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Expert Analysis

'K2' and Consequences of Insurers' Breach of Duty to Defend

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The more things change, the more they remain the same. On Feb. 18, 2014, the Court of Appeals reversed itself, vacating a short-lived decision issued eight months earlier, and reinstated the status quo in New York with regard to the consequences of an insurer's breach of the duty to defend. After a brief period of uncertainty following the decision in *K2 Investment Group, LLC v. American Guarantee & Liab. Ins. Co.* (*K2-I*),[1] the law in New York returned to its preexisting state with the decision issued in *K2 Investment Group, LLC v. American Guarantee & Liab. Ins. Co.* (*K2-II*)[2]; an insurer's breach of the duty to defend does not create coverage where none otherwise existed. According to the Court of Appeals in *K2-II*, even where an insurer has breached the duty to defend, the insurer may properly refuse to indemnify if the claim at issue is barred by an applicable policy exclusion.

The recent decision in *K2-II* does not alter the landmark Court of Appeals' decision issued in *Isadore Rosen & Sons v. Sec. Mut. Ins. Co. of New York*.[3] The K2-II decision makes clear that in the absence of a covered loss, the insurer simply has no duty to indemnify. In contrast, under *Isadore Rosen*, an insurer that breaches the duty to defend a claim for loss that is covered under the policy will be held liable for the insured's reasonable settlement of that claim—regardless of whether the insurer consented to such settlement.

'K2-I'

The K2 cases involved loans made by plaintiffs (two LLCs) to defendants (one LLC and its two principals) and defendants' subsequent default on their obligations. Plaintiffs sued defendants, asserting several claims including a legal malpractice claim against defendant Daniels, who had acted as plaintiffs' attorney in connection with the loans and allegedly failed to record certain mortgages.

Daniels' legal malpractice carrier denied coverage and refused to defend him in the underlying lawsuit based on two policy exclusions: (1) insured's status (policy shall not apply to any claim based upon or arising out of insured's status as an officer, director, partner, trustee, shareholder, manager or employee of a business enterprise); and (2) business enterprise (policy shall not apply to any claim based upon or arising out of the alleged acts or omissions by an insured for any business enterprise in which any insured has a controlling interest). Plaintiffs made a settlement demand on Daniels for substantially less than the policy limit, which the insurer rejected. Plaintiffs then moved for default on the legal malpractice claim against Daniels for an amount in excess of the policy limit. Daniels assigned his rights against the insurance carrier to plaintiffs.

Subsequently, plaintiffs sued the insurer for breach of contract (seeking to recover the $2 million policy limit) and bad faith (seeking to recover the full amount of their default judgment). The trial court granted summary judgment to plaintiffs on the breach of contract claim, holding that the insurer breached its duty to defend Daniels and was therefore liable up to the $2 million limit of its policy, but dismissed the bad faith claim. The Appellate Division affirmed and both parties appealed again.

In *K2-I*, the Court of Appeals affirmed the Appellate Division, explaining that "when a liability insurer has breached its duty to defend its insured, the insurer may not later rely on policy exclusions to escape its duty to indemnify the insured for a judgment against him."[4] Invoking principles of fairness, the court reasoned that in order for insureds to gain the full benefit of their bargain, insurers need an incentive to defend the cases they are bound by contract to defend.[5] "We hold that by breaching its duty to defend [the insured], [the insurer] lost its right to rely on these exclusions in litigation over its indemnity obligation."[6]

'K2-II'

The Court of Appeals in *K2-II* granted the insurer's motion for reargument, vacated its prior decision in *K2-I*, reversed the Appellate Division and denied plaintiffs' motion for summary judgment on the grounds that issues of fact remained as to whether the policy exclusions were applicable. The Court of Appeals conceded in *K2-II* that it had erred in *K2-I* by failing to consider controlling precedent set forth in *Servidone Const. Corp. v. Security Ins. Co. of Hartford*, in which the court held that an insurer who breaches the duty to defend is not necessarily precluded from denying coverage with regard to the duty to indemnify.[7] The court in *K2-II* explained that "[t]he Servidone and K2-I holdings cannot be reconciled… we must either overrule *Servidone* or follow it. We choose to follow it."[8]

