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Insurers Do Not Waive Contractual Rights After All: New York's Highest Court Vacates K2 Decision

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Earlier today, in a highly anticipated decision, the New York Court of Appeals reversed its prior holding in K2 Investment Group, LLC v. American Guarantee & Liability Insurance Company. Today's ruling lays to rest the argument that a professional liability insurer "waives" the right to raise policy exclusions in a subsequent coverage dispute where it is alleged the insurer breached a duty to defend the underlying lawsuit. The original K2 decision emboldened policyholder lawyers to argue an insurer's purported failure to defend an insured without first obtaining a declaratory judgment ruling or awaiting a final determination of the underlying litigation somehow stripped an insurer of all rights under a policy. By vacating the June 11, 2013 decision in K2, the Court of Appeals makes clear that this argument has no merit.

K2 involved a legal malpractice claim against a lawyer named Daniels who was insured under a lawyers malpractice policy (the "Policy") issued by American Guarantee & Liability Insurance Company ("American Guarantee"). Initially, American Guarantee denied coverage and refused to defend Daniels in the underlying lawsuit based on two Policy exclusions. Plaintiffs (the "K2 Group") then entered a default judgment against Daniels on the malpractice claims and Daniels assigned his rights against American Guarantee to the K2 Group. The K2 Group pursued American Guarantee for breach of contract and bad faith seeking to collect on the judgment.

In June 2013, the Court of Appeals appeared to hold that by breaching a purported duty to defend Daniels, American Guarantee waived its right to rely on the Policy exclusions in the subsequent coverage litigation. However, the June 2013 decision did not address prior precedent from the Court of Appeals on the precise issue. Notably, the Court of Appeals 2013 decision did not distinguish Servidone, which held that the breach of the duty to defend "does not create coverage" and thus does not prohibit an insurer from relying on applicable policy exclusions. See Servidone Constr. Corp. v. Security Ins. Co. of Hartford, 64 N.Y.2d 419 (1985).

Accordingly, a motion for re-argument and amici submissions in support of American Guarantee quickly followed the June 2013 decision. Today's holding was the result. The Court concluded it could not reconcile its June 2013 holding in K2 with its prior decision in Servidone, and did not find any reason to overrule Servidone. Indeed, the Court of Appeals proclaimed: "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."

Of course, each case presents unique challenges when evaluating whether a claim triggers an insurer's duty to defend. Insurers should heed the advice offered in dicta that an insurer may be wise to pursue a declaratory relief action where it does not defend an insured. Importantly, however, today's decision will have the salutary effect of undermining those who have sought to upend traditional notions of contract law by evoking K2 as a bar to the orderly application of policy terms, conditions and exclusions to professional liability claims.

To read the decision, click here.