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THE EFFECT OF BREACHING THE DUTY TO DEFEND ON THE DUTY TO INDEMNIFY

[Ref. Good Faith Claims Handling, Para 4.02]

It is common knowledge among claims professionals that the duty to defend is broader than the duty to indemnify. Liability policies require an insurer to provide a defense whenever the facts alleged in a complaint could arguably give rise to coverage. It is not necessary that the allegations of the complaint be proved true before the duty to defend is triggered. The duty to defend arises if the allegations, even if groundless, false, or fraudulent, could reasonably give rise to coverage. A dilemma confronts an insurer, however, when it concludes that the allegations in a complaint are not covered by the policy.

When an insurer receives a complaint filed against its insured, the insurer has three options. The first option is to provide its insured with an unconditional defense, in which case the insurer waives its coverage defenses. The second option is to provide a conditional defense under the protection of a reservation of rights or nonwaiver agreement, in which case the insured is provided with a defense, the insurer preserves its coverage defenses, and the issue of coverage can be resolved in a separate declaratory judgment action. The third option is to deny coverage and refuse to provide a defense, leaving the insured to fend for himself.

What are the consequences to the insurer if it denies a defense and it is later determined that its decision was incorrect? Does the insurer only have to reimburse the insured for defense costs or does a wrongful denial affect the insurer's duty to indemnify the insured for his liability to the third party? This article will discuss the consequences of an insurer's failure to defend in relation to its duty to indemnify.

The wrongful failure to defend is a breach of contract and it is clear that, at a minimum, the insurer is liable for the costs incurred by the insured to defend the original action. In some cases, however, the insurer can face additional consequences. One of the most significant is a limitation on the insurer's right to contest its duty to indemnify. By wrongfully denying a defense to its insured an insurer runs the risk that it will be obligated to indemnify the insured for any judgment or settlement in the original action. In some states (e.g., Illinois and Connecticut) an insurer may be estopped from raising coverage defenses in a later dispute about its duty to indemnify. The majority rule, however,

is that an insurer, even after wrongfully refusing to defend, is entitled to raise coverage defenses in a later dispute over its duty to indemnify. In a recent decision of the Court of Appeals of New York, *K2 Investment Group v.* American *Guarantee & Liability Insurance Company*, 2014 N.Y. LEXIS 201 (N.Y. 2014), the state's highest court followed New York precedent and the majority rule.

The *K2* case involved a claim of legal malpractice against an insured, a lawyer, for failing to record certain mortgages. The insurer refused to defend based on the argument that recording mortgages does not amount to the rendering of legal services and the insured's failure to record them was not covered under his professional liability policy. The insured defaulted and a default judgment was entered. The insured then assigned his rights against the insurer to the plaintiffs and they brought suit against the insurer alleging breach of contract, seeking the $2 million policy limit. The court held that the factual allegations in the complaint potentially involved covered legal services, the insured was entitled to a defense, and the insurer was wrong in failing to provide one. Nonetheless the court held that the insurer was entitled to raise coverage defenses in the dispute about its duty to indemnify. The court's rationale was that to prohibit the insurer from raising coverage defenses would be to expand the contract between the parties beyond their intent.

While the court in *K2* followed the majority rule in permitting the assertion of coverage defenses, it was careful to point out that in situations in which coverage may be arguable, a prudent insurer might be better served to reserve its rights and seek a declaratory judgment to resolve the issue of its duty to defend.

Note that whether or not an insurer is estopped from raising coverage defenses, in most states the insurer is only required to indemnify up to the policy limit, absent proof of bad faith on its part.

The court in *K2* followed the majority rule and allowed the insurer to raise coverage defenses in the subsequent dispute over its duty to indemnify. It's important to note, however, that even in states that follow the majority rule, an insurer might not be allowed to raise coverage defenses if the facts underlying those defenses were considered and disposed of in the underlying litigation. Rather, an insurer that wrongfully refused to defend its insured would be bound by the issues litigated in the underlying action. This is true of findings of fact by judge or jury. If, for example, a default judgment was entered against the insured on the basis of his negligence, the insurer could not raise an intentional injury exclusion as a defense to its duty to indemnify. The insurer, however, could argue another policy breach if that issue had not been addressed in the underlying action.

