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COURT OF APPEALS

STATE OF NEW YORK

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K2 INVESTMENT GROUP, LLC and  
ATAS MANAGEMENT GROUP, LLC,

Respondents,

-against-

No. 106

AMERICAN GUARANTEE AND LIABILITY  
INSURANCE COMPANY

Appellant.

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20 Eagle Street  
Albany, New York 12207  
April 25, 2013

Before:

CHIEF JUDGE JONATHAN LIPPMAN  
ASSOCIATE JUDGE VICTORIA A. GRAFFEO  
ASSOCIATE JUDGE SUSAN PHILLIPS READ  
ASSOCIATE JUDGE ROBERT S. SMITH  
ASSOCIATE JUDGE EUGENE F. PIGOTT, JR.  
ASSOCIATE JUDGE JENNY RIVERA

Appearances:

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David Rutt  
Official Court Transcriber

1 CHIEF JUDGE LIPPMAN: 106, K2 Investment Group.  
2 Counselor, you want any rebuttal time?

3 MR. KELLY: Two minutes, Your Honor.

4 CHIEF JUDGE LIPPMAN: Two?

5 MR. KELLY: Two minutes, Your Honor.

6 CHIEF JUDGE LIPPMAN: Sure. Go ahead.

7 MR. KELLY: May it please the court, Robert J.  
8 Kelly, Coughlin Duffy, on behalf of American Guarantee and  
9 Liability Insurance Company.

10 The default judgment for which coverage is  
11 sought in this case stems from a failure of a company,  
12 real estate venture, co-owned by the attorney, Mr.  
13 Daniels. K2 loaned that real estate company, taking back  
14 notes in the amount of the loans that were in part signed  
15 by Mr. Daniels. Mr. Daniels also personally guaranteed  
16 all of the notes in the amount of almost three million  
17 dollars which were given by K2 to the company.

18 CHIEF JUDGE LIPPMAN: Counselor, but we know all  
19 of that.

20 MR. KELLY: Okay.

21 CHIEF JUDGE LIPPMAN: But you disclaim and now  
22 you want to contest.

23 MR. KELLY: Yes.

24 CHIEF JUDGE LIPPMAN: Explain why that - - - why  
25 you should be able to do that - - -

1 MR. KELLY: Because - - -

2 CHIEF JUDGE LIPPMAN: - - - after disclaiming.

3 MR. KELLY: Because the default judgment, which  
4 is based on a default judgment for legal malpractice, does  
5 not foreclose the applicability of exclusions to the  
6 policy.

7 JUDGE SMITH: You - - - you acknowledge that you  
8 dis - - - that your disclaimer was bad?

9 MR. KELLY: No, Your Honor.

10 JUDGE SMITH: You - - - you think there's not  
11 even a duty to defend on this complaint?

12 MR. KELLY: We believe that the company had  
13 grounds for a disclaimer based upon the - - - what was  
14 contained in the complaint.

15 JUDGE SMITH: And if - - - even with the duty to  
16 defend?

17 MR. KELLY: Yes, Your Honor.

18 JUDGE SMITH: If we should - - -

19 JUDGE GRAFFEO: Didn't you say that - - -

20 JUDGE SMITH: If we should disagree with you on  
21 that, does that change the result?

22 MR. KELLY: Not as to indemnity, Your Honor.

23 JUDGE GRAFFEO: Didn't you take the risk by  
24 looking at this complaint and deciding that it was more a  
25 business arrangement rather than a legal malpractice case?

1 MR. KELLY: Well, we - - - it is more of a  
2 business - - - it is a legal malpractice case that arises  
3 out of a business relationship.

4 JUDGE GRAFFEO: Well, but, I mean, that's a  
5 judgment that you made.

6 MR. KELLY: Yes.

7 JUDGE GRAFFEO: That's a determination.

8 MR. KELLY: Yes.

9 JUDGE GRAFFEO: But the duty to defend is  
10 broader than the duty to indemnify.

11 MR. KELLY: It is.

12 JUDGE GRAFFEO: So didn't you take the risk that  
13 you would be stuck?

14 MR. KELLY: We would be stuck with a default  
15 judgment as to legal malpractice. We are not stuck with  
16 respect to application of the exclusions.

