

Client Alert

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An Insurer Who Wrongfully Refuses to Defend its Insured in New York Cannot Rely on Policy Exclusions to Contest its Duty to Indemnify

On June 11, 2013, the New York Court of Appeals held, in *K2 Investment Group, LLC et al., v. American Guarantee & Liability Insurance Company*, No. 106, 2013 WL 2475869 (N.Y. June 11, 2013), that an insurer who breaches its duty to defend must indemnify its insured for the resulting judgment, even if policy exclusions would otherwise have negated the duty to indemnify.

Background

This case stems from a legal malpractice action against Jeffrey Daniels, who was a principal of an entity that borrowed money from plaintiffs. Plaintiffs claimed that Daniels also acted as their attorney with respect to the loans and that his failure to record mortgages amounted to malpractice.

American Guarantee & Liability Insurance Company (AGLIC) was Daniels's malpractice insurer. AGLIC refused to provide defense or indemnity coverage for the claim against Daniels on the grounds that the allegations were not based on the rendering or failure to render legal services for others. Following AGLIC's disclaimer, plaintiffs demanded \$450,000 from Daniels to settle the claim. AGLIC refused to pay this demand, maintaining its disclaimer of coverage.

After AGLIC refused to pay the settlement demand, plaintiffs obtained a default judgment against Daniels in excess of the \$2 million policy limit. Daniels assigned to plaintiffs all his rights against AGLIC. Plaintiffs brought an action against AGLIC seeking \$2 million for breach of contract and the full amount of the default judgment for bad faith failure to settle.

AGLIC argued that two policy exclusions defeated coverage for the judgment. The "insured's status" exclusion precluded coverage for claims based upon or arising out of the insured's capacity as an officer, director, partner, shareholder, trustee, manager or employee of a business enterprise. The "business enterprise" exclusion precluded coverage when the acts or omissions giving rise to the claim were in connection with a business enterprise in which any insured has a controlling interest.

The lower court dismissed the bad faith claim, but granted summary judgment for plaintiffs that AGLIC was liable for the \$2 million judgment because it breached its duty to defend and the exclusions did not apply.

Holding

Upon review, the New York Court of Appeals held that AGLIC was liable for the \$2 million judgment because it breached its duty to defend. The court held that it need not address the applicability of the policy exclusions because AGLIC lost its right to rely on these exclusions when it wrongfully declined to defend.

In New York, an insurer has a duty to defend whenever the allegations of the complaint "suggest a

reasonable possibility of coverage ... no matter how groundless, false or baseless the suit may be.” The court acknowledged that AGLIC had reason to be skeptical of the malpractice claim against Daniels because it is unusual in a loan transaction for lenders to retain a principal of a borrower as their counsel. But AGLIC’s broad duty to defend applied even to a seemingly groundless claim. There was no evidence of collusion between plaintiffs and Daniels to plead a claim covered by insurance.

In New York, when an insurer breaches its duty to defend and is called upon to indemnify for a judgment against its insured, the insurer may not assert defenses that would have defeated the insured’s liability for the underlying claim, but may only litigate the validity of its disclaimer of coverage. This case presented a different scenario because AGLIC was not asserting defenses to Daniels’s liability, but was relying on policy exclusions. The court of appeals has now extended the rule to mean that where a disclaimer of the duty to defend is wrongful, the insurer must indemnify its insured for the resulting judgment and cannot rely on policy exclusions, even if they would otherwise have negated the duty to indemnify.

The court explained that this rule strongly incentivizes insurers to defend the cases they are contractually bound to defend. The court viewed it as unfair to force insureds to litigate the effect of policy exclusions on the duty to indemnify where an insurer had already wrongfully declined to defend. The court did, however, recognize that this rule does not bar an insurer who breaches its duty to defend from asserting that indemnifying a judgment would violate public policy where, for example, the insured’s misconduct was willful.

Implications

This decision should prompt insurers to evaluate a decision to decline a defense with even greater scrutiny. Insurers should separately evaluate potential coverage for defense and indemnity. A strong defense to indemnity coverage may influence the insurer’s decision on whether to provide a defense. The duties, however, are separate, and an insurer who declines to defend does so at some risk. Insurers may be less likely to refuse to defend even when they think the claim has no merit and that they have valid defenses to indemnity coverage. There may also be an uptick in declaratory judgment actions brought by insurers seeking to avoid the heavy consequences for breaching a defense obligation. Further, because the court noted that an insurer who breaches its duty to defend may still assert public policy defenses to indemnity, there may be renewed attempts by insurers to expand public policy restrictions on coverage.

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