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COURT OF APPEALS
STATE OF NEW YORK

K2 INVESTMENT GROUP, LLC AND ATAS MANAGEMENT GROUP, LLC,

Plaintiffs-Respondents-Cross-Appellants,

- against-

AMERICAN GUARANTEE & LIABILITY INSURANCE COMPANY,

Defendant-Appellant-Cross-Respondent.

Docket Number: APL-2012-00055

BRIEF OF AMICUS CURIAE, UNITED POLICYHOLDERS, IN SUPPORT OF PLAINTIFFS-RESPONDENTS-CROSS-APPELLANTS K2 INVESTMENT GROUP, LLC AND ATAS MANAGEMENT GROUP, LLC

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Dated: November 8, 2013

DISCLOSURE STATEMENT OF UNITED POLICYHOLDERS

Pursuant to 22 N.Y.C.R.R. 500.1(f)

Pursuant to Rule § 500.1(f) of the Rules of Practice of the Court of Appeals, United Policyholders advises the Court that it is a non-profit 501(c)(3) consumer organization and that it does not have a parent corporation, subsidiary, or corporate affiliate.

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STATEMENT OF INTEREST OF AMICUS CURIAE

United Policyholders, a non-profit 501(c)(3) organization founded in 1991, serves as an independent information resource and a voice for insurance consumers in all 50 states. Donations, foundation grants and volunteer labor fuel the organization. United Policyholders' Board of Directors includes the former Chief Justice of the Arizona Supreme Court, as well as the former Washington State Insurance Commissioner.

United Policyholders divides its work into three program areas: (1) *Roadmap to Recovery* provides tools and resources that help individuals and businesses solve insurance problems that can arise after an accident, illness, disaster, or other adverse event; (2) the *Roadmap to Preparedness* program promotes insurance and financial literacy as well as disaster preparedness; and (3) the *Advocacy and Action* program advances policyholders' interests in courts of law, legislative and public policy forums, and in the media.

United Policyholders participates in the proceedings of the National Association of Insurance Commissioners ("NAIC") as an official consumer representative. United Policyholders interfaces with the Insurance Division of the Department of Financial Services when providing disaster recovery and claim help to New York State residents through a "Roadmap to Recovery" program. United Policyholders maintains an extensive, publically-available library of publications,

legal briefs, sample policies, forms, and articles on commercial and personal lines insurance products, coverage, and the claims process on its website, www.unitedpolicyholders.org.

In addition to serving as a resource for individual and commercial policyholders throughout New York State, United Policyholders monitors legal and marketplace developments in the Empire State. United Policyholders has participated in legislative and other public forums related to home, auto and title insurance rates and claim practices, and is currently working in partnership with the Touro Law Center on Long Island on Superstorm Sandy recovery.

United Policyholders seeks to assist courts throughout the United States by filing *amicus curiae* briefs in insurance cases. United Policyholders has filed nine briefs in the New York Court of Appeals.[1] Most recently, United Policyholders filed an *amicus curiae* brief in *United States Fidelity & Guaranty Co. v. American Re-Insurance Co.*, 21 N.Y.3d 923 (2013). United Policyholders has also submitted eight *amicus curiae* briefs to the United States Court of Appeals

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[1] *U.S. Fid. & Guar. Co. v. Am. Re-Insurance Co.*, 21 N.Y.3d 923 (2013); *Bi-Economy Mkt., Inc. v. Harleysville Ins. Co. of N.Y.*, 10 N.Y.3d 187 (2008); *U.S. Underwriters Ins. Co. v. City Club Hotel, LLC*, 3 N.Y.3d 592 (2004); *Belt Painting Corp. v. TIG Ins. Co.*, 100 N.Y.2d 377 (2003); *Consol. Edison Co. v. Allstate Ins. Co.*, 98 N.Y.2d 208 (2002); *Travelers Cas. and Sur. Co. v. Certain Underwriters at Lloyd's of London*, 96 N.Y.2d 583 (2001); *A-One Oil, Inc. v. Mass. Bay Ins. Co.*, 92 N.Y.2d 814 (1998); *Am. Home Assurance Co. v. Int'l Ins. Co.*, 90 N.Y.2d 433 (1997); *Town of Harrison v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 89 N.Y.2d 308 (1996).

for the Second Circuit,[2] as well as *amicus curiae* briefs in numerous cases before the United States Supreme Court.[3] The U.S. Supreme Court referenced United Policyholders' *amicus curiae* brief in its opinion in *Humana, Inc. v. Forsyth*, 525 U.S. 299 (1999).

United Policyholders has a vital interest in ensuring that insurance companies fulfill the promises they make to their New York policyholders. While insurance companies profit from their assumption of risk, businesses and individuals rely on insurance to protect property and livelihoods. United Policyholders seeks to prevent insurance companies from shifting risk back to policyholders through schemes that are not authorized by insurance contracts or public policy. The organization works to counterbalance the widely-represented interests of the insurance industry by advocating for policyholders—large and small—in courts throughout the country.