Consequently, the court abandoned the K2-I approach and reaffirmed that New York, along with an arguable majority of jurisdictions that have considered the question, follow the Servidone rule. The court reached its decision, relying on the doctrine of stare decisis: "When our Court decides a question of insurance law, insurers and insureds alike should ordinarily be entitled to assume that the decision will remain unchanged unless or until the Legislature decides otherwise. In other words, the rule of stare decisis, while it is not inexorable, is strong enough to govern this case."[9]

The Servidone Rule

In *Servidone*, an employee injured on a construction project sued his employer, the general contractor (insured) and the federal government (owner of the project). The government commenced a third-party action against the general contractor,

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asserting a right of indemnity both under common law (alleging that its negligence was at most passive or secondary) and under the construction contract (which expressly imposed responsibility for safety precautions to protect workers on the contractor). The insured contractor tendered the defense to its insurer. The insurer initially agreed to defend both claims asserted by the government but reserved the right to disclaim coverage for any loss based on contractual indemnification pursuant to an exclusion in the policy.

When a pretrial order was issued which defined the third-party action as one "in contract for indemnity," the insurer immediately withdrew its defense, contending that the government had abandoned its common-law indemnification claim and that the remaining contract claim was expressly excluded by the policy. After the insurer withdrew from the defense, the insured contractor engaged new counsel and settled with the injured employee for $50,000. The insured contractor then sued the insurer for breach of contract. The Appellate Division affirmed the trial court's order granting summary judgment to the insured contractor, finding that the insurer had breached the duty to defend and was therefore liable for the $50,000 settlement.

The Appellate Division majority opinion imposed a duty to indemnify on the insurer because it had breached the duty to defend: "where a claim for coverage exists and the insurer breaches its duty to defend, it must indemnify the insured for a reasonably arrived-at settlement because it is impossible to determine on what theory of liability plaintiff might have prevailed."[10] In contrast, the dissent found no evidence that the settlement was necessitated by the insurer's withdrawal and argued that an insurance contract does not create a duty to indemnify unless there is a covered loss.[11]

On appeal, the Court of Appeals agreed with the dissent, holding that even where an insurer breaches a contractual duty to defend its insured in a personal injury action, and the insured thereafter concludes a reasonable settlement with the injured party, the insurer has no duty to indemnify unless the loss is covered under the terms of the policy.[12] Accordingly, the Court of Appeals reversed and remanded the case to the trial court to determine the basis for the insured contractor's liability: "the burden of proof will rest with the insurer to demonstrate that the loss compromised by the insured was not within policy coverage. If the insurer does not establish that this loss falls entirely within the policy exclusion as claimed, it will have failed to sustain its burden."[13]

'Isadore Rosen' Still Good Law

The Court of Appeals' decisions issued in *Isadore Rosen* and *Servidone* both address the consequences of an insurer's breach of the duty to defend but are distinguishable from one another. The crucial distinction is that, in *Isadore Rosen*, in contrast to *Servidone*, the underlying claim was not barred by an exclusion and was therefore within the scope of indemnity coverage.

In *Isadore Rosen*, the defendant insurance company issued a "wrap-up" policy to the general contractor of an apartment construction project in which plaintiff subcontractor was named as an additional insured. During the course of the project, the general contractor claimed that the subcontractor negligently caused damage and therefore withheld the final payment due to the subcontractor. As a result, the subcontractor was forced to settle with the general contractor in order to obtain the final payment due under the contract.

