

New York Federal Court: Prior to Judicial Determination of No Coverage, Insurer Has Duty to Advance Defense Costs

July 2008

The United States District Court for the Southern District of New York has held that, under New York law, an insurer has a duty to advance defense costs until it obtains a judicial determination that its policy does not afford coverage. *Axis Reinsurance Company v. Bennett*, No. 07-7924 (GEL), 07-9420 (GEL), 07-9842 (GEL), 07-10302 (GEL) (S.D.N.Y. Jun. 26, 2008). While the court held that an insurer could negate that duty by including explicit policy language stating that it reserved the right unilaterally to deny coverage, the court held that the language in the policy at issue was ambiguous, and thus the insurer had a present duty to advance defense costs.

The insurer had denied coverage for various underlying lawsuits based on a prior knowledge exclusion and warranty exclusion. After the insured company entered bankruptcy, the insurer filed suit in the bankruptcy court seeking a declaration of no coverage. Various former directors and officers filed counterclaims seeking, among other things, an injunction requiring the insurer to advance defense costs for the underlying lawsuits. The directors and officers pointed to a provision in the policy stating that "[t]he Insurer will pay covered Defense Costs on an as-incurred basis. If it is finally determined that any Defense Costs paid by the Insurer are not covered under this Policy, the Insureds agree to repay such non-covered Defense Costs to the Insurer" (the "Advancement Provision"). The bankruptcy court held that the propriety of the insurer's coverage denial was contested and could not presently be adjudicated, both because the coverage issues implicated issues of fact that would be determined in the underlying lawsuits and because the insureds contended that the prior knowledge exclusion and warranty were not properly a part of the insurer's policy. Nevertheless, the bankruptcy court entered an injunction in favor of the insureds and ordered the insurer to advance defense costs.

On appeal, the district court affirmed the bankruptcy court's ruling. The court initially asserted that, under New York law, an insurer's "duty to pay for the defense of its insured" is a heavy one. The court did not differentiate between a duty to defend and a policy providing for advancement of defense costs. The court further maintained that, in order to relieve itself of the duty to advance defense costs based on an exclusion, the insurer must show that "no legal or factual basis exists that would potentially obligate the insurer to indemnify

the insured," and that "as a matter of law the allegations in the complaint could not give rise to any obligation to indemnify, or the allegations fall within a policy exclusion."

Focusing on the Advancement Provision, the court characterized the parties' dispute as centering on "who bears the burden of uncertainty regarding whether defense costs are ultimately covered" during the time the coverage litigation is pending. The insurer argued that the Advancement Provision obligated it only to advance "covered" Defense Costs on a contemporaneous basis. The insurer further noted that, unlike the fraud and personal profit exclusions in the policy, neither the warranty letter nor prior knowledge exclusion required a "final adjudication adverse to the Insured" before taking effect. In contrast, the insureds argued that use of the term "covered" in the first sentence of the Advancement Provision meant only that "as long as a claim on its face falls within the policy's insuring agreement, it is covered unless and until there is a final determination that an exclusion applies." The insureds further argued that, based on the second sentence of the Advancement Provision, a "final determination" of non-coverage was required to terminate the insurer's advancement obligation, regardless of the lack of "final adjudication" language in the warranty provision and prior knowledge exclusion.

The court held that both the insurer and the insureds had advanced reasonable interpretations of the Advancement Provision, rendering the provision ambiguous. The court held that the insurer had offered no extrinsic evidence to support its position in the face of the ambiguity, and therefore the bankruptcy court's grant of summary judgment in favor of the insureds was proper. The court further opined that "[g]iven the general rule governing advancement of defense costs under New York law," and because adopting the insurer's position would "effectively render the advancement obligation worthless," an insurance policy granting the insurer the unilateral right to terminate advancement must "clearly state that right."