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2 *Woodhams v. Allstate Fire and Cas. Co.*, 453 F. App'x 108 (2d Cir. 2012); *Schwartz v. Liberty Mutual Insurance Co.*, 539 F.3d 135 (2d Cir. 2008); *Harris v. First Unum Life Ins. Co.*, 202 F. App'x 479 (2d Cir. 2006); *Duane Reade, Inc. v. St. Paul Fire & Marine Ins. Co.*, 411 F.3d 384 (2d Cir. 2005); *Allstate Ins. Co. v. Serio*, 261 F.3d 143 (2d Cir. 2001); *Shapiro v. Berkshire Life Ins. Co.*, 212 F.3d 121 (2d Cir. 2000); *United States v. Brennan*, 183 F.3d 139 (2d Cir. 1999); *Stonewall Ins. Co. v. Asbestos Claims Mgmt. Corp.*, 73 F.3d 1178 (2d Cir. 1995).

3 *See e.g., U.S. Airways, Inc. v. McCutchen*, 133 S. Ct. 1537 (U.S. 2013); *Fuller-Austin Insulation Co., v. Highlands Ins. Co.*, 549 U.S. 946 (2006); *Philip Morris USA v. Mayola Williams*, 547 U.S. 1162 (2006); *Aetna Health, Inc. v. Davila*, 542 U.S. 200 (2004); *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003); *Rush Prudential HMO v. Debra Moran*, 533 U.S. 948 (2001), *aff'd*, 536 U.S. 355 (2002); *Humana Inc. v. Forsyth*, 525 U.S. 299 (1999).

United Policyholders seeks to appear as *amicus curiae* to address matters before the Court on reargument concerning the duty of liability insurance companies to defend their policyholders and the remedies available to policyholders when an insurance company materially breaches its insurance contract by wrongfully disclaiming the duty to defend. This issue has significance well beyond the application of New York law to the specific facts of this case. United Policyholders' proposed brief will assist the Court by, among other things, identifying and analyzing authorities from other jurisdictions that have settled on remedies similar to that set forth by this Court nearly ten years ago in *Lang v. Hanover Insurance Co.*, 3 N.Y.3d 350 (2004) and reiterated in its June 11, 2013 decision in *K2 Investment Group, LLC v American Guarantee & Liability Insurance Co.,* 21 N.Y.3d 384 (2013). The authorities presented by United Policyholders confirm that New York's approach is and has been consistent with the approach taken in many other jurisdictions. None of those authorities were analyzed in the brief submitted on behalf of the insurance industry by Complex Insurance Claims Litigation Association and the American Insurance Association.

Unpaid volunteer counsel performed all of the legal research and writing in this brief, and no party to this appeal participated in the drafting of this brief or funded this work.

STATEMENT OF THE CASE

United Policyholders adopts the Statement of the Case and Statement of Facts of plaintiffs and respondents K2 Investment Group, LLC and ATAS Management Group, LLC, as set forth in their brief submitted to the Court of Appeals. (*See Brief for Plaintiffs-Respondents-Cross-Appellants*, filed October 2, 2013, at pp. 8-20.)

The Court of Appeals released its unanimous decision on June 11, 2013. See *K2 Inv. Group, LLC v American Guarantee & Liab. Ins. Co.*, 21 N.Y.3d 384 (2013) ("*K2 Investment Group.*"). It granted appellant American Guarantee's motion for reargument on September 3 and set the case for the Court's January 2014 session. *Amici* Complex Insurance Claims Litigation Association ("CICLA") and the American Insurance Association ("AIA") (collectively "*amici*" or "insurance industry *amici*") filed a brief in support of American Guarantee on July 9, 2013. United Policyholders' motion for leave to file this brief is set for the Court's December 2013 session.

PRELIMINARY STATEMENT

Refusing to defend a policyholder without justification is, in the words of Justice Holmes, to "cut at the very root of the mutual obligation" between the insurance company and its policyholder. *St. Louis Dressed Beef & Provision Co. v. Maryland Cas. Co.*, 201 U.S. 173, 181 (1906). The remedy set forth in

Lang v. Hanover Insurance Co., 3 N.Y.3d 350 (2004) and *K2 Investment Group* (the "*Lang* Rule") is entirely appropriate given that an insurance company's wrongful refusal to defend its policyholder abandons that policyholder in what is often the policyholder's greatest time of need. The remedy provided by the *Lang* Rule is commensurate with and rationally related to the harm caused by the insurance company. It is a contractual remedy for a material breach of contract.

The *Lang* Rule provides the policyholder with nothing more and nothing less than full performance of the insurance company's obligations under the contract. Having chosen to abandon its policyholder and vitiate the contract of insurance when the policyholder most needs it, many jurisdictions, including New York, have confirmed that the insurance company will not be given a second opportunity to escape its contractual obligations and will instead be obligated to provide full performance under the contract. This is exactly what the *Lang* Rule prescribes, and with good reason: without such a remedy, policyholders in New York can have little confidence that the insurance companies to which they paid premiums will honor the obligation to defend them. Indeed, it sadly occurs all too often that an insurance company functions solely in its own economic interest, believing that the only consequence for breaching the duty to defend will be one day to pay no more than the defense costs it was always obligated to pay. Such a benign consequence gives insurance companies little incentive to consider

anyone's interest but their own, and forces policyholders to bear staggering and unrecoverable legal expenses merely to get the insurance company to provide the contractual benefits for which the policyholder already paid.

ARGUMENT

I. The Court's Decision in *K2 Investment Group* Applies a Remedy that Was Clearly Articulated in *Lang v. Hanover Ins. Co.* and Progeny.

