No. 6

K2 Investment Group, LLC, et al.,
Respondents-Appellants,
v.
American Guarantee & Liability Insurance Company,
Appellant-Respondent.

Kevin T. Coughlin, for appellant-respondent.
Michael A. Haskel, for respondents-appellants.
Complex Insurance Claims Litigation et al.; United Policyholders; New York Insurance Association, Inc. et al.; Coltec Industries Inc. et al., amici curiae.

SMITH, J.:

American Guarantee & Liability Insurance Company contends, on reargument, that our prior decision in this case, K2 Inv. Group, LLC v Am. Guar. & Liab. Ins. Co. (21 NY3d 384) (K2-I), erred by failing to take account of a controlling precedent, Servidone Const. Corp. v Security Ins. Co. of Hartford

(64 NY2d 419 [1985]). We hold that American Guarantee is correct.

I

A brief summary of the case will do for present purposes: Claims for legal malpractice were brought against American Guarantee's insured, Jeffrey Daniels, which American Guarantee -- wrongly, it is now conceded -- refused to defend. Daniels suffered a default judgment, and then assigned his rights against American Guarantee to the plaintiffs in the suit against him. Those plaintiffs brought the present case, seeking to enforce American Guarantee's duty to indemnify Daniels for the judgment. In defense, American Guarantee asserted that the loss was not covered, relying on two exclusions in the policy. (The facts are described in more detail in our K2-I opinion, 21 NY3d at 387-389.)

In K2-I, we affirmed an order granting plaintiffs summary judgment, holding that American Guarantee's breach of its duty to defend barred it from relying on policy exclusions. We later granted reargument (21 NY3d 1049 [2013]), and we now vacate our prior decision and reverse the Appellate Division's order.

II

In Servidone -- a case in which, as in this one, the insurer was relying on policy exclusions in defending against a suit for indemnification -- we stated the question as follows:

> "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, is the insurer liable to indemnify the insured even if coverage is disputed?"

(64 NY2d at 421.)

We answered the question in Servidone no. In K2-I, we held 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" (21 NY3d at 387). The Servidone and K2-I holdings cannot be reconciled.

Plaintiffs suggest that the cases are distinguishable because in Servidone the insured had settled with the plaintiff in the underlying litigation, whereas here there was a judgment, not a settlement. We do not find the distinction persuasive. A liability insurer's duty to indemnify its insured does not depend on whether the insured settles or loses the case. It is true that a judgment, unlike most settlements, is a binding determination of the issues in the underlying litigation. Thus it can be said here, as it could not in Servidone, that the issues in the suit brought against the insured are now res judicata. But that is irrelevant, because American Guarantee does not seek here, and the defendant in Servidone did not seek, to relitigate the issues in the underlying case. It is well established that such relitigation is not permitted after an insurer has breached its duty to defend (see the authorities discussed in K2-I, 21 NY3d at 390). The issue in Servidone, as

here, is whether the insurer may rely on policy exclusions that do not depend on facts established in the underlying litigation.

Plaintiffs also rely, as we did in K2-I, on our decision in Lang v Hanover Ins. Co., 3 NY3d 350, 356 [2004]). We said in Lang that, when an insurer has refused to defend its insured, it "may litigate only the validity of its disclaimer" when it is later sued on a judgment obtained against the insured. But the issue we now face was not presented in Lang. We decided in Lang "that a judgment is a statutory condition precedent to a direct suit against the tortfeasor's insurer" (id. at 352); we did not consider any defense based on policy exclusions. The sentence on which plaintiffs rely was offered as support for our statement that

> "an insurance company that disclaims in a situation where coverage may be arguable is well advised to seek a declaratory judgment concerning the duty to defend or indemnify the purported insured"

(id. at 356). That continues to be sound advice, but Lang should not be read as silently overruling Servidone.

The dissent would read Servidone as being limited to cases in which the defense was "based on noncoverage" rather than "predicated on an exclusion" (dissenting op at 3). It is true, as the dissent says, that we have made such a distinction in cases arising under Insurance Law § 3420, which imposes an obligation of timely disclaimer. It could hardly be clearer, however, that we were not making that distinction in Servidone.

