Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

NY Strikes Fear Into Insurers Waffling On Defense Coverage

By **Bibeka Shrestha**

Law360, New York (June 12, 2013, 8:52 PM ET) -- The New York Court of Appeals rattled insurers Tuesday when it punished American Guarantee & Liability Insurance Co. for violating its duty to defend by holding the insurer could no longer rely on policy exclusions to avoid covering an underlying judgment, making clear that such breaches will come with heavy consequences.

New York's high court found that insurers that wrongly refuse to defend their policyholders can only litigate the validity of their disclaimer of coverage and can no longer point to policy exclusions that otherwise would have saved them from covering a judgment or settlement in the underlying suit, according to the ruling.

Attorneys differed on whether the decision created a new rule in New York or merely reaffirmed existing law on the duty to defend, but they agreed that the holding means insurers will have to tread carefully when deciding whether to deny coverage.

Randy Maniloff, a White and Williams LLP attorney and author of the insurance law newsletter Coverage Opinions, said the ruling would fundamentally change how insurers approach their duty to defend policyholders, an obligation that courts typically interpret broadly.

"Even if the insurer believes that its risk of being wrong is very low, it may now choose to defend because of the significant consequences of a duty being found to have been owed," Maniloff said. "Insurers will decide to pay defense costs as a small premium for insurance against losing the ability to disclaim coverage for what could be significantly higher amounts."

According to Bill Passannante, the co-chair of Anderson Kill & Olick PC's insurance recovery group, Tuesday's ruling doesn't mark a sea change in New York law, but it would still benefit policyholders. It warns insurance counsel and claims handlers to proceed cautiously when receiving a claim for defense coverage, he said.

Some jurisdictions have gone even further than New York and awarded attorneys' fees and multiplied damages to policyholders who were wrongly denied a defense, according to Passannante.

"To have the Court of Appeals to say that the breach of the duty to defend is severe enough that there will be a consequence is another important reaffirmation of the defense obligation," Passannante said.

On Tuesday, the New York Court of Appeals held American Guarantee could not rely on policy exclusions to avoid covering a roughly $3 million default judgment in a legal malpractice suit because it had breached its duty to defend K2 Investment Group LLC and ATAS Management Group.

To support that finding, the high court turned to its 2004 decision in Lang v. Hanover Insurance Co., which made clear that when an insurer wrongfully refuses to defend an underlying suit, it can't try to relitigate its policyholder's liability or damages in the underlying suit after the fact.

The Court of Appeals said the Lang court meant what it said when it held an insurer that violates its defense obligations could only "litigate the validity of its disclaimer."

When it's held that an insurer breached its duty to defend a policyholder, that insurer cannot later rely on policy exclusions to escape its duty to indemnify the policyholder for an underlying judgment, the court said.

"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," the high court said. "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 the policy exclusions on the duty to indemnify."

The Court of Appeals noted, though, there may be exceptions to that rule if, for example, public policy would prevent an insurer from covering a judgment for intentional wrongdoing, but that was not the case here.

The decision clears up lingering uncertainty in New York law and provides a cautionary tale for insurers, said Jeffrey Kingsley, a partner in Goldberg Segalla's global insurance services practice group.

It will encourage insurers to provisionally defend their policyholders when there's a close call on coverage and then bring a declaratory action in court to determine their true obligations, Kingsley said.

"It demonstrates the risks associated with a carrier disclaiming coverage," Kingsley told Law360. "If you on the front end, fail your duty to defend, on the back end, you're limited only to the disclaimer."

Matthew Jacobs, a partner at Jenner & Block LLP, said the American Guarantee decision will raise the stakes for insurers that are trying to determine whether to defend a policyholder, but that it falls in line with what courts have ruled for decades.

"The court is embracing the breadth and scope of the duty to defend as it was intended," Jacobs said. "If you don't impose a consequence on an insurer for breaching its duty to defend, then it's an empty promise."

K2 and ATAS are represented by the Law Offices of Michael A. Haskel.

American Guarantee is represented by Robert Kelly of Coughlin Duffy LLP.

The case is K2 Investment Group v. American Guarantee & Liability Insurance Co., case number 106, in the Court of Appeals of the State of New York.

--Editing by John Quinn and Jeremy Barker.