17 CHIEF JUDGE LIPPMAN: Why not? Why not?

18 MR. KELLY: Because - - -

19 CHIEF JUDGE LIPPMAN: What's your legal basis -  
20 - -

21 MR. KELLY: Because the policy - - -

22 CHIEF JUDGE LIPPMAN: - - - for saying you're  
23 not stuck?

24 MR. KELLY: Because the policy has two pieces.  
25 It has a coverage grant and it has exclusions. On - - -

1 under the Schiff case, the sum and substance of a policy  
2 is what the grant gives and what the exclusions take away.  
3 Here, the default judgment is premised upon legal  
4 malpractice, but the exclusions say that claims that arise  
5 - - - that are based upon or arise out of self-dealing or  
6 intermingling of a business relationship between a lawyer  
7 and his business relationship are excluded.

8 So here, we are not challenging the default  
9 judgment for legal malpractice. What we are saying, as  
10 was found by the dissent, was that even if there has been  
11 legal malpractice under the coverage grant, the  
12 exclusions, the business enterprise exclusions, can take  
13 that coverage away. And in this circumstance, you had the  
14 attorney was a member of the business that he co-owned.  
15 He signed over 600,000 dollars in notes for the company,  
16 and he personally guaranteed almost three million dollars  
17 in the notes.

18 The reason why there was a legal malpractice  
19 claim for failure to secure the notes with mortgages was  
20 because first, Mr. Daniels' company hadn't paid the notes,  
21 and second, Mr. Daniels hadn't paid the personal  
22 guarantees.

23 JUDGE SMITH: I certainly can see how it's  
24 possible that the malpractice claim arose out of the  
25 lawyer's relationship with the principal there. On the

1 other hand, the default judgment in itself doesn't  
2 establish that. It's also possible that the guy was - - -  
3 that he was simply negligent and that the relationship  
4 with the business enterprise was immaterial, isn't it?  
5 And both those are - - - the default judgment doesn't rule  
6 out either possibility.

7 MR. KELLY: What the exclusions say is that even  
8 if there is a - - - even if there's legal malpractice  
9 negligence, that can be excluded.

10 JUDGE SMITH: I understand. It has to arise out  
11 of the relationship with the business enterprise, right?

12 MR. KELLY: Yes.

13 JUDGE SMITH: What I'm suggesting to you is that  
14 when you look at the complaint and you look at the default  
15 judgment, you don't know whether the malpractice did or  
16 didn't necessarily arise out of the relationship with the  
17 business enterprise. You agree with that?

18 MR. KELLY: That's what the dissent - - - that's  
19 what the dissent found, and that's the relief that we're  
20 seeking in this court.

21 JUDGE SMITH: I didn't say anything about  
22 relief.

23 MR. KELLY: Okay.

24 JUDGE SMITH: Do you agree with what I said,  
25 which is that when you look at the default judgment, you

1 don't know whether the - - - whether this particular - - -  
2 whether these facts fit within the business exclusion or  
3 not?

4 MR. KELLY: Your Honor, respectfully, we  
5 disagree with that.

6 JUDGE SMITH: Okay.

7 MR. KELLY: Under the complaint when it came in

8 - - -

9 JUDGE SMITH: You - - - you say there's no way  
10 to read this other than to - - - other than to say it's  
11 within the business enterprise exclusion.

12 MR. KELLY: We believe that disclaim was proper  
13 for that reason, yes.

14 JUDGE SMITH: Well, I'm really asking about the  
15 complaint - - - okay, you believe the disclaimer is  
16 proper.

17 MR. KELLY: Right.

18 JUDGE SMITH: But if we decide this case on the  
19 assumption the disclaimer is not proper and that there - -  
20 - and that under that complaint you could prove a non-  
21 excluded loss, then it also follows the default judgment  
22 doesn't determine whether the exclusion applies or not,  
23 right?

