‘K2’ and Consequences of Insurers’ Breach of Duty to Defend

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 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,
asserting a right of indemnity both under com-
mon 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 there-
after concludes a reasonable settlement with the
injured party, the insurer has no duty to indem-
nify for payment, even though it may be liable
to the injured party, the insurer has no duty to indem-
nify for payment, even though it may be liable
because it breached the duty to defend: “the burden of proof will rest with the
insured to demonstrate that the loss compromised
the insurer to demonstrate that the loss compromised
the insured contractor’s
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insurer to demonstrate that the loss compromised
the insured contractor’s
liability.”14 In contrast, the dissent found that the settlement could not recover for
a settlement reached before its obligations
were finally determined by judgment absent
the consent of the insurer.15

The recent decision in ‘K2-II’
does not alter the landmark
Court of Appeals’ decision is-
issued in ‘Isadore Rosen & Sons’.

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 unre-
asonably delayed responding to the negligence
claim under circumstances where it had no notice
of the economic pressure on the subcontractor. As
a result, the court remanded for further proceed-
ings 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 “unjusti-
fiably 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 settle-
ments 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 with-
out the consent of the insurer. In Isadore Rosen,
the court refused to enforce the consent obliga-
tion 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.

York, 31 N.Y.3d 342 (N.Y. 1972) (Francis Bergan, J.)
5. Id. at 391 (citing Lang v. Hancock Ins. Co., 3 N.Y.3d 350, 356 (2004)).
8. K2-II.
9. Id.
10. Servidone at 423 (quoting Servidone Const. Corp. v. Securi-
ty Ins. Co. of Hartford, 102 A.D.2d 59, 63 (3d Dep’t 1984).
11. Servidone at 423 (citing Servidone Const. Corp. v. Secu-
12. ld. at 421.
13. Id. at 425.
15. Id. at 345.
16. Id. at 347.
17. Servidone at 423.
18. Isadore Rosen at 347.

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