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New York's Highest Court Sends Clear Message to Liability Insurance Companies: Disclaim the Duty to Defend at Your Own Peril

By Allen R. Wolff and Eric R. Reed

The New York Court of Appeals' June 11, 2013 opinion in *K2 Investment Group, LLC v. American Guarantee & Liability Ins. Co.*, 21 N.Y.3d 384, 993 N.E.2d 1249 (2013) reiterated a clear message to liability insurance companies: disclaim the duty to defend a policyholder at your own peril. If the insurance company is later found to have done so unjustifiably, *K2 Investment Group* confirms that the insurance company may not thereafter deny coverage and must instead indemnify its policyholder "even if policy exclusions would otherwise have negated coverage."

New York's Highest Court Reconfirms That Insurance Companies May Need "An Incentive to Defend"

K2 Investment Group arose from a business dispute in which the plaintiff loaned approximately $2.8 million to a corporation, secured by mortgages on property held by the corporation's two principals. The plaintiff, K2 Investment Group, soon discovered the mortgages were not recorded, which prejudiced its rights as a creditor when the corporation defaulted and entered bankruptcy. K2 sued the corporation and the principals. Among the claims asserted by K2 was a cause of action for legal malpractice against one of the principals, an attorney, who had also been responsible for drafting and recording K2's mortgages.

The attorney's legal malpractice carrier, American Guarantee, disclaimed its duty to defend on the grounds that the principal was acting as a businessman, not an attorney, when he neglected to record the mortgages. K2 obtained a default judgment and an assignment of rights from the principal, and it then sued American Guarantee for breach of contract. The trial court granted judgment in favor of K2; the Appellate Division affirmed in full. The Court of Appeals likewise upheld the result, and further clarified and confirmed a remedy espoused nine years earlier in *Lang v. Hanover Ins. Co.*, 3 N.Y.3d 350, 820 N.E.2d 855 (2004):

> [W]e now make clear that *Lang*…means what it says: an insurance company that has disclaimed its duty to defend "may litigate only the validity of its disclaimer …" If

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> 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, and thus to give insureds the full benefit of their bargain. *K2 Investment Group*, 21 N.Y.3d at 391.

Estoppel Rule Gaining Steam in the States

K2 Investment Group confirms that the estoppel rule applies in New York, as it does in at least four other states. The Illinois Supreme Court was an early and ardent proponent of this remedy:

> The general rule of estoppel provides that an insurer which takes the position that a complaint potentially alleging coverage is not covered under a policy…may not simply refuse to defend the insured. Rather, the insurer has two options: (1) defend the suit under a reservation of rights or (2) seek a declaratory judgment that there is no coverage. If the insurer fails to take either of these steps and is later found to have wrongfully denied coverage, the insurer is estopped from raising policy defenses to coverage.

(*Employers Insurance of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134-35 (Ill. 1999), citations omitted.)

Ehlco explained how an insurance company's failure to defend a policyholder was not just a breach, but a repudiation, of the contract:

> The estoppel doctrine has deep roots in Illinois jurisprudence. It arose out of the recognition that an insurer's duty to defend under a liability insurance policy is so fundamental an obligation that a breach of that duty constitutes a repudiation of the contract.

(*Id*., at 1135, citing *Kinnan v. Charles B. Hurst Co.*, 148 N.E. 12, 14 (Ill. 1925), emphasis added.)

Pulte Home Corp. v. American Southern Ins. Co., 647 S.E.2d 614 (N.C. App. 2007) described North Carolina's approach. A subcontractor's employee sued the general contractor and subcontractor for negligence after falling and injuring himself. The subcontractor's commercial general liability insurance company denied coverage and refused to defend the contractor. American Southern prevailed on summary judgment, but the appellate court reversed:

> It is well established in North Carolina that "when an insurer without justification refuses to defend its insured, the insurer is estopped from denying coverage and is obligated to pay the amount of any reasonable settlement made in good faith by the insured…"

(*Id*. at 617, citing *Ames v. Cont'l Cas. Co.*, 340 S.E.2d 479, 486 (N.C. App. 1986).)

The North Carolina court warned that "an insurer undertakes a substantial risk when it chooses not to provide a defense." (*Id*.) The duty to defend is excused only "if the facts are not even arguably covered by the policy." (*Id*. at 620, quoting *Waste Mgmt. of Carolinas, Inc. v. Peerless Ins. Co.*, 340 S.E.2d 374, 376 (N.C. 1986).) The court determined that American Southern had a duty to defend its insured, and awarded the contractor the full amount of its settlement with the employee as well as attorney's fees and costs.

Connecticut's implementation of the estoppel rule, termed the "Rule of Messengers," arises from the Connecticut Supreme Court's *Missionaries of the Company of Mary, Inc. v. Aetna Casualty and Surety Co.*, 230 A.2d 21 (Conn. 1967). The court reasoned that an insurance company should not be permitted to benefit from its breach:

> The defendant, after breaking the contract by its unqualified refusal to defend, should not thereafter be permitted to seek the protection of that contract in avoidance of its indemnity provisions. Nor should the defendant be permitted…to cast upon the plaintiff the difficult burden of proving a causal relation between the defendant's breach of the duty to defend and the results which are claimed to have flowed from it.

(*Id*., at 26, citing *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966).)

Reargument of K2 Set for January 2014

K2 Investment Group immediately caught the attention of the insurance industry. American Guarantee moved for reargument, while the Complex Insurance Claims Litigation Association and the American Insurance Association filed a brief as *amici curiae* in favor of the motion. The Court of Appeals granted the motion without comment and scheduled reargument for January of 2014.

If Defense is Improperly Denied, Estoppel May Obligate the Insurance Company to Pay for the Loss

If paying defense costs is the only consequence an insurance company faces for breaching its duty to defend the insured, an insurance company has a financial incentive to "kick the can down the road." The policyholder is left to defend itself in the underlying action, while simultaneously and separately having to pursue legal recourse against its insurance company. *Lang* and now *K2 Investment Group* confirm that New York will no longer abide insurance companies that abandon their policyholders in this way. Anderson Kill will monitor the developments in *K2 Investment Group* and provide additional commentary when New York's highest court issues its final decision.

About Anderson Kill

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