24 MR. KELLY: What - - - it follows that - - -  
25 under those circumstances that you are now dealing with

1 indemnity as opposed to defense, and under those  
2 circumstances you would be - - - and where the - - - what  
3 the dissent and the Appellate Division found, which is  
4 there - - - that as they found there are insufficient  
5 facts to determine - - - make that determination for  
6 indemnity. It was under New York law if the duty - - - if  
7 you find that there was - - - that we were incorrect in  
8 our disclaimer and there was a duty to defend, that  
9 doesn't determine the indemnity obligation which is what  
10 this case - - -

11 JUDGE SMITH: I - - - I understand that. But  
12 the question - - - and what I think the question is in  
13 this case, and maybe you can correct me, is whether you're  
14 entitled, having failed to disclaim and assume the fail -  
15 - - having disclaimed and assume you disclaimed wrongly,  
16 having disclaimed wrongly, are you entitled to show that  
17 the - - - even though the record doesn't prove it, even  
18 though the complaint and the default judgment leave it  
19 open, are you entitled to show that the facts fit within  
20 the exclusion? You say yes.

21 MR. KELLY: Respectfully disagreeing with the  
22 hypothetical on the defense, the answer is yes, we're able  
23 to do that because - - -

24 JUDGE READ: Do you know of any other case where  
25 that - - - where we've held that to be the case?

1 MR. KELLY: The - - -

2 JUDGE READ: Or what's the closest? What's the  
3 closest?

4 MR. KELLY: The question is - - - the cases - -  
5 - lots of cases dealing with default judgments with the  
6 seeking of coverage, and the issue is whether the coverage  
7 issue was actually determined in the default judgment.

8 JUDGE READ: Well, I guess the question here is  
9 maybe we can't tell.

10 MR. KELLY: Well, you can tell because the  
11 default judgment is based - - - they say the default  
12 judgment is solely based on the legal malpractice claim  
13 against Mr. Daniels when the - - - what the exclusions say  
14 is that assuming a legal malpractice claim, if that legal  
15 mal - - - assuming a legal malpractice judgment, if that  
16 judgment is based upon or arising out of these  
17 impermissible business entanglements, I'll call it, which  
18 are the basis for these exclusions, that will exclude  
19 coverage.

20 JUDGE SMITH: But the question is, are you  
21 entitled to prove, having, we assume wrongly, disclaimed -  
22 - - rejected the defense, are you still entitled to prove  
23 what the record does not necessarily show, that the facts  
24 of this case fit within the exclusion?

25 MR. KELLY: Yes, because the - - -

1           JUDGE SMITH: And what - - - well, first of all,  
2 why doesn't Lang say the opposite? Lang says you're stuck  
3 - - - if you disclaim, all you can do is defend your  
4 disclaimer.

5           MR. KELLY: And we are disclaim - - - defending  
6 our disclaimer.

7           JUDGE SMITH: Okay, but if you lose that  
8 defense, why isn't the case over?

9           MR. KELLY: Because the indemnity question is  
10 different than the defense question. If you rule against  
11 us on - - - on - - -

12           JUDGE SMITH: Let me go back to Judge Read's  
13 question. What case says what you're now saying? I mean,  
14 I don't mean the general proposition that indemnity and  
15 defense are different, but what case says that having  
16 refused defense, wrongly refused defense and suffered a  
17 default judgment, you can now litigate the underlying  
18 facts of the case to say that I've no indemnity  
19 obligation?

20           MR. KELLY: I'm not - - - we're not litigating  
21 the underlying facts of the case. The facts have been  
22 determined that there was legal malpractice on behalf of  
23 Daniels.

24           JUDGE SMITH: But you - - - but it is a fact of  
25 the case whether the business - - - whether these facts

1 fit within the business enterprise exclusion, right?

2 MR. KELLY: No, because that was not determined  
3 in the default judgment.

4 JUDGE SMITH: Right. That's what I'm  
5 suggesting. My question is, having disclaimed - - -  
6 having suffered a default judgment, are you entitled to  
7 prove facts not already in the record that show that  
8 you're within the business enterprise exclusion?