K2 Investment Group addressed the consequences of an insurance company breaching its duty to defend a policyholder in a liability claim. The decision did not break new ground. *Lang v. Hanover Insurance Co.*, 3 N.Y.3d 350 (2004) and several other decisions over the last decade placed insurance companies on notice of the risks associated with unilaterally disclaiming the duty to defend.

Lang considered whether an injured houseguest could sue a homeowner's insurance company under New York Insurance Law section 3420 before obtaining judgment against the person who injured him. The plaintiff argued that he could not obtain a judgment against the tortfeasor—a fellow houseguest who shot him in the eye with a paintball gun—because the tortfeasor had since petitioned for bankruptcy. The Court of Appeals noted that federal authorities permitted injured parties to obtain judgment against a bankrupt defendant solely for the purposes of satisfying section 3420's requirements. *Lang,*

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N.Y.3d at 355. It upheld the Appellate Division's dismissal of plaintiff's declaratory judgment action against Hanover on the grounds that securing a judgment, serving it, and complying with 30-day waiting period were clear statutory prerequisites to an injured party filing a direct action against the tortfeasor's insurance company. *Lang*, 3 N.Y.3d at 355-356.

While *Lang* allowed Hanover to escape liability, the Court cautioned insurance companies to seek declaratory relief on the issues of their duty to defend and indemnify before refusing to defend a policyholder:

> [W]e note 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. If it disclaims and declines to defend in the underlying lawsuit without doing so, it takes the risk that the injured party will obtain a judgment against the purported insured and then seek payment pursuant to Insurance Law § 3420. Under those circumstances, ***having chosen not to participate in the underlying lawsuit, the insurance carrier may litigate only the validity of its disclaimer and cannot challenge the liability or damages determination underlying the judgment.***

Lang, 3 N.Y.3d at 356 (emphasis added).

In *Lang's* wake, lower courts admonished insurance companies repeatedly to seek declaratory relief before refusing to participate in the defense of their policyholders. *Bowker v. New York State Insurance Fund*, 39 A.D.3d 1162 (4th Dep't 2007) involved a contractor sued by an injured employee of a

subcontractor. The contractor filed a third-party action against the subcontractor for causing plaintiff's injuries. The subcontractor's insurance company, the State Insurance Fund ("SIF"), disclaimed coverage on the ground that the policy excluded coverage for "[l]iability assumed under a contract." The subcontractor defaulted and assigned his claims to the contractor, who then filed a section 3420 suit seeking a declaration that SIF was required to indemnify the contractor for plaintiff's personal injury claims. The trial court denied the contractor's motion for summary judgment as to SIF's duty to indemnify. The Appellate Division reversed and granted summary judgment, quoting *Lang's* admonition to insurance companies about the risks of disclaiming the duty to defend without first seeking declaratory judgment. It concluded:

> SIF took that risk here, and SIF therefore "**may litigate only the validity of its disclaimer and cannot challenge the liability or damages determination underlying the [order and interim judgment obtained upon Harmon's default]**" (*id.*). SIF's policy does not exclude from coverage the waiver of a defense but, rather, the policy excludes only liability assumed under a contract. SIF therefore improperly disclaimed coverage based on Harmon's "liability assumed under a contract," and NVR is entitled to judgment declaring that SIF is obligated to indemnify Harmon in the first third-party action with respect to the order and interim judgment entered against him in that action.

Bowker, 39 A.D.3d at 1164, *citing Lang*, *supra*, 3 N.Y.3d at 356 (emphasis added); *see also Republic Franklin Ins. Co. v. Pistilli*, 16 A.D.3d 477, 479 (2d Dep't 2005),

citing Lang, *supra*, 3 N.Y.3d at 356 ("When in doubt, an insurer should issue a prompt disclaimer and then seek a declaratory judgment concerning its duty to defend or indemnify, rather than seeking such a judgment in lieu of issuing a disclaimer, as the plaintiff has done here").

State Farm Fire & Casualty Co. v. Ricci, 96 A.D.3d 1571 (4th Dep't 2012) provides an example of the advisable way for an insurance company to handle a claim in which it seeks to challenge coverage. Plaintiff and Ricci were involved in a fight while attending a youth hockey game. Plaintiff brought a personal injury action against Ricci, who tendered the claim to his homeowner's insurance company, State Farm. State Farm agreed to defend but reserved its right to deny coverage. During the course of litigation, State Farm sought declaratory relief relating to the parties' rights under the policy. Ricci counterclaimed for defense costs and "bad faith and improper conduct." State Farm moved for partial summary judgment on several of his counterclaims. The Supreme Court granted the motion in part, but left Ricci's bad faith counterclaim intact. The Appellate Division reversed, explaining that State Farm had adhered to the recommendations set forth in *Lang*:

> State Farm's reservation of rights is based on the complaint and, after reserving its right to deny and disclaim coverage, State Farm maintained its defense of Ricci in the underlying action. By commencing this declaratory judgment action, State Farm seeks merely to

> clarify its obligations under the policy, and ***such an approach is not only permissible but advisable.***

Ricci, 96 A.D.3d at 1572-1573, *citing Lang*, *supra*, 3 N.Y.3d at 356 (emphasis added); *see also Jimenez v. New York Central Mutual Fire Ins. Co.*, 71 A.D.3d 637, 640 (2d Dep't 2010) (*Lang* Rule did not apply to insurer that did not receive notice of the action until after entry of judgment; insurer did not have "a full and fair opportunity to contest the decision").

