wiley

NEWSLETTER

New York High Court: Insurer May Not Rely on Policy Exclusions If It Breaches Duty to Defend

June 12, 2013

The New York Court of Appeals, applying New York law, has held that, where an insurer breaches its duty to defend, the insurer "may not later rely on policy exclusions to escape its duty to indemnify the insured for a judgment . . . ." *K2 Invest. Group, LLC v. Am. Guar. & Liab. Ins. Co.*, 2013 WL 2475869 (N.Y. June 11, 2013). The court also held that the lower court properly dismissed claims alleging bad faith for failing to accept a demand within limits prior to the entry of the default judgment.

The insurer issued to a law firm a professional liability policy with a $2 million aggregate and per claim limit of liability. Plaintiffs in the underlying action made loans to a real estate investment company. A lawyer associated with the insured law firm was also a member of the real estate investment company. Plaintiffs alleged that the lawyer, acting as their attorney, failed to record mortgages in plaintiffs' favor to secure their loans. The real estate investment company subsequently became insolvent and never made payments on the unsecured loans. Plaintiffs sued the lawyer and made a settlement demand of $450,000. The insurer denied coverage for the underlying litigation and settlement demand based on policy exclusions for claims arising out of the insured's capacity or status as a director or officer of a business enterprise and for claims arising out of alleged acts or omissions of the insured for any business enterprise in which the insured had a controlling interest. The lawyer failed to appear in the litigation, and a default judgment in excess of the policy limits was entered against him. The lawyer then assigned his claims against the carrier, including bad faith claims, to plaintiffs. In the

Authors

Jason P. Cronic
Partner
202.719.7175
jcronic@wiley.law

resulting declaratory judgment action, the trial court found that the insurer breached its duty to defend, and the intermediate appellate court affirmed, holding that the exclusions relied upon by the insurer were inapplicable.

On appeal, the New York high court affirmed. In so doing, the court determined that the underlying complaint "unmistakably [pled] a claim for legal malpractice" within the scope of coverage of the policy. Accordingly, the court noted that it would not reach the issue of whether the exclusions relied upon by the insurer applied to bar coverage, because, where it is "quite clear" that the insurer breached its duty to defend, "by breaching its duty to defend [the insurer] lost its right to rely on these exclusions in litigation over its indemnity obligation." Additionally, relying on *Lang v. Hanover Insurance Co.*, 820 N.E.2d 855 (N.Y. 2004), the court stated that an insurer disclaiming coverage "is well advised to seek a declaratory judgment concerning the duty to defend or indemnify the purported insured . . . . [because 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." The court explained that "an insurance company that has disclaimed its duty to defend 'may litigate only the validity of its disclaimer.' If 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."

The court explained that "[t]his 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 court noted, however, that there may be exceptions to this rule, citing as an example a scenario in which an insured's conduct was intentional such that public policy could prohibit the insurability of intentional wrongdoing.

The court also held that the lower courts properly dismissed the bad faith claims against the insurer. In this regard, the court stated that "[a]n insurer's rejection of a settlement offer for less than the full amount of its policy does not by itself establish the insurer's bad faith, even when the insured later suffers a judgment greater than the policy limit." The court further noted that the plaintiffs failed to allege any facts that evidenced bad faith on the part of the insurer.