9 MR. KELLY: Yes, yes. We - - - I don't have the  
10 - - - our brief cited numerous cases where, for example -  
11 - -

12 CHIEF JUDGE LIPPMAN: What's the best case that  
13 says you have that right?

14 MR. KELLY: Best case that we've - - - that - -  
15 - we have a string of late notice cases where basically  
16 the - - - a coverage defense of late notice, the  
17 intentional act cases - - - I'll find them shortly - - -  
18 cases where there was a default judgment and then there  
19 was a coverage defense based upon an intentional act that  
20 was not determined in the - - - under the default  
21 judgment. And here - - - okay. We may not raise defenses  
22 to the merits of the plaintiff's claim. Hough v. - - -  
23 Hough v. USAA Casualty, since the underlying - - -

24 JUDGE SMITH: That's an Appellate Division  
25 decision?

1 MR. KELLY: Yes, yes. The cases that we've  
2 cited deal with situations where the coverage - - -  
3 coverage issue was not determined in the underlying - - -  
4 under action. The claim that is - - - was made by the  
5 plaintiff and as found by the majority was just the fact  
6 that there was a legal malpractice decision or judgment  
7 was determinative and - - -

8 JUDGE PIGOTT: Could you have done something  
9 prior to the default judgment being entered in terms of a  
10 DJ or something to protect yourself from having a default  
11 judgment rendered against you - - - against your client?  
12 The reason I ask is it's conceivable in some cases where  
13 there's more than one cause of action and you may have  
14 coverage on one and not on the other. With this one,  
15 you've got - - - you're saying there may be legal  
16 malpractice coverage, but there isn't enterprise coverage.

17 MR. KELLY: Well, that - - - and this is - - -  
18 it was clear from the - - - from the - - -

19 JUDGE GRAFFEO: Isn't that what Lang suggests,  
20 that the insurer should attempt to secure a declaratory  
21 judgment?

22 MR. KELLY: In this case, Your Honor, the - - -  
23 we were - - - the facts were - - - from the complaint  
24 provided grounds for disclaimer, and those facts,  
25 particularly the notes signed by the attorney, the

1 personal guarantees, and the intermingling of his business  
2 with his legal work gave rise to the grounds to disclaim.  
3 If the court should feel - - - disagree with us on that,  
4 it's clear that the default judgment did not determine the  
5 applicability of these exclusions. The dissent in the  
6 Appellate Division made it clear that the exclusions are  
7 to be construed broadly and that under the circumstances  
8 here, there were grounds to - - - for the application of  
9 the - - -

10 JUDGE PIGOTT: Is it conceivable that - - -  
11 maybe it's not - - - that you owed a defense on the legal  
12 malpractice despite the fact that it also involved the  
13 enterprise? In other words, you're his malpractice  
14 carrier.

15 MR. KELLY: No, based upon what the complaint  
16 laid out, which was the fact that the reason why this  
17 claim had been brought was because there was a two - - -  
18 three million dollar personal guarantee obligation owed by  
19 this attorney who - - - that hadn't been paid. That  
20 rendered the disclaimer appropriate.

21 CHIEF JUDGE LIPPMAN: Okay, counselor. Thank  
22 you. You'll have rebuttal.

23 MR. HASKEL: May it please the court, my name is  
24 Michael Haskel. I represent K2/ATAS. On the cross-  
25 appellants, I'd like one minute, if that's possible, on

1 rebuttal on the bad faith.

2 CHIEF JUDGE LIPPMAN: Okay.

3 MR. HASKEL: Thank you, Your Honors.

4 This is a clear case of a carrier just basically  
5 ignoring its obligations, not only to defend, but if you  
6 look at the complaint, the complaint, the two causes of  
7 action from - - - for legal malpractice are based upon  
8 legal malpractice, the elements of which include  
9 obligations of - - - to the client, an attorney-client  
10 relationship, services for the client. As the majority  
11 said, these make the exclusions patently inapplicable,  
12 because if we win on these, we win, and it - - -

13 JUDGE SMITH: Suppose the proof at trial shows  
14 that he was your lawyer and that he did fail to file the  
15 mortgages and the reason that he did it was because he had  
16 divided loyalties, but he also had loyalty to the business  
17 enterprise. Does the exclusion apply?