Describing the defense asserted by the insurer in that case, we said:

> "Security responded that, pursuant to an exclusion in the policy, a loss based upon any obligation the insured had assumed by contact was outside coverage"

(64 NY2d at 422; emphasis added).

Thus, "outside coverage," as Servidone used the term, describes a loss to which a policy exclusion applies.

In short, to decide this case we must either overrule Servidone or follow it. We choose to follow it.

There is much to be said for the rule of K2-I, as our previous opinion shows; but, as the Servidone opinion shows, there is also much to be said for the Servidone rule. Several states follow the Servidone approach (e.g., Sentinel Ins. Co. v First Ins. Co. of Hawai'i, Ltd., 76 Hawaii 277, 290-297, 875 P2d 894, 907-914 [1994]; Polaroid Corp. v Travelers Indemnity Co., 414 Mass 747, 760-766, 610 NE2d 912, 919-923 [1993]), while others adopt a rule like that of K2-I (e.g., Employers Ins. of Wausau v Ehlco Liquidating Trust, 186 Ill2d 127, 150-154, 708 NE2d 1122, 1134-1136 [1999]; Missionaries of Co. of Mary, Inc. v Aetna Cas. and Sur. Co., 155 Conn 104, 112-114, 230 A2d 21, 25-26 [1967]). A federal district judge, writing in 1999, said that "the majority of jurisdictions which have considered the question" follow the Servidone rule (Flannery v Allstate Ins. Co., 49 F Supp 2d 1223, 1227 [D Colo 1999]).

Under these circumstances, we see no justification for

overruling Servidone. Plaintiffs have not presented any indication that the Servidone rule has proved unworkable, or caused significant injustice or hardship, since it was adopted in 1985. 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.

III

Having decided that American Guarantee is not barred from relying on policy exclusions as a defense to this lawsuit, we must also decide whether the applicability of the exclusions it relies on presents an issue of fact sufficient to defeat summary judgment. We conclude that it does.

The exclusions in question are the so-called "insured's status" and "business enterprise" exclusions, contained in the following policy language:

> "This policy shall not apply to any Claim based upon or arising out of, in whole or in part . . .
>
> "D. the Insured's capacity or status as:
>
> "1. an officer, director, partner, trustee, shareholder, manager or employee of a business enterprise . . .
>
> "E. the alleged acts or omissions by any Insured . . . for any business enterprise . . . in which any Insured has a Controlling Interest."

The malpractice claims brought against Daniels, American Guarantee's insured, were based on the allegation that he represented plaintiffs as lenders in a transaction with a borrower known as Goldan. The alleged malpractice consisted of Daniels's failure to record mortgages that Goldan had given to plaintiffs. Daniels was one of two principals of Goldan; it is fair to infer that he was at least a "manager" of Goldan, and had a "Controlling Interest" in it, within the meaning of the policy. We cannot say on this record as a matter of law that the malpractice claims did not arise "in whole or in part" out of his status as a manager; nor can we say that they did not arise out of any of his "acts or omissions" on Goldan's behalf. We therefore agree with the Appellate Division dissenters that plaintiffs' motion for summary judgment should have been denied.

The Appellate Division majority's rationale for granting summary judgment was, essentially, that a case arising out of the alleged attorney-client relationship between plaintiffs and Daniels could not also arise out of Daniels's managerial status with, or acts or omissions for, Goldan. But the claims could arise out of both. Because the malpractice case was resolved on default, the record tells us little about the substance of the claims; it is at least possible, however, that the alleged malpractice occurred because Daniels was serving two masters -- plaintiffs, his clients, and Goldan, the company of which he was a principal. If that is the case, it can fairly be

said that the malpractice claims arose partly out of Daniels's law practice and partly out of his status with or activity for Goldan -- precisely the situation that the insured's status and business enterprise exclusions seem to contemplate.

Accordingly, upon reargument, our prior decision should be vacated, the remittitur recalled, the order of the Appellate Division reversed, with costs, and plaintiffs' motion for summary judgment on their first and second causes of action seeking to enforce the default judgment in the underlying action denied.