For nearly ten years, *Lang v. Hanover Insurance Co.* and its progeny have cautioned insurance companies about the risk of refusing to defend their policyholders in New York.[4] Appellant American Guarantee elected to ignore those warnings and instead wrongfully disclaimed its duty to defend the policyholder while also failing to seek declaratory relief. In so doing, American

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[4] The duty to defend is very broad. "If the allegations of the complaint are even potentially within the language of the insurance policy, there is a duty to defend." *Town of Massena v. Healthcare Underwriters Mut. Ins. Co.*, 98 N.Y.2d 435, 443 (2002). To have so clearly operated in its own self-interest, to the obvious detriment of its policyholder, is a material breach that vitiates the insurance contract at the very moment when the policyholder most needs it. The contractual remedy articulated by the Court in this case is therefore entirely appropriate under the circumstances and can be distinguished from *Servidone Construction Corp. v. Security Insurance Co. of Hartford*, 64 N.Y.2d 419 (1985), decided almost 30 years ago, long before it became necessary for the Court to caution insurers as it did ten years ago in in *Lang*. Simply stated, *Servidone* proved itself inadequate; it perpetuated a benign consequence that gave insurance companies little incentive to consider anyone's interest but their own. To the extent that notions of *stare decisis* are invoked, it must be remembered that precedent does not compel the Court "to perpetuate an unjust rule 'out of tune with the life about us.'" *See Endresz v. Friedberg*, 24 N.Y.2d 478, 488-489 (1969), citing *Bing v. Thunig*, 2 N.Y.2d 656, 667 (1957). *Stare decisis* is most applicable in matters of statutory interpretation. *See e.g., People v Hobson*, 39 N.Y.2d 479, 489 (1976) ("Precedents involving statutory interpretation are entitled to great stability . . . in such cases courts are interpreting legislative intention and a sequential contradiction is a grossly arrogated legislative power").

Guarantee spared itself the expense of defending its policyholder in the underlying action and the expense of a declaratory judgment action, but it wrongfully exposed its policyholder to a judgment without the benefit of any protection from its insurance company. Every court that has reviewed this matter since then has confirmed that American Guarantee's disclaimer was wrongful. American Guarantee should not have been surprised, then, when this Court restated its ruling in *Lang* and confirmed the appropriateness of a contractual remedy that is related to, and proportionate with, the nature of the contractual damages suffered by the policyholder. *See* WILLISTON ON CONTRACTS § 64.1 (4th ed. 1990) ("both the nature of the damages recoverable and their amount ordinarily rests within the sound discretion of the trial court, which will not be reversed on appeal unless there has been an abuse of that discretion."); *United States Trust Co. v. O'Brien*, 143 N.Y. 284, 287-288 (1894) ("the rule of damages should not depend upon the form of the action. In all civil actions the law gives or endeavors to give a just indemnity for the wrong which has been done the plaintiff . . ."). It is entirely appropriate for the insurance company to bear the consequences of its wrongful decision to disclaim coverage by later facing the related obligation to pay the judgment entered against its policyholder.[5]

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[5] Insurance industry *amici* refer to New York's remedy as "Automatic Indemnity." That is a fiction. The Court's decision in *K2 Investment Group* specifically observed that: "[p]erhaps there are exceptions to the rule that we stated in *Lang* and now reaffirm . . . But no public

II. Many States Take a Similar Approach to the *Lang* Rule as the Remedy for an Insurance Company's Breach of the Duty to Defend.

Lang v. Hanover Insurance Co. and now *K2 Investment Group* confirm that an insurance company which elects to play "high stakes poker" with a policyholder by unilaterally disclaiming the duty to defend is risking its right to challenge coverage in the future.[6] More than one in four states, including New York, have adopted approaches that go beyond *Servidone*-type remedies in an attempt to encourage insurance companies to defend potentially covered lawsuits when the duty to indemnify is not yet known with certainty. These remedies are intended to protect this basic right and ensure that policyholders are not deprived of benefits they purchased.

A. Illinois Takes a Similar Approach.

Illinois was an early and ardent proponent of a rule that used the estoppel doctrine to prevent insurance companies from contesting coverage after breaching the duty to defend. The Supreme Court of that state described the rule as follows:

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policy argument is available to American Guarantee here, and there is no reason to make this case an exception to the general rule [set forth in *Lang*]." *K2 Investment Group*, 21 N.Y.3d at 391.

6 See Plitt, Steven & Jordan R. Plitt, *High Stakes Poker in New York Over Insurer's Decision Not to Defend Its Insured*, 9 WESTLAW J. INS. BAD FAITH 2 (Aug. 29, 2013).

> The general rule of estoppel provides that an insurer which takes the position that a complaint potentially alleging coverage is not covered under a policy . . . may not simply refuse to defend the insured. Rather, the insurer has two options: (1) defend the suit under a reservation of rights or (2) seek a declaratory judgment that there is no coverage. If the insurer fails to take either of these steps and is later found to have wrongfully denied coverage, the insurer is estopped from raising policy defenses to coverage.