The subcontractor sought recovery from the insurer under the terms of the policy—which clearly covered damage due to negligence—but the insurer balked, denying coverage under two provisions of the policy. First, the insurer asserted that the subcontractor had violated the policy prohibition on voluntary payments by the insured.[14] Second, the insurer contended that the subcontractor could not recover for a settlement reached before its obligations were finally determined by judgment absent the consent of the insurer.[15]

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The trial court denied the insurer defendant's motion for summary judgment but the Appellate Division reversed, granting the motion based on the two arguments asserted by the insurer. On appeal, the Court of Appeals reversed the Appellate Division, denying the insurer's motion for summary judgment. In so ruling, the Court of Appeals explained that there were triable issues of fact regarding whether the insurer had unreasonably delayed responding to the negligence claim under circumstances where it had notice of the economic pressure on the subcontractor. As a result, the court remanded for further proceedings to determine whether the insurer should be deemed to have waived the policy prohibition against settlement without prior consent.

The Court of Appeals based its decision on the New York rule that where an insurer "unjustifiably refuses to defend a suit, the insured may make a reasonable settlement or compromise of the injured party's claim, and is then entitled to reimbursement from the insurer, even though the policy purports to avoid liability for settlements made without the insurer's consent."[16]

In *Servidone*, the Court of Appeals held that the insurer's breach of the duty to defend does not create coverage and that, even in cases of negotiated settlements, there can be no duty to indemnify unless there is first a covered loss.[17] In contrast, in *Isadore Rosen*, where an insurer breached its duty to defend and there was a covered loss, the Court of Appeals held that, under such circumstances, an insurer may not challenge a reasonable settlement reached by an insured.[18]

Looking Forward

The Isadore Rosen case remains relevant 40 years later because insurance policies often contain a clause prohibiting settlement without the consent of the insurer. In *Isadore Rosen*, the court refused to enforce the consent obligation where the insurer had breached its duty to defend, determining that where the insurer has wrongfully left the insured to fend for itself, the insured is entitled to enter into a reasonable settlement and recover the settlement amount from the insurer.

The recent K2-I and K2-II decisions establish the boundary of the Isadore Rosen rationale. In *K2-II*, the Court of Appeals made clear that the insurer will only be obligated to reimburse the insured for a settlement if the claim falls within the scope of coverage under the terms of the policy. In so doing, the Court of Appeals reinforced the longstanding rule that, in the absence of a covered loss, the insurer has no duty to indemnify.

1. *K2 Investment Group, LLC v. American Guarantee & Liab. Ins. Co.*, 21 N.Y.3d 384 (N.Y. 2013) (Robert S. Smith, J.) (*K2-I*).
2. *K2 Investment Group, LLC v. American Guarantee & Liab. Ins. Co.*, 22 N.Y. 3d 578 (N.Y. 2014) (Robert S. Smith, J.) (*K2-II*).
3. *Isadore Rosen & Sons, Inc. v. Sec. Mut. Ins. Co. of New York*, 31 N.Y.2d 342 (N.Y. 1972) (Francis Bergan, J.)
4. *K2-I* at 387.
5. Id. at 391 (citing *Lang v. Hanover Ins. Co.*, 3 N.Y.3d 350, 356 (2004)).
6. *K2-I* at 389.
7. *Servidone Const. Corp. v. Security Ins. Co. of Hartford*, 64 N.Y.2d 419 (N.Y. 1985) (Judith S. Kaye, J.).
8. *K2-II*.
9. Id.
10. *Servidone* at 423 (quoting *Servidone Const. Corp. v. Security Ins. Co. of Hartford*, 102 A.D.2d 59, 63 (3d Dept. 1984).
11. *Servidone* at 423 (citing *Servidone Const. Corp. v. Security Ins. Co. of Hartford*, 102 A.D.2d 59, 65 (3d Dept. 1984).
12. Id. at 421.
13. Id. at 425.
14. *Isadore Rosen* at 345.
15. Id. at 345.
16. Id. at 347.
17. *Servidone* at 423.
18. *Isadore Rosen* at 347.