18 MR. HASKEL: Actually, I don't think it does,  
19 because I think our claims are based upon the legal  
20 malpractice before us.

21 JUDGE SMITH: But you can see how someone might  
22 think otherwise?

23 MR. HASKEL: I can see, but that begins with the  
24 bad faith, but I - - - yes, I could see how somebody might  
25 think otherwise but not at this stage. And furthermore,

1           once you fail to - - -

2                   JUDGE SMITH: I guess what I'm saying is if - -  
3           - if they had defended and suffered a judgment, they would  
4           still be free, after they'd suffered the judgment, to  
5           prove the facts that I just stated hypothetically,  
6           assuming that hadn't been disproved, right?

7                   MR. HASKEL: I don't - - - I don't believe so,  
8           and the reason I don't believe so is the following: the  
9           disclaimer is based upon the lack of an attorney-client  
10          relationship to K2/ATAS; it's a relationship to Goldan.  
11          Why not, in the course of the proceeding, put an answer  
12          and say, you know what, you're not the attorney, Mr. Gold  
13          - - - Mr. Goldman doesn't owe you a duty, he owes a duty  
14          to Goldan, and they could have easily done that because it  
15          coincides. That's what makes it traversable. So they  
16          didn't do that.

17                   JUDGE SMITH: I'm - - - I'm sorry; I'm losing  
18          you.

19                   MR. HASKEL: All right. You have a situation  
20          where the insured says, look, I was supposed to perform  
21          services for Goldan - - -

22                   JUDGE SMITH: That - - - that's his position.  
23          He says he was never their lawyer.

24                   MR. HASKEL: That's correct.

25                   JUDGE SMITH: Okay.

1 MR. HASKEL: You have a claim for legal  
2 malpractice.

3 JUDGE SMITH: Okay. The - - -

4 MR. HASKEL: Put an answer in, you know what,  
5 there is no legal malpractice because there's no attorney-  
6 client relationship.

7 JUDGE SMITH: Okay, but - - -

8 MR. HASKEL: That's a traversable - - -

9 JUDGE SMITH: - - - in my hypothetical, you've  
10 done that and you've lost the case, and there's a whole  
11 big record, and what the record shows is that he was your  
12 lawyer and that he did commit malpractice, and that the  
13 reason for his committing malpractice had a lot to do with  
14 his involvement with another business enterprise. Take  
15 those as the facts. After having - - - after they've  
16 defended that case and lost that case, aren't they  
17 entitled to reject indemnity?

18 MR. HASKEL: I don't think so, but I don't  
19 understand how they could do that if it's determined,  
20 because wouldn't it be determined in the course of the  
21 trial that Mr. Daniels was the attorney for AT - - -  
22 K2/ATAS? If it wasn't determined, then - - - then they  
23 would win. In other words, Daniels would win, and there  
24 would be no case, but if it's determined at trial - - -

25 JUDGE SMITH: I - - - what I'm saying is, isn't

1           there a theoretical possibility that Daniels could lose  
2           based upon facts that did not - - - that came within the  
3           exclusion to the policy?

4                       MR. HASSEL: I don't think so, not on the basis  
5           of the disclaimer.

6                       JUDGE SMITH: Okay. Assume - - - assume there  
7           were.

8                       MR. HASSEL: Okay.

9                       JUDGE SMITH: Assume that you could imagine a  
10          set of facts where Daniels could lose the case, the  
11          malpractice case, but the facts on which he lost them  
12          would not - - - would exclude coverage. They're entitled  
13          to prove those facts, aren't they?

14                      MR. HASSEL: Yes, they are. If there were such  
15          a hypothetical situation - - - which is the examples that  
16          my adversary gave. He said, well, we have cases on late  
17          notice. Well, of course, in that case, yes, you're  
18          absolutely right.

19                      JUDGE SMITH: Okay. And then - - - then the  
20          next step, now - - - all that was on the assumption that  
21          they didn't disclaim, that they defended. How does the  
22          disclaimer change that, or does it change it?

