New York Court Addresses Impact of Allowing Insured to Default

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The recent decision by New York's Appellate Division, First Department, in *K2 Investment Group, LLC v. American Guarantee & Liability Ins. Co*., 2012 N.Y. App. Div. LEXIS 16 (Jan. 3, 2012) illustrates the dangers under New York law in denying a duty to defend, and allowing an insured to default, when coverage is questionable.

The underlying matter in *K2* involved a convoluted factual scenario, complicated by the insured's default. Plaintiffs, K2, were a group of limited liability companies that made a series of loans to non-party Goldan, LLC. Goldan's principal was Jeffrey Daniels. Mr. Daniels also happened to be an attorney, and in this capacity, he represented K2 in connection with the loan to Goldan. How or why K2 agreed to be represented by Mr. Daniels despite the apparently obvious conflict of interest was not explained by the court. After the loans were made, Goldan became insolvent and defaulted on the loans, whereupon K2 learned that Mr. Daniels had failed to properly secure the loans with mortgages and had failed to obtain title insurance.

K2 subsequently brought a malpractice action against Mr. Daniels and demanded $450,000 to settle their claims, which was within the $2 million limit of liability on Mr. Daniels' legal malpractice policy issued by American Guarantee. American Guarantee nevertheless denied coverage to Mr. Daniels based on two policy exclusions: one applicable to claims based upon or arising out of the insured's capacity as an officer or director of a business enterprise and the other applicable to acts or omissions of the insured for any business enterprise in which the insured had a controlling interest. American Guarantee's argument, therefore, was that the exclusions applied because Mr. Daniels represented K2 in connection with loans made to a company in which he was a principal. Mr. Daniels failed to appear in K2's lawsuit, resulting in a default judgment in the amount of $688,716. Following entry of the judgment, Mr. Daniels assigned his rights under the policy to K2, including bad faith claims. K2 thereafter brought a direct action against American Guarantee.

The court explained that having allowed its insured to default, American Guarantee could litigate the application of the exclusions, but could not otherwise challenge the underlying or damages determination, citing to *Lang v. Hanover Ins. Co*., 787 N.Y.S.2d 211 (N.Y. 2004) and *Rucaj v. Progressive Ins. Co*., 797 N.Y.S.2d 79 (N.Y. 1st Dep't 2005). The court nevertheless concluded that the exclusions relied on by American Guarantee did not apply since K2's suit related to Mr. Daniels' capacity as their own lawyer rather than his capacity as a director or officer of Goldan. The court noted that by having failed to defend its insured, American Guarantee "cannot at this juncture assert defenses that would have defeated the legal malpractice claims (for example, that Daniels was not performing legal services for plaintiffs but instead was representing Goldan) or would have established the applicability of the exclusions … ." In other words, the court suggested that there were facts that would have either refuted K2's malpractice claim, or that could have supported application of the policy exclusions, but by having allowed its insured to default, American Gurantee could not rely on or seek to discover such facts, and instead was limited to the allegations in the complaint in support of its policy exclusions.

In passing, the court rejected K2's claim for bad faith, holding that under *Pavia v. State Farm Mut. Auto Ins. Co.,* 82 N.Y.2d 445 (N.Y. 1993), K2 failed to demonstrate American Guarantee's "gross disregard" of its insured's interests under the policy.