

ARTICLE

Insurer Liable for Default Judgment Against Insured Where Asserted Policy Exclusions Did Not Apply

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The New York Supreme Court, Appellate Division, has held that, based on the allegations of the underlying complaint, two policy exclusions did not bar coverage for underlying litigation in which a default judgment had been entered against the insured. *K Investment Group, LLC v. American Guarantee & Liability Insurance Co.*, 2012 WL 5746 (N.Y. App. Div. Jan. 3, 2012). The court also held, however, that the insurer was not liable for bad faith for failing to accept a demand within limits prior to the entry of the default judgment.

The insurer issued a professional liability policy to a law firm 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 demanded \$450,000 to settle their claims with the lawyer. The insurer denied coverage for the underlying litigation, and the lawyer failed to appear in the litigation. A default judgment in excess of \$3 million was entered against the lawyer, who assigned his claims, including bad faith claims, against the insurer to plaintiffs.

Prior to the underlying litigation, the lawyer provided notice to the insurer that he was aware of circumstances that could give rise to a claim and described the circumstances as arising out of legal services he rendered for the real estate company. The insurer later

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denied coverage for the underlying litigation based on an exclusion for claims arising out of the insured's capacity or status as a director or officer of a business enterprise and an exclusion for claims arising out of alleged acts or omissions of the insured for any business enterprise in which he had a controlling interest.

The court stated that, after denying coverage for the action, the insurer could not challenge the damages or liability determination in the underlying action and could not raise defenses against the claims asserted against the lawyer that led to the default judgment. The court concluded that the allegations of the underlying litigation were focused solely on the lawyer's negligence in his capacity as plaintiffs' counsel and that his liability was premised solely on that attorney-client relationship rather than any interest he had in the real estate investment company. The court therefore determined that no material issues of fact existed with respect to the coverage issues and that the cited exclusions did not apply.

The court, however, rejected the bad faith claims against the insurer after determining that plaintiffs failed to establish a prima facie case based on "gross disregard" of the insured's interests. In so concluding, the court noted that the lawyer had represented to the insurer that his firm rendered legal services for the real estate investment company and "the overall questionable circumstances of the underlying transactions."

The court therefore affirmed summary judgment granted in favor of the claimants on the coverage issues and affirmed the lower court's dismissal of the bad faith claims.