

New York High Court Holds That Insurer's Breach of Duty to Defend Does Not Mean Automatic Indemnity Coverage

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The New York Court of Appeals, applying New York law, has held on reargument that an insurer's breach of its duty to defend does not bar it from later relying on policy exclusions. *K2 Investment Group, LLC v. Am. Guarantee & Liability Ins. Co.*, 2014 WL 590662 (N.Y. Feb. 18, 2014). In so holding, the court vacated its previous decision. *K2 Investment Group v. Am. Guarantee & Liability Ins. Co.*, 21 N.Y.3d 387 (2013).

The 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. The plaintiffs alleged that the lawyer, acting as their attorney, failed to record mortgages in the plaintiffs' favor to secure their loans. The real estate investment company subsequently became insolvent and never made payments on the unsecured loans. The plaintiffs sued the lawyer and made a settlement demand within policy limits. The law firm's insurer denied coverage for the underlying litigation and settlement demand based on policy exclusions for claims arising out of the policyholder'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 policyholder had a controlling interest. The lawyer failed to appear in the litigation, resulting in a default judgment in excess of the policy limits. The lawyer then assigned his claims against the carrier, including bad faith claims, to the plaintiffs.

In the resulting declaratory judgment action, the trial court found that the insurer had breached its duty to defend, and the intermediate appellate court affirmed, holding that the exclusions relied upon by the insurer were inapplicable. By its previous order, the New York highest court had affirmed, determining that, where an insurer breaches its duty to defend, it loses the right to rely on policy exclusions in litigation over its indemnity obligation.

On reargument, the New York Court of Appeals held that its prior decision erroneously failed to take account of a controlling precedent, *Servidone Construction Corp. v. Security Insurance Co. of Hartford*, 64 N.Y.2d 419 (1985), which held that an insurer that breaches its duty to defend is not automatically liable to indemnify the policyholder where coverage is disputed. The court rejected the plaintiffs' contention that *Servidone* was distinguishable from this case because it involved an underlying settlement rather than a judgment against

the insured. The court also declined to make a distinction between cases where the breaching insurer raises defenses based on "noncoverage" (*i.e.*, claims that do not fall within the insuring agreement) rather than policy exclusions. Refusing to limit *Servidone* in this way, the court concluded that both policyholders and insurers should be able to rely on the court's decisions unless the state legislature decides otherwise.

The court then concluded that the applicability of the business enterprise and insured's status policy exclusions presented an issue of fact sufficient to defeat summary judgment because it was a factual question whether the malpractice claim against the lawyer arose partly out of his status or activity with the real estate investment company. The court remanded the case to the trial court to deny the plaintiffs' motion for summary judgment.