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GRAFFEO, J. (dissenting):

I would adhere to the general principle that a breach of a liability insurer's duty to defend prohibits it from subsequently invoking policy exclusions to escape its corollary duty to satisfy a judgment entered against the insured by a third party (see Lang v Hanover Ins. Co., 3 NY3d 350, 356 [2004]). This rule makes sense for several reasons. An insurer should be subjected to some legal consequence for breaching its duty to defend an insured. Prohibiting exclusions from being collaterally invoked provides an insurer with an incentive to appear on behalf of the policyholder in the underlying lawsuit, as it agreed to do in return for the payment of premiums. It also encourages the initiation of a declaratory judgment by an insurer that seeks judicial authorization to rely on a policy exclusion to avoid indemnification. Bringing all of the interested parties -- injured plaintiffs; insured defendants; and insurance carriers -- together in a judicial forum further contributes to the efficient resolution of factual issues for the benefit of litigants without unduly burdening the ability of injured parties to obtain recovery for covered losses.

A fundamental purpose of an insurance contract is to

provide "litigation insurance" for the policy holder (see e.g. Automobile Ins. Co. of Hartford v Cook, 7 NY3d 131, 137 [2006], citing Seaboard Sur. Co. v Gillette Co., 64 NY2d 304, 310 [1984]). This is particularly true in the context of legal malpractice insurance coverage such as that purchased by Jeffrey Daniels in this case. It is imperative that an insurer timely defend its insured. A contrary rule encourages unnecessarily repetitive judicial proceedings by allowing an insurer to wrongfully abandon its policyholder's defense, subsequently forcing the insured to later litigate the effect of a policy exclusion on the duty to indemnify.

At first glance, Servidone Constr. Corp. v Security Ins. Co. of Hartford (64 NY2d 419 [1985]) appears to adopt a different rule. Closer scrutiny, however, reveals that Servidone may have intended to endorse a more limited principle. Our insurance cases have long drawn a distinction between "noncoverage" and "exclusions" (see e.g. Matter of Worcester Ins. Co. v Bettenhauser, 95 NY2d 185, 188-189 [2000]; Zappone v Home Ins. Co., 55 NY2d 131, 134 [1982]). Noncoverage involves the situation where an insurance policy does not contemplate coverage at its inception. For example, a homeowner's policy would not provide malpractice liability coverage. Exclusions, in contrast, involve claims that fall within the ambit of the policy's coverage parameters but are excepted by a particular contractual exclusion provision. Hence, a homeowner's policy might contain

an exclusion for certain types of water damage to the house. The distinction between the two is not always easy to identify and in many cases the result is the same -- the insured will not be entitled to indemnification.

But our precedents make clear that the classification of an insurer's defense as one based on noncoverage or one predicated on an exclusion can have significant legal ramifications. For example, we have held that the failure of a carrier to timely disclaim coverage under Insurance Law § 3420 (d) will preclude the carrier from later invoking a policy exclusion to deny coverage (see Matter of Worcester Ins. Co. v Bettenhauser, 95 NY2d at 188-189). In other words, the carrier will be obligated to indemnify the insured for the loss, despite the fact that the claim was expressly exempted under an exclusion clause. But an identical violation of Insurance Law § 3420 (d) will not bar the carrier from later raising a defense of noncoverage (see id. at 188 ["Disclaimer pursuant to section 3420 (d) is unnecessary when a claim falls outside the scope of the policy's coverage portion"]). The rationale for this result is that, "[u]nder those circumstances, the insurance policy does not contemplate coverage in the first instance, and requiring payment of a claim upon failure to timely disclaim would create coverage where it never existed" (id.; see also Markevics v Liberty Mut. Ins. Co., 97 NY2d 646, 648-649 [2001]; Fair Price Med. Supply

Corp. v Travelers Indem. Co., 10 NY3d 556, 565 [2008]).[1]

Servidone acknowledged this concept, explaining that the "bargained-for coverage" could not be "enlarged . . . as a penalty for [the insurer's] breach of the duty to defend" (64 NY2d at 424). As a result, the insurer could attempt to demonstrate that the loss at issue "was not within policy coverage" despite the breach (id. at 425). In so holding, Servidone contrasted earlier decisions in which our Court held that "an insurer cannot by virtue of its own breach escape liability for the reasonable settlement of a covered risk" where there was "no question that the loss was within the policy" (id. at 424, citing Rosen & Sons v Security Mut. Ins. Co., 31 NY2d 342 [1972]; Cardinal v State of New York, 304 NY 400 [1952]).