Employers Reinsurance of Wausau v. Ehlco Liquidating Trust, 186 Ill. 2d 127, 150-151 (1999) (citations omitted).

Ehlco Liquidating Trust arose from two CERCLA matters involving a pair of wood treatment facilities in Wyoming and Arkansas for which Ehlco was responsible. Ehlco's CGL insurance company, Employers Insurance of Wausau ("Wausau"), refused to defend Ehlco. The cases settled and Ehlco demanded indemnification from Wausau. Wausau sought declaratory judgment in Illinois as to coverage after the underlying cases concluded in each state. The trial court found as a matter of law that Wausau had breached its duty to defend Ehlco and by doing so was estopped from asserting its coverage defenses. *Ehlco,* 186 Ill. 2d at 135. It ordered Wausau to pay for clean-up and defense costs at one site, and to indemnify Ehlco for the settlement relating to the other site. *Ehlco,* 186 Ill. 2d at 135-136. Wausau appealed. The appellate court reversed the coverage ruling as to the Arkansas site because the underlying case was prosecuted by the EPA as an administrative action in federal district court, and thus did not constitute a "suit" as

contemplated by the insurance policy. *Ehlco*, 186 Ill. 2d at 137. The appellate court also reversed the Wyoming ruling, finding that Ehlco had not properly notified Wausau of the underlying claim. *Ehlco*, 186 Ill. 2d at 137-138.

The Supreme Court of Illinois found that triable issues of fact remained as to Wausau's duty to defend the Arkansas case and affirmed that portion of the appellate court's ruling. *Ehlco*, 186 Ill. 2d at 146-147. It reversed the Wyoming ruling and reinstated the trial court's ruling that Wausau had breached its duty to defend Ehlco, and as a result, was barred from raising coverage defenses. *Ehlco,* 186 Ill. 2d at 155, 158-159. The court explained how an insurance company's failing to defend a policyholder was not merely breaching, but *repudiating*, their contract:

> The estoppel doctrine has deep roots in Illinois jurisprudence. It arose out of the recognition that an insurer's duty to defend under a liability insurance policy is so fundamental an obligation that a breach of that duty constitutes a repudiation of the contract.

Ehlco, 186 Ill. 2d at 151, *citing Kinnan v. Charles B. Hurst Co.*, 317 Ill. 251, 257 (1925) (emphasis added).

The court rejected Wausau's "late notice defense," i.e., that the policyholder's failing to provide timely notice justified the insurance company's denying of coverage and disclaiming the duty to defend:

> Wausau contends that its late-notice defenses act to excuse its failure to take either of these actions. We

> disagree. The estoppel doctrine has long provided insurers in Wausau's circumstances with the proper recourse. If an insurer believes that it received notice too late to trigger its obligations, it should defend its insured under a reservation of rights or litigate the matter in a declaratory judgment action. [Citations.] The insurer cannot simply abandon its insured. We therefore hold that there is no exception to the estoppel doctrine for late-notice defenses of the types asserted here. To hold otherwise would seriously undermine the effectiveness of the estoppel doctrine and its intended enforcement of the duty to defend. (citations omitted)

Ehlco, 186 Ill. 2d at 154.[7]

B. North Carolina Takes a Similar Approach.

Pulte Home Corp. v. American Southern Insurance Co., 185 N.C. App. 162 (2007) described the approach of North Carolina, which like Illinois, has used the estoppel doctrine to remedy breaches of the duty to defend. A subcontractor's employee sued the general contractor and subcontractor for negligence after falling and injuring himself. The contractor, which was an additional insured on the subcontractor's American Southern CGL policy, tendered its defense to American Southern. The insurance company denied coverage on the grounds that the policy did not cover liability for the contractor's *own* negligence—only vicarious liability arising from the subcontractor's negligence. It thereafter refused to defend the contractor because plaintiff's complaint, as

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[7] *See* S. Nardoni & J. Vishneski, *The Illinois Estoppel Doctrine Revisited: How Promptly Must an Insurer Act?*, 24 N. ILL. U. L. REV. 211 (Spring 2004) (summarizing history of the rule outlined in *Ehlco*).

interpreted by American Southern, alleged only independent negligence against the contractor. American Southern prevailed on summary judgment. The contractor appealed.

The Court of Appeals of North Carolina warned at the outset of its opinion that "an insurer undertakes a substantial risk when it chooses not to provide a defense." *Pulte,* 185 N.C. App. at 163. It recited North Carolina's version of the *Lang* Rule as follows:

> It is well established in North Carolina that when an insurer without justification refuses to defend its insured, the insurer is estopped from denying coverage and is obligated to pay the amount of any reasonable settlement made in good faith by the insured . . .

Pulte, 185 N.C. App. at 165, *citing Ames v. Cont'l Cas. Co.*, 79 N.C. App. 530, 538 (1986).

The court described American Southern's interpretation of the policy as "cramped" and determined the conduct alleged was at least "arguably" covered. *Pulte*, 185 N.C. App. at 169-172. As a result, it determined the insurance company had unjustifiably disclaimed its duty to defend. *Pulte*, 185 N.C. App. at 175. The court reversed summary judgment and remanded for judgment in favor of the contractor for the full amount of the settlement, as well as defense costs. *Pulte*, 185 N.C. App. at 175-176.

