Westlaw Journal
INSURANCE COVERAGE
Litigation News and Analysis • Legislation • Regulation • Expert Commentary
VOLUME 23, ISSUE 44 / AUGUST 9, 2013

Expert Analysis

High-Stakes Poker In New York Over Insurer's Decision Not To Defend Its Insured

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It is axiomatic that if a claim against an insured is clearly not covered by the policy, the insurer has no duty to defend the insured.[1] Where there is no possibility that any of the underlying claims could be covered by the policy, a judgment in favor of the insurer regarding the duties to defend and indemnify may be appropriate.

The insurer may be relieved of its duty to defend in a very limited number of circumstances. As an example, an insurer would have no duty to defend when the facts underlying a claim arise after the policy period expires.[2] As another example, if no form of relief sought by the plaintiff is recoverable, then the insurer may not have a duty to defend.[3] Where the policy provides no potential basis for coverage, the liability insurer is under no duty to defend.[4]

The insurer's duty to defend is not absolute and is measured by the nature and kinds of risks covered by the policy.[5] In order to defeat a duty to defend, generally, the insurer must establish that there is no factual or legal basis on which the insurer might eventually be held liable to indemnify the insured.[6]

A wrongful failure to defend the insured can result in a variety of exposures that include the payment of attorney fees and costs,[7] exposure for judgments entered against the insured in excess of the policy limits,[8] consent settlements entered into by the insured,[9] and potential exposure for bad faith.

Another exposure exists when an insurer is found to have breached its duty to defend. This exposure presents in the form of estoppel. The major proponent of the estoppel approach is the state of Illinois.

The so-called "Illinois rule" prohibits insurance companies from using policy provisions or exclusions to deny coverage for a claim when they wrongfully breach their duty to defend.[10] Most states do not follow the Illinois rule.[11] Those courts that have rejected the Illinois rule have found that the duty of indemnity and the duty to defend are separate and distinct contractual duties that must be addressed individually such that if the insurer breaches its duty to defend, it should not be estopped from arguing that it does not have a duty to indemnify.[12]

Recently, the New York Court of Appeals embraced the Illinois rule in *K2 Investment Group LLC v. American Guarantee & Liability Insurance Co.*[13] The state high court held that "when a liability insurer has breached its duty to defend its insured, the insurer may not later rely on policy exclusions to escape its duty to indemnify the insured for a judgment against him."[14]

The case involved a suit by two plaintiffs that had made loans totaling $2.83 million to a third-party company, Goldan LLC. The loans were to be secured by mortgages on the property. When Goldan failed to repay the loans, the plaintiffs discovered that the acquired mortgages had not been recorded. Thereafter, Goldan filed for bankruptcy.

The plaintiffs sued Goldan and two of its principals, asserting various claims. A legal malpractice claim was asserted against one of Goldan's principals, lawyer Jeffrey Daniels. It was alleged that Daniels' failure to record the mortgages was "a departure from good and accepted legal practice."[15]

Daniels notified American Guarantee & Liability Insurance Co., his malpractice insurer, regarding the claim and provided a copy of the complaint to the insurer. American Guarantee disclaimed coverage and its duty to defend the lawsuit, asserting that the allegations made against Daniels were not "based on the rendering or failing to render legal services for others."

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Following this disclaimer, the plaintiffs sent a settlement demand to Daniels for an amount significantly less than the policy limits of the American Guarantee policy. The insurer rejected the settlement demand.[16]

Daniels defaulted in the underlying action, which allowed the plaintiffs to obtain a default judgment in excess of the American Guarantee policy limit. The court entered judgment only on the malpractice claims, and the other claims asserted against Daniels were discontinued. After the entry of judgment, Daniels assigned all his rights against American Guarantee to the plaintiffs. In turn, the plaintiffs, as Daniels' assignees, sued the insurer for breach of contract and bad-faith failure to settle.

American Guarantee moved for summary judgment, relying upon two policy exclusions. In a split ruling, the Supreme Court Appellate Division (with two justices dissenting in part) held that the exclusions American Guarantee relied upon were inapplicable to the malpractice claim upon which the default judgment was based.[17]

The dissent simply concluded that fact issues existed as to whether the exclusions applied.[18] The New York Court of Appeals affirmed judgment in favor of the plaintiffs on the breach-of-contract claims without reaching the question of whether the two exclusions relied upon by American Guarantee did in fact apply to preclude indemnification. The high court found that it was clear from the record that American Guarantee breached its duty to defend and then observed that it did not appear that the insurer contended otherwise.[19]

The underlying lawsuit brought against Daniels "unmistakably" pleaded a claim for legal malpractice. Although the court found that it was appropriate for American Guarantee to be skeptical of the merits of the claim, given how unusual it was for lenders to retain a principal of the borrower to act as their lawyer in a loan transaction as was alleged, that situation only meant that the claims against Daniels may have been "groundless, false or baseless ... meritless or not covered," which did not allow American Guarantee to escape its duty to defend.[20]