In *Metropolitan Property and Casualty Ins. Co. v. Morrison*, 951 NE2d 662 (Mass. 2011), the Massachusetts Supreme Court addressed the effect of a default judgment on the insurer's duty to indemnify. Morrison was the son of Metropolitan's named insureds. When he was sued for bodily injury sustained by a police officer, Morrison sought a defense under his parents' policy. The injury occurred when the officer was attempting to frisk Morrison after a motor vehicle stop. When Morrison attempted to run from the officer, the officer tried to stick out his leg in front of Morrison but the officer's boot caught on the asphalt and the officer fell, fracturing his ankle. Morrison was charged with assault and battery on a public employee. Metropolitan denied any obligation to defend or indemnify Morrison. When no answer was filed on Morrison's behalf, the court entered a default in the lawsuit against him and later conducted an assessment of damages hearing. The hearing resulted in an award of over $84,000 to the officer and judgment for that amount was entered against Morrison.

Metropolitan filed a declaratory judgment action. Morrison asserted that Metropolitan breached its duty to defend and indemnify him in the police officer's suit and that Metropolitan could not deny coverage on the basis of the policy's intentional and criminal acts exclusion because the default judgment established that his negligence caused the officer's injury. He argued that as a result of the default judgment the facts alleged in the complaint had to be accepted as true. Metropolitan

countered that it did not owe coverage because Morrison lied to its investigator about his residency at the time of the incident, a breach of the policy's concealment or fraud provision, and that the officer's injury was the result of Morrison's intentional and criminal acts. The state supreme court held that if the insurer was in breach of its duty to defend when the default judgment was entered "it would be bound by the default judgment that established Morrison's liability for negligence."

The court explained:

> Where there is uncertainty as to whether an insurer owes a duty to defend, the insurer has the option of providing the insured with a defense under a reservation of rights, filing a declaratory judgment action to resolve whether it owes a duty to defend or to indemnify, moving to stay the underlying action until a declaratory judgment enters, and withdrawing from the defense if it obtains a declaration that it owes no duty to the insured. A declaratory judgment of no coverage, either by summary judgment or after trial, does not retroactively relieve the primary insurer of the duty to defend; it only relieves the insurer of the obligation to continue to defend after the declaration. Where material facts as to the duty to indemnify are in dispute, an insurer has a duty to defend until the insurer establishes that no potential for coverage exists.
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> Metropolitan did not pursue this option. Instead it disclaimed a duty to defend without first obtaining a judicial declaration, and failed to file an answer or responsive motion to the Langliers' personal injury complaint. By the time Metropolitan moved for summary judgment on October 26, 2009, a default judgment against Morrison had already been issued in the underlying personal injury action.
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> Apart from consequences arising from a breach of contract, an insurer's breach of a duty to defend may also trigger a duty to indemnify because an insurer in breach of its duty to defend "is bound by the result of the underlying action as to all matters therein decided which are material to recovery by the insured in an action on the policy."
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> Where a defendant defaults, the factual allegations in the complaint as to liability are deemed to be admitted by the defendant and treated as if they are true.
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> Where, as here, the plaintiff in the underlying action brings a negligence claim and the factual allegations in the complaint are sufficient to support such a claim, the default judgment conclusively establishes negligence as to the defendant insured and, if the insurer has committed a breach of its duty to defend, as to the insurer. Therefore, where an insurer commits a breach of its duty to defend and the insured defaults, the insurer is bound by the factual allegations in the complaint as to negligence in determining whether the insurer has a duty to indemnify; where an insurer did not breach its duty to defend, it is not bound by the factual allegations of negligence in determining indemnification.

If the insurer had breached its duty to defend, it could not argue that the intentional and criminal acts exclusion applied because the insurer would be bound by the default judgment that was based on negligence. Since Morrison's liability was based on negligence, the insurer would not be able to argue that he acted intentionally. The court went on to say, however, that Metropolitan would be free to assert another policy defense, e.g., breach of the concealment or fraud clause, not inconsistent with negligence.

CONCLUSION

An insurer should not refuse to defend without carefully considering the consequences. In some states, an insurer that wrongfully refuses to defend will be estopped from raising coverage defenses with respect to its duty to indemnify. Even in the majority of states that do not follow the estoppel rule, an insurer that has wrongfully refused to defend may be barred from raising coverage defenses that rely on facts previously considered and resolved in the underlying litigation. In any event, an insurer that refuses to defend gives up control over the underlying litigation and settlement negotiations and, if it is later determined that its no-defense position was incorrect, it will be obligated to pay a judgment or settlement up to the policy limit in addition to costs incurred by its insured in conducting its own defense. As the court in *K2* suggested, when coverage is arguable, it may be prudent for an insurer to reserve its rights and seek a declaratory judgment concerning its duty to defend.