C. Connecticut Takes a Similar Approach.

Connecticut's implementation of an estoppel rule, termed the "Rule of *Messengers*," arises from the Supreme Court of Connecticut decision in *Missionaries of the Company of Mary, Inc. v. Aetna Casualty and Surety Co.*, 155 Conn. 104 (1967). The court reasoned that an insurance company should not be permitted to benefit from its breach:

> The defendant, after breaking the contract by its unqualified refusal to defend, should not thereafter be permitted to seek the protection of that contract in avoidance of its indemnity provisions. Nor should the defendant be permitted . . . to cast upon the plaintiff the difficult burden of proving a causal relation between the defendant's breach of the duty to defend and the results which are claimed to have flowed from it.

Missionaries, 155 Conn. at 114, *citing Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263 (1966); *see also Hartford Cas. Ins. Co. v. Litchfield Mut. Fire Ins. Co.*, 274 Conn. 457 (2005), *quoting Keithan v. Massachusetts Bonding and Ins. Co.*, 159 Conn. 128, 139 (1970) (breaching insurance company "is liable to pay to the insured not only his reasonable expenses in conducting his own defense but, in the absence of fraud or collusion, the amount of a judgment obtained against the insured up to the limit of liability fixed by the policy").

D. Montana Takes a Similar Approach.

In recent years, the Supreme Court of Montana has issued a trio of opinions applying the estoppel doctrine in the context of an insurance company

breaching the duty to defend. The first is *Farmers Union Mutual Insurance Co. v. Staples*, 321 Mont. 99 (2004), decided the same year as *Lang v. Hanover Insurance Co.* In *Staples*, Farmers Union refused to defend a rancher responsible for pasturing a horse that escaped and caused a traffic accident. The insurance company denied coverage and disclaimed its duty to defend because the horse's ownership was not clear at the time of the accident. Specifically, Farmers Union's adjuster concluded the named insured no longer held a co-interest in the horse, a decision which deprived the rancher of his status as an additional insured on the policy. The rancher confessed judgment in plaintiffs' favor and assigned his rights against Farmers Union. In the subsequent coverage action, the trial court decided as a matter of law that Farmers Union should have defended the rancher, but simultaneously found that the rancher was not an additional insured. The Supreme Court reversed on the grounds that the trial court should have ended its analysis upon finding Farmers Union breached its duty to defend:

> If FUMIC wished to dispute coverage, it could have defended Staples under a reservation of rights and later sought judicial determination through a declaratory judgment action to determine whether coverage existed. However, because FUMIC unjustifiably refused to defend, it is estopped from denying coverage.
>
> Having correctly determined that FUMIC had a duty to defend, ***the court should have ended the analysis and concluded that since FUMIC breached that duty, it was estopped from denying coverage*** and Staples was entitled to summary judgment. The court erred when it

> proceeded to resolve disputed issues of fact in ruling on a motion for summary judgment in favor of FUMIC.

Staples, 321 Mont. at 108 (emphasis added) (citations omitted).

Farmers Union found itself in front of Montana's highest court again three years later in *Farmers Union Mutual Insurance Co. v. Rumph*, 339 Mont. 251 (2007). Rumph faced several lawsuits after his son injured three people while driving Rumph's truck. He tendered the lawsuits to Farmers Union under several commercial lines policies covering the operations of Rumph's auto repair business. Farmers Union initially refused to defend, but eventually agreed to do so under a reservation of rights. It sought declaratory relief as to coverage and prevailed. In affirming, the Supreme Court explained its estoppel rule did not apply when an insurance company wisely heeded *Staples* by defending its policyholder:

> Appellants argue FUMIC was estopped from denying coverage because it "first unreasonably refused to supply a defense [to the Rumphs] and then offered a late defense as it aggressively pursued a declaratory judgment action against its insured." An insurer that unjustifiably refuses to defend is estopped from denying coverage. *Staples*, ¶ 28 (citations omitted).

> While FUMIC may have been slow to the punch in providing a defense, that delay was justified given the absence of facts in the Nielsens' first complaint indicating a covered event. The amended complaint also failed to allege facts bringing the claim within coverage. Because we hold that the Nielsens' amended complaint unequivocally demonstrated that the Nielsens' claim was not covered, no duty to defend arose and FUMIC was not estopped from denying coverage.

Rumph, 339 Mont. at 257.

Newman v. Scottsdale Ins. Co., 370 Mont. 133 (2013) is the most recent of the three Montana estoppel cases. The policyholder operated a reform school at which a young woman committed suicide. The woman's mother sued the school. The school's primary and excess insurance companies, Scottsdale Insurance Company ("Scottsdale") and National Union Fire Insurance Company ("National Union"), respectively, disclaimed the duty to defend. Scottsdale denied on the grounds that the suicide was "intentional" and thus did not constitute and "occurrence." National Union invoked a professional services exclusion and a notice condition, while also claiming that Scottsdale's lack of coverage excused National Union's obligation, as an excess insurance company, to defend the school. The school settled for $3 million—the combined limits of both policies—and assigned its rights against the insurance companies to the mother.