Clarifying prior case precedent,[21] the court found that "an insurance company that has disclaimed its duty to defend 'may litigate only the validity of its disclaimer.'"[22] If the disclaimer is found to be wrongful, the insurer is then required to indemnify the insured for the resulting judgment, "even if policy exclusions would otherwise have negated the duty to indemnify."[23]

The court explained its adoption of estoppel (the Illinois rule) as follows:

> This rule will give insurers an incentive to defend the cases they are bound by law to defend, and thus to give insureds the full benefit of their bargain. It would be unfair to insureds, and would promote unnecessary and wasteful litigation, if an insurer, having wrongfully abandoned its insured's defense, could then require the insured to litigate the effect of policy exclusions on the duty to indemnify.[24]

Recently, the New York Court of Appeals embraced the Illinois rule.

The New York Court of Appeals' decision in the case does not leave much room for insurance companies to successfully argue against the attachment of a duty to defend. Because New York has adopted the "allegations of the complaint supplemented by extrinsic evidence"[25] approach to the triggering of the duty to defend,[26] it is probable that most insurers will now defend against virtually all liability cases under a reservation of rights.[27] The estoppel approach is a minority view that ignores the fact that the duty to defend is a separate and distinct duty from the duty to indemnify.[28]

NOTES

1 Steven Plitt & Jordan R. Plitt, Practical Tools for Handling Insurance Cases, § 2:16, p. 2-93 (Thomson Reuters 2011).

2 *See, e.g., Baroco West Inc. v. Scottsdale Ins. Co.*, 110 Cal. App. 4th 96, 1 Cal. Rptr. 3d 464 (Cal. Ct. App., 4th Dist. 2003).

3 *See, e.g., United States v. Thorson*, 300 F. Supp. 2d 828 (W.D. Wis. 2003) (interpreting Wisconsin law).

4 *Ananda Church of Self-Realization v. Mass. Bay Ins. Co.*, 95 Cal. App. 4th 1273, 116 Cal. Rptr. 2d 370 (Cal. Ct. App., 3d Dist. 2002).

5 *Cunningham v. Universal Underwriters*, 98 Cal. App. 4th 1141, 120 Cal. Rptr.2d 162 (Cal. Ct. App., 4th Dist. 2002).

6 *Cotter Corp. v. Am. Empire Surplus Lines Ins. Co.*, 90 P.3d 814 (Colo. 2004), *as modified on denial of reh'g* (June 7, 2004).

7 *See* Practical Tools for Handling Insurance Cases, § 2:16, p. 2-96, n.17 (citing cases).

8 *See id.*, § 2:16, p. 2-96, n.18 (citing cases).

9 *See id.*, § 2:16, p. 2-97, n.19 (citing cases).

10 *See id.*, § 2:16, p. 2-97, n.21 (citing cases).

11 *See id.*, § 2:16, p. 2-97.

12 *See id.*, § 2:16, p. 2-97 (citing cases).

13 *K2 Inv. Group LLC v. Am. Guar. & Liab. Ins. Co.*, 2013 N.Y. Slip Op. 04270, at *3-4, 2013 WL 2475869 (N.Y. June 11, 2013).

14 *Id.* at *1-2.

15 *Id.* at *2.

16 *Id.* at *2.

17 *See K2 Inv. Group LLC v. Am. Guar. & Liab. Ins. Co.*, 91 A.D.3d 401, 936 N.Y.S.2d 139 (N.Y. App. Div., 1st Dep't 2012).

18 *Id.* at 405-411 (Andreas, J. dissenting).

19 *K2 Inv. Group,* 2013 N.Y. Slip Op. 04270, at *3-4.

20 *Id.* at *4.

[21] The Court of Appeals referenced *Lang v Hanover Insurance Co*., 3 N.Y.3d 350, 356 (2004), where the court stated: "[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 court acknowledged that *Lang* did not involve a situation directly applicable to the facts before the court. However, the court wanted to make clear that *Lang* applied to situations like those before the court.

[22] *K2 Inv. Group*, 2013 N.Y. Slip Op. 04270, at *5.

[23] *Id*.

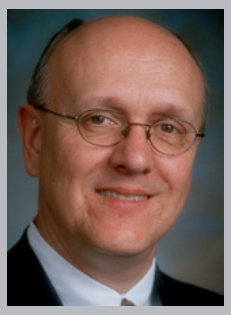
[24] *Id*.

[25] *See* Practical Tools for Handling Insurance Cases, § 2:12, p. 2-84.

[26] *See Fitzpatrick v. Am. Honda Motor Co.*, 78 N.Y.2d 61, 571 N.Y.S.2d 672, 575 N.Y.2d 90 (1991).

[27] *See* PRACTICAL TOOLS FOR HANDLING INSURANCE CASES, § 2:17, pp. 2-99 – 2:108 for a discussion of reservation of rights defenses.

[28] *See id.*, § 2:1, pp. 2-2 – 2-4 discussing the difference between the two duties.



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