23                      MR. HASSEL: It does, because once you disclaim  
24          wrongly, you lose rights. I mean, here, at the most  
25          vulnerable part - - - point in the insured's legal career,

1 he's facing a potentially extremely large judgment, what  
2 you do is you just turn your back on him. There should be  
3 consequences. They roll the dice - - -

4 JUDGE SMITH: Okay, I - - -

5 MR. HASKEL: - - - so a lawful disclaimer  
6 results - - -

7 JUDGE SMITH: Now the Chief Judge's question,  
8 what's your best case that says that?

9 MR. HASKEL: Well, Lang certainly gives you the  
10 warning.

11 JUDGE SMITH: Actually, the Appellate Division  
12 case that he came up with does say the opposite, doesn't  
13 it? A very short opinion, but it does seem to say what he  
14 says.

15 MR. HASKEL: The question is, and I think that  
16 it was a misstatement, there's no claim for self-dealing,  
17 by the way. There's no exclusion that I know of for self-  
18 dealing. But I don't know if that case has the opposite,  
19 but many of the cases cited, you have to look at the  
20 policy. In this particular policy, which is - - - it's  
21 fact sensitive, you have a clause that excludes situations  
22 where you're representing a trust, and it says, any acts  
23 that relate to the trust: acts.

24 So here, we have a claim based upon, with the  
25 exclusion for trust, it says any acts that relate to the

1 trust, and I'm paraphrasing. So if the - - - in the case  
2 that he's citing, I would have to look at the policy to  
3 see whether or not the exclusions state that it's a claim  
4 based upon, and if it isn't, if it's something different,  
5 then the exclusion can't be viewed in the same way.

6 JUDGE GRAFFEO: So what should they have done if  
7 they felt that their exclusion covered this situation?

8 MR. HASKEL: They should have followed Lang.  
9 All they should have done was, they give a defense to this  
10 attorney who is now left twisting in the wind. Give him a  
11 defense, because it's - - - you're obligated to do it and  
12 they know because of Moskowitz that they're obligated.

13 JUDGE GRAFFEO: But why couldn't they do a  
14 declaratory judgment and determine before they got  
15 involved in the defense whether - - -

16 MR. HASKEL: Well, I guess they could have tried  
17 to stay the action. They could - - - there was a lot of  
18 things they could have done, but we can't - - - in this  
19 state, we can't let carriers roll the dice and basically  
20 ignore their - - - you know - - -

21 JUDGE SMITH: You say they could do anything  
22 except walk away.

23 MR. HASKEL: They can't walk away, not when - -  
24 - within the four corners of the complaint, this is  
25 clearly covered, without question. It's bad faith to walk

1 away. They are grossly disregarding their client's rights  
2 here. They should be liable for the entire amount.

3 JUDGE SMITH: Assume - - - assume they did - - -  
4 I'm now switching to the bad faith claim. Assume they did  
5 walk away in bad faith, does that mean you get the  
6 judgment beyond the policy limits, that by itself?

7 MR. HASKEL: I think so. I think under Pavia -  
8 - - although Pavia dealt with settlement, I think that  
9 that's a gross disregard. It's especially - - -

10 JUDGE SMITH: But this - - - so they didn't give  
11 Daniels a defense and they should have, but if they - - -  
12 no matter how - - - but if they had given him a defense,  
13 they're only liable up to the policy limits; he's still  
14 stuck for everything above that. Why should their failure  
15 to give him a defense give him more coverage?

16 MR. HASKEL: Because it was the failure to give  
17 a defense - - - if, in fact, that's - - - you know, that  
18 was wrongful - - - that would have led to the judgment,  
19 because, let's face it - - -

20 JUDGE SMITH: How do we know that? Maybe - - -  
21 maybe it was a merit of the case that led to the judgment.

22 MR. HASKEL: Well, that's an interesting point.  
23 There's two possibilities. The merit of the case, in  
24 other words, Daniels represents K2/ATAS and he performed -  
25 - - he was supposed to perform service, and the failure to

1 record the mortgage has proximately resulted in damage.  
2 That's what the complaint says; that's what's established  