The mother reduced the settlement to judgment and sued Scottsdale and National Union for breach of the duty to defend and indemnify. She prevailed on summary judgment and was awarded the underlying judgment and interest, plus over $1 million in attorney's fees. The Supreme Court affirmed the finding of breach, citing *Staples*:

> [T]here must exist an unequivocal demonstration that the claim against the insured does not fall within the policy coverage before an insurer can refuse to defend;

> otherwise, the insurer has a duty to defend. *Staples*, ¶ 24. If an insurer unjustifiably refuses to defend a claim, that insurer is estopped from denying coverage. *Staples*, ¶¶ 27–28.

Newman, 370 Mont. at 149.

The analysis in *Newman* focused on whether Scottsdale and National Union justifiably refused to defend the school. The court stated that Scottsdale's and National Union's exclusions rendered coverage "confusing and ambiguous." *Newman,* 370 Mont. at 145, 150. It dismissed National Union's "no underlying coverage" position as "disingenuous," and considered the insurance company's late notice defense to have been waived. *Newman,* 370 Mont. at 150-152. The court stated that the appropriate course for the insurance company opting to challenge coverage would have been to attend mediation on the policyholder's behalf, negotiate a settlement, or try the case while seeking declaratory relief to clarify whether the policy covered plaintiff's allegations. *Newman,* 370 Mont. at 152-153. It affirmed the trial court's grant of summary judgment against the insurance companies and its interest award. *Newman,* 370 Mont. at 156.[8]

E. Wisconsin Takes a Similar Approach.

Wisconsin prefers that insurance companies resolve disputes over the duty to defend by requesting "a bifurcated trial on the issue of coverage while

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[8] *Newman* questioned the trial court's attorney's fees award and reversed that portion of the judgment. The court remanded for recalculation consistent with the opinion. *Newman,* 370 Mont. at 153-156.

moving to stay proceedings on the merits of the liability action." *Liebovich v. Minnesota Ins. Co.*, 310 Wis. 2d 751, 784 (2008). In addition, insurance companies may raise coverage issues by "seeking a declaratory ruling or agreeing to provide a defense under a reservation of rights." *Liebovich,* 310 Wis. 2d at 784, *citing Baumann v. Elliot*, 286 Wis. 2d 667 (Ct. App. 2005). The Supreme Court of Wisconsin has stopped short of requiring insurance companies to take these measures before refusing to defend, but explains the risks of not doing so as follows:

> [W]e strongly encourage insurers wishing to contest liability coverage to avail themselves of one of these procedures rather than unilaterally refuse to defend. A unilateral refusal to defend without first attempting to seek judicial support for that refusal can result in otherwise avoidable expenses and efforts to litigants and courts, deprive insureds of their contracted-for protections, and estop insurers from being able to further challenge coverage. *Baumann,* 286 Wis. 2d 667, at ¶ 8.

In *Radke v. Fireman's Fund Insurance Co.,* 217 Wis. 2d 39 (Ct. App. 1998), a high school student filed a federal action against a teacher, Radke, after he allegedly sexually abused her during a field trip. Radke's homeowner's insurance company invoked the intentional acts exclusion and refused to defend him. He thereafter settled with the student and brought a coverage action against the insurance company in state court. The court found the student's claims for negligent infliction of emotion distress were at least "arguably" covered by the

policy, thus triggering the insurance company's duty to defend. *Radke*, 217 Wis. 2d at 47-48. Its breach of this duty meant it could "not now challenge or otherwise litigate the coverage issues." *Radke*, 217 Wis. 2d at 48, *citing Grube v. Daun*, 173 Wis. 2d 30, 74-75 (1992). The court ordered the insurance company to reimburse Radke for his defense costs as well as the amount he paid to settle with the student. *Radke*, 217 Wis. 2d at 48-49.

The Supreme Court of Wisconsin's recent opinion in *Maxwell v. Hartford Union High School District*, 341 Wis. 2d 238 (2012) explored the limits of the rule, declining to extend estoppel to create coverage where it did not exist in the first place. In *Maxwell*, a terminated employee sued the school district that fired her. The district's insurance company defended the case without issuing a reservation of rights letter. The court awarded the employee compensatory damages, which the insurance company refused to pay on the grounds that the policy excluded coverage for actions seeking "compensation for loss of salary or fringe benefits" of its employees. The district filed a third-party complaint alleging that the insurance company was estopped from denying coverage because it defended without reserving its rights. *Maxwell,* 341 Wis. 2d at 249-250. The insurance company prevailed after the trial court ruled that the employee's compensatory damages were subject to the cited exclusion, and the fact that the

insurance company neglected to reserve its rights "did not create coverage for that aspect of the claim." *Maxwell,* 341 Wis. 2d at 250.

The Wisconsin Supreme Court affirmed the *Maxwell* ruling in a deeply split opinion. It described indemnification for judgments and settlements to be among the damages that flow "naturally" from an insurance company's breach of its duty to defend:

> [A] party aggrieved by an insurer's breach of its duty to defend is entitled to recover all damages naturally flowing from the breach . . . Damages which naturally flow from an insurer's breach of its duty to defend include: (1) the amount of the judgment or settlement against the insured plus interest; (2) costs and attorney fees incurred by the insured in defending the suit; and (3) any additional costs that the insured can show naturally resulted from the breach.

Maxwell, 341 Wis. 2d at 262, *quoting Newhouse v. Citizens Security Mut. Ins. Co.,* 176 Wis. 2d 824, 830.

