. & Liab. Ins. Co., 2013 N.Y. Slip Op 4270 (N.Y. June 11, 2013). According to that view, the court imported into New York law a small minority, and highly criticized, rule known alternatively as "coverage by estoppel," or "the Illinois estoppel doctrine."

This view appears, for example, in a recent Law360 commentary: K2 court "adopts the minority rule for coverage by estoppel," and "an insurer's breach of its duty to defend … creates coverage."

We disagree with that view and do not believe that the court imported such a rule into New York law. To do so would have been unnecessary in the K2 case and would have completely changed existing New York law on the subject without even a reference to prior law.

K2 is best understood simply as a routine opinion that reached the right result under established legal principles applied to the facts of that case. We further believe that the court's extraordinary action, taken on Sept. 3, to grant reargument of K2 confirms that the perceived dominant view of that opinion is not what the court intended, and so, the court now intends to correct that misperception.

The court, in recent years, has granted less than 1 percent of reargument motions, and to do so here clearly telegraphs the court's concern over its initial opinion and how it is being construed.

As context, in jurisdictions that follow the coverage-by-estoppel rule, where an insurer denies a defense that the insurer is later held to have owed, the insurer must also provide indemnity coverage even if the policy did not require the insurer to do so. Thus, as a special penalty for this particular kind of breach of contract, the insurer is forced to insure a risk it never actually covered and for which it never charged a premium. This has never been the rule in New York.

In K2, the insurer had denied a defense under a legal malpractice policy, based on certain exclusions for a lawyer's outside, nonlegal business ventures. It appeared that the claims may have arisen from outside work in real estate development rather than from the practice of law.

However, after the lawyer's default, the trial court entered judgment against him based on legal malpractice, thus adjudicating that the claim in fact arose from his insured law practice.

Under established law, the insurer could not reargue facts already adjudicated against the insured lawyer. Therefore, the insurer could no longer rely on exclusions for side business activity because this had been adjudicated to be a legal malpractice claim.

Thus, the insurer owed not only a defense but also owed indemnity coverage. Yet, the insurer nevertheless continued to cite the exclusions. The K2 court simply applied established law and concluded that the insurer had no valid reason to continue to deny its defense duty and that the insurer also owed indemnity coverage. None of this is controversial.

In most cases though, where an insurer denies a defense, there is no underlying judgment that resolves the disputed facts. This more typical scenario is presented in Servidone Construction Corp. v. Security Ins. Co., 64 N.Y.2d 419 (1985). There, the insurer's denial of a defense was found to

be error, but the underlying case ultimately settled (i.e., there was no judgment and no underlying resolution of any disputed facts).

In the resulting coverage case, the lower courts summarily held that the wrongful denial of a defense created coverage for indemnity. The Court of Appeals, though reversed, specifically held that "an insurer's breach of its duty to defend does not create coverage and that … there can be no duty to indemnify unless there is first a covered loss." Id., at 423.

This is the result because "[t]he duty to defend is measured against the allegations of pleadings but the duty to pay is determined by the actual basis for the insured's liability to a third party." Id., at 424. By contrast, the lower court had "enlarged the bargained-for coverage as a penalty for breach of the duty to defend, and this it cannot do." Id.

Servidone is a highly respected and oft-cited ruling. Shepardizing it shortly after the K2 decision yielded nearly 350 favorable citations over the course of 28 years. It is not possible that the Court of Appeals would have intended to cast aside Servidone, and its extensive progeny, without even mentioning it. Plus, the K2 ruling is correct on its facts, without any need to cast aside the Servidone rule.

So why have so many commentators concluded that the Court of Appeals in K2 adopted coverage by estoppel without mentioning the word "estoppel" and cast aside Servidone without a whisper of that name?

It is because of this: In the course of its short opinion, the K2 court cited language from an earlier opinion (Lang v. Hanover Ins. Co., 3 N.Y.3d 350 (2004)), in which the court stated that (just as was the case in K2) where an insurer declines to defend, and "the injured party … obtain[s] a judgment against the purported insured," then the insurer "may litigate only the validity of its disclaimer" and may not challenge any determinations "underlying the judgment" that was reached in the case below. K2, 2013 N.Y. Slip Op 4270 (quoting Lang and then concluding that if the denial of a defense "is found bad, the insurance company must indemnify its insured for the resulting judgment").

Thus, it appears that K2 simply confirmed that when an insurer denies a defense where instead it should have defended, and a judgment is then entered against the insured, the insurer cannot relitigate issues that were resolved in that judgment. That was the situation in K2, and it was the situation discussed in Lang.

Reading K2 as limited to its actual situation also avoids the absurd conclusion that the court in K2 meant to silently overrule the firmly established and widely followed Servidone ruling without even mentioning it.

Even beyond that, it makes no sense to assume that, sub silentio or not, the New York Court of Appeals meant to adopt the Illinois estoppel doctrine and implement as a routine "penalty" the creation of coverage rights that never existed.

Both in the general commercial context and in insurance law in particular, given New York's historical role as a commercial capital, its law has always placed the highest importance on predictable, literal, nonpunitive rules of contract construction. This has been consciously in contrast to more subjective efforts elsewhere to use the law to try to achieve what may seem to be "abstract justice" in individual, commercial transactions.

Special, onerous penalties for certain categories of breaches could not be more inconsistent with that historical approach. Moreover, courts and commentators have long criticized the special, punitive, minority rule that so many commentators now (we believe) wrongly assume has become the law of New York.[1]

In sum, we expect that the Court of Appeals will clarify on reargument that the dominant interpretation of the scope of K2 is not correct and that the court did not intend to, and in fact did not, import the extreme, minority "coverage by estoppel" doctrine into New York law.

In the meantime, insurers must not simply accept that dominant interpretation. Rather, they must be prepared to explain how K2 is a routine, correct ruling that does not and could not have been intended to, cast aside settled New York precedent or import a small-minority view on a crucial issue of insurance law.

The initial interpretations of the K2 decision should not be considered controlling in any event since the court's decision to allow reargument should for now render its June 11, 2013, ruling inoperative.

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[1] See, e.g., A. Windt, Insurance Claims & Disputes §4.37 (6th ed. [2013]) ("The vast majority of cases have properly held that an insurer's unjustified refusal to defend does not estop it from later denying coverage under its duty to indemnify"). See also Morales v. Zenith Ins. Co., 714 F.3d 1220, 1227 (11th Cir. 2013) (Florida law) (an insurer's liability depends upon whether a claim is covered by the policy "even when the insurer has unjustifiably failed to defend its insured in the underlying action"); Capital Environmental Servs. Inc. v. North River Ins. Co., 536 F. Supp. 2d 633, 645 (E.D. Va. 2008) (VA law) ("even if an insurer breaches the duty to defend, [i]t remains free ... to argue that the assumed liability was not in actuality covered under its policy, and thus no duty to indemnify arises"); Polaroid Corp. v. Travelers Indem. Co., 414 Mass. 747, 762, 610 N.E.2d 912 (Mass. 1993) ("A failure to defend does not bar an insurer from contesting its indemnity obligation."); American States Ins. Co. v. State Auto Ins. Co., 721 A.2d 56, 64 (Pa. Super. Ct. 1998) ("[W]e will not adopt a blanket rule that if there is a breach of a duty to defend and a settlement, then it automatically requires the breaching insurer to indemnify").