NEW YORK COURT OF APPEALS ROUNDUP

COURT OF APPEALS DECIDES TWO INSURANCE CASES AND WHEN THE NON-MEDICAL MALPRACTICE STATUTE OF LIMITATION APPLIES

ROY L. REARDON AND MARY ELIZABETH MCGARRY
SIMPSON THACHER & BARTLETT LLP

FEBRUARY 10, 2005

The Court of Appeals recently handed down two significant insurance decisions, both written by Judge George Bundy Smith. This month we discuss those decisions, as well as a case brought against an architecture firm that addresses when claims, including claims arising from a breach of contract, are subject to the three-year statute of limitations for non-medical malpractice.

Declaratory Judgment Action – When the Insurer Pays the Cost

In another instance of what has become a frequently used procedural approach by federal courts of seeking the assistance of state courts to resolve questions implicating state public policy or to clarify state law, the United States Court of Appeals for the Second Circuit in *U.S. Underwriters Ins. Co. v. City Club Hotel, LLC*, certified questions to the Court of Appeals. The principle issue was whether an insurer that sued its insured for a declaratory judgment that there is no coverage under policy and lost that action, but had also provided the insured with a defense in the underlying case, is liable to the insured for its costs incurred in defending the declaratory judgment action.

The matter arose out of a general liability policy issued to Shelby Realty, Inc. ("Shelby") and City Club on behalf of itself and its members in certain circumstances, in connection with renovation work being performed by City Club on property owned by Shelby. An employee of City Club was seriously injured on the job. In July 2000, the employee notified the insurer of his claim and also provided the insurer with his lawyer's letter to Shelby informing the company that it might be sued. The insurer acknowledged receipt of the notice and identified Shelby and City Club as its insureds.

In November 2000, the employee sued Shelby and two entities that were members of City Club. City Club was not joined as a defendant, presumably because the employee would have been barred from recovering from his employer under the worker's compensation law. On December 20, 2000 - five months after it had received notice of the claim

- the insurer disclaimed coverage of Shelby and City Club, but proceeded to provide Shelby with a defense to the worker's personal injury action.

Earlier, in September 2000, the insurer had filed suit in the federal District Court, based upon diversity jurisdiction, seeking a declaratory judgment that it owed no duty to defend City Club, Shelby, or the two other entities named as defendants in the employee's suit. After both sides moved for summary judgment, the District Court granted summary judgment to the defendants, finding the insurer's disclaimer untimely as a matter of law. The defendants' motion for attorneys' fees in defending the declaratory judgment action was denied because the insurer had provided a defense to the employee's action.

The Second Circuit affirmed the District Court's conclusion that the disclaimer was untimely as to all named defendants, held that Shelby was entitled to a defense and indemnity, did not determine whether the two additional entities sued by the worker were entitled to coverage under the policy because those entities had not sought adjudication of that issue in the District Court, and dismissed the suit against City Club because it had never sought coverage.

As to defendants' claim for attorneys' fees, the Second Circuit certified two questions. It is apparent that the Circuit Court was concerned about the implications of awarding counsel fees in a declaratory judgment action when the insurer provided a defense to the underlying suit. The possibility exists that such a result would have the effect of causing an insurer to decline to give its insured a defense and force the insured to bring its own action for coverage against the insurer - as opposed to providing a defense and instituting a declaratory judgment action as the insurer had done here - because the general rule if applied would deny the insured recovery of attorneys' fees even if it prevailed in a coverage action that it had instituted. The Court of Appeals did not discuss this concern in its opinion.

With respect to the first certified question – whether an insured can recover its attorneys' fees incurred in successfully defending the insurer's declaratory judgment suit – the Court, relying principally upon the language of *Mighty Midgets, Inc. v. Centennial Ins. Co.,* 74 N.Y.2d 487 (1989), concluded that it can. Shelby's recovery of attorneys' fees was "incidental" to the insurer's duty to defend Shelby. In addition, the Court unequivocally held that the fact that the insurer had provided a defense to Shelby did not change the result.

The remaining question that the Circuit Court had invited the Court of Appeals to decide was whether attorneys' fees should be awarded to one or more defendant "in the special circumstances of this case." Because it was unclear to the Court of Appeals what the Second Circuit meant by the "special circumstances of the case," it declined to answer the second question. Are the two City Club members' fees to be reimbursed; if those entities presented a common defense with Shelby, how would the amount of fees be determined? These "thorny" factual issues are returned to the federal courts for resolution.