The court recognized that earlier Wisconsin authorities often referred to insurance companies being "estopped" from denying coverage after committing bad faith or breaching the duty to defend. *Maxwell,* 341 Wis. 2d at 263-264 *citing Newhouse*, 176 Wis. 2d 824; *Grube v. Daun*, 173 Wis. 2d 30 (Ct. App. 1992); *Professional Office Buildings, Inc. v. Royal Indem. Co.*, 145 Wis. 2d 573 (Ct. App. 1988). However, it stated that these decisions "do not refer to estoppel in the traditional sense and the estoppel referred to does not expand or create coverage."

Maxwell, 341 Wis. 2d at 265. The court concluded by admonishing defending insurance companies to send reservation of rights letters to preserve defenses they may wish to assert in the future. *Maxwell*, 341 Wis. 2d at 265.

F. Mississippi Takes a Similar Approach.

Mississippi couches a similar rule relating to settlements and consent judgments in terms of "waiver." In *Mississippi Insurance Guaranty Ass'n v. Byars*, 614 So. 2d 959 (Miss. 1993), an off-duty member of the Navy sustained severe head injuries while riding a motorcycle in Virginia. His guardian sued the Michigan store that sold the helmet, among others, in plaintiff's home state of Mississippi. The defendants' insurance companies had all entered bankruptcy by the time of the lawsuit, and as a result, counsel notified the Mississippi Insurance Guarantee Fund ("MIGA") of the lawsuit. MIGA refused to defend or indemnify the Michigan store on the grounds that it was not a Mississippi resident. *Byars,* 614 So. 2d at 962. Plaintiff and the store settled for $375,000 and entered a consent judgment. The store paid $75,000 up front and assigned plaintiff the right to sue MIGA for the balance. *Byars,* 614 So. 2d at 962. In the subsequent coverage suit, MIGA argued that plaintiff "failed to preserve any defenses or causes of action" covered by the policies when he settled with the store. The court found MIGA's argument without merit and determined that MIGA had breached its duty to defend. It described Mississippi's remedy for this breach as follows:

> [I]t has long been established that when an insurer breaches its duty to defend an insured, the insurer is liable and bound by any settlement agreements made by the insured as a result of this breach.

Byars, 614 So. 2d at 962 *citing Mavar Shrimp & Oyster Co. v. United States Fidelity & Guaranty Co.*, 187 So. 2d 871, 875 (Miss. 1966).

The court's inquiry was limited to ensuring that the settlement was "reasonable under the circumstances and that MIGA had been notified of . . . of the upcoming settlement conference in Detroit, Michigan." *Byars,* 614 So. 2d at 965. It answered these questions in the affirmative and held that "MIGA is therefore bound by this settlement agreement and cannot deny coverage now by claiming that Byars did not follow the policy language requiring the insurance company's approval before acceptance of a settlement." *Byars,* 614 So. 2d at 965.

Jones v. Southern Marine & Aviation Underwriters, Inc., 888 F.2d 358 (5th Cir. 1989), among the cases cited by the Mississippi Supreme Court in *Byars*, arose from a coverage dispute over a blown gas well and the resulting environmental contamination. Hartford provided general liability coverage to Tomlinson, the well's owner. Southern Marine & Aviation Underwriters ("Underwriters") provided separate blowout and re-drill coverage. Hartford and plaintiffs executed a roughly $1.6 million consent judgment, $600,000 of which plaintiffs agreed to seek from Underwriters. Underwriters thereafter refused to pay because (a) the consent judgment did not satisfy the coverage conditions that

272, 282 (1974) (an *amicus* cannot raise new issues in a case). Because the due process implications of the underlying judgment were never previously put before the Court by the parties, they need not be considered on reargument. Rules of Court of Appeals, 22 NYCRR § 500.23(a)(4).

CONCLUSION

One of the central promises that an insurance company makes to its policyholder is that it will defend potentially covered lawsuits, even when the duty to indemnify is not yet known with certainty. Absent the protection provided by the *Lang* Rule, policyholders in New York will continue to be subjected to the sort of delay and denial that American Guarantee demonstrated in this case, which regrettably has become all too common in the three decades since *Servidone Construction Corp. v. Security Inurance Co. of Hartford* was decided. In that time, insurance companies have come to believe that the only consequence they may face for breaching the duty to defend will be one day to pay no more than the defense costs they were already obligated to pay.

When insurance companies provide their policyholders with no protection whatsoever and simultaneously spare themselves the effort and expense of a declaratory judgment action, they ignore the express guidance offered by this Court in *Lang*. An insurance company's wrongful refusal to defend its policyholder vitiates the insurance contract and abandons the policyholder at a

critical time. The *Lang* Rule imposes an appropriate contractual remedy for the insurance company's material breach (if not outright repudiation) of the insurance contract. It provides full contract performance by the breaching party in favor of the non-breaching party. As seen in the states surveyed above, the approach outlined in *Lang* and *K2 Investment Group* is consistent with the approach taken in states across the entire nation. In every instance, those states share a common goal: to provide policyholders with the full benefit of their bargain by giving insurers an incentive to defend the cases they are bound by law to defend. Policyholders in New York are entitled to have their insurance contracts honored in the same way.

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Respectfully submitted,

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