Servidone did, however, refer to the insurer's ability to invoke a "policy exclusion" notwithstanding its breach of the duty to defend (64 NY2d at 425 [emphasis added]). But I believe Servidone should be applied more restrictively -- and thereby reconciled with our other precedent -- to clarify that an insurer's breach of the duty to defend prohibits it from avoiding indemnification on the basis of policy exclusions, but not from demonstrating that there never was coverage for the loss in the

[1] See also 1 Dunham, New Appleman New York Insurance Law 2d, § 15.04 (1) (c) at 15-47 ("Most New York courts distinguish between a failure to disclaim on grounds of 'noncoverage' . . . which generally does not effect a waiver, and failure to disclaim based upon a policy exclusion, which generally does").

first instance.[2]

Applying these principles here, it is apparent that American Guarantee must satisfy the judgment that was entered against its policyholder. Daniels purchased legal malpractice coverage from American Guarantee. A judgment premised on legal malpractice was secured against Daniels after American Guarantee refused to honor its obligation to defend him in that action. Assuming Daniels was insured against this particular claim under the terms of the malpractice policy, American Guarantee should not now be allowed to avoid satisfying the judgment on the ground that the claim in the underlying lawsuit actually fell under a policy exclusion. If, as the majority asserts, Daniels' liability for professional negligence may have partially arisen

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[2] A number of decisions from other jurisdictions (see majority op at 4-5) are similarly reconcilable under a rule that allows noncoverage (but not exclusions) to be raised even if the duty to defend is breached (see e.g. Employers Ins. of Wausau v Ehlco Liquidating Trust, 186 Ill 2d 127, 150-151, 708 NE2d 1122, 1135 [1999] [an insurer that breaches the duty to defend "is estopped from raising policy defenses to coverage" but may seek to prove that "there clearly was no coverage or potential for coverage"]; Polaroid Corp. v Travelers Indem. Co., 414 Mass 747, 764, 610 NE2d 912, 922 [1993] ["agree[ing] with the Court of Appeals of New York that an insurer that wrongfully declines to defend a claim will have the burden of proving that the claim was not within its policy's coverage"]; Alabama Hosp. Assn. Trust v Mutual Assur. Socy. of Alabama, 538 So 2d 1209, 1216 [Alabama 1989] ["A failure of an insurer to defend a claim against an insured does not work an estoppel on the issue of coverage"]; Flannery v Allstate Ins. Co., 49 F Supp 2d 1223, 1229 [D. Colo. 1999] ["I hold . . . that an insurer is not precluded from contesting coverage when it has breached its obligation to defend its insured"]).

from his actions as both an attorney and a manager of Goldan -- and was therefore precluded under the "insured's status" or "business enterprise" exclusion clauses -- American Guarantee should have fully participated in the underlying action and attempted to establish the basis for the exclusion. I believe that these issues should have been resolved in the original action rather than being delayed for years. The majority's decision to authorize additional litigation and fact finding will prolong final resolution of this matter even further.

Accordingly, I would affirm the order of the Appellate Division.

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Upon reargument, this Court's decision of June 11, 2013 vacated, the remittitur recalled, order appealed from reversed, with costs, and plaintiffs' motion for summary judgment on their first and second causes of action seeking to enforce the default judgment in the underlying action denied. Opinion by Judge Smith. Chief Judge Lippman and Judges Read and Rivera concur. Judge Graffeo dissents and votes to affirm the order appealed from in an opinion in which Judge Pigott concurs. Judge Abdus-Salaam took no part.

Decided February 18, 2014