Reinsurance Agreement Cap

A suspicious warehouse fire led to a spate of litigation that ended with a Court of Appeals decision in *Excess Ins. Co. Ltd. v. Factory Mut. Ins. Co.,* holding that a reinsurance agreement's limit applied not only to the reinsured's payments on a claim, but also to its loss adjustment expenses.

Factory Mutual Insurance Company provided $48 million in property insurance for equipment stored in a warehouse. The warehouse burned down, leading to two coverage actions between Factory Mutual and its insured. Factory Mutual expended $35 million in litigation costs before it settled those actions.

Factory Mutual then made claims against a $13.5 million layer of facultative reinsurance (an agreement that covers the reinsured's risk under a specific insurance policy it issued), $7 million of which had been obtained from various London reinsurers. No fewer than five actions were commenced between Factory Mutual and the London reinsurers concerning whether the policy should be annulled for misrepresentations and nondisclosure, and whether Factory Mutual could recover not only $7 million for its payments on the underlying property damage claim, but also $5 million in loss adjustment expenses consisting of a portion of its costs from litigation with the property owner.

The parties' contract contained a "follow the settlements" clause, pursuant to which a reinsurer must follow the actions of the reinsured in adjusting and settling claims against a policy issued by the reinsured.[1] The issue before the Court of Appeals was whether this obligation to bear a proportionate share of Factory Mutual's litigation expenses was subject to the reinsurance agreement limit.

The Court concluded that $7 million was the total extent of the London reinsurers' liability, and that the reinsurers therefore were entitled to summary judgment. Judge Smith's opinion for the majority reasoned that in interpreting contracts courts must give effect to all material provisions, including in this case the $7 million limit provision. Factory Mutual could have negotiated explicit language excluding expenses from the indemnification cap but did not, and therefore could not expose the reinsurers to "limitless liability." The Court also stated that its holding was consistent with Second Circuit decisions interpreting "follow the fortunes" clauses similar to the "follow the settlements" clause at issue.[2]

Judge Susan Phillips Read dissented. She concluded that summary judgment was inappropriate because the contract was ambiguous and thus there was a factual issue as to the parties' intent. The dissent noted that the company that had issued the $6.5 million balance of the $13.5 million reinsurance layer had paid Factory Mutual both indemnification up to its agreement limit and its proportion of litigation costs, and that the various courts to consider the issue prior to the Court of Appeals had interpreted the relevant reinsurance contract provisions

differently. With respect to the Second Circuit authority relied upon by the majority, Judge Read both criticized and distinguished it, argued that evidence of industry practice and custom had been ignored, observed that commentators have faulted the opinions, and expressed concern that the Second Circuit's contract-specific holding was being expanded by the Court of Appeals majority "into a rule of general applicability."

Architectural Malpractice

In *Kliment* v. *Halsband*, the Court unanimously held that the three year statute of limitations for non-medical malpractice governs a claim against an architecture firm that allegedly failed to exercise due care in carrying out its professional obligations, even if the conduct at issue violated an explicit provision of the parties' contract.

Plaintiff attempted to invoke the six year statute of limitations for contract actions. It alleged that the defendant firm's failure to provide fire protection in compliance with the state building code breached a provision in the parties' contract that all specifications and documents furnished by the architecture firm must comply with applicable codes. Judge Carmen Beauchamp Ciparick's opinion explained that CPLR 214(6) was amended in 1996 to overturn the effect of prior Court of Appeals decisions that had determined the applicable statute of limitations based upon the proposed remedy. Sectioin 214(6) now provides that, "regardless of whether the underlying theory is based in contract or tort," a malpractice action other than for medical, dental or podiatric malpractice must be brought within three years. Thus, in cases such as this where the plaintiff asserts "essentially a malpractice claim," the shorter statute of limitations must be applied.

[1] The agreement provided that "[r]einsurers agree to follow the settlements of the Reassured in all respects and to bear their proportion of any expenses incurred, whether legal or otherwise, in the investigation and defence of any claim hereunder."

[2] *See Bellefonte Reins. Co. v. Aetna Cas. and Surety Co.*, 903 F.2d 910 (2d Cir. 1990), and *Unigard Security Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049 (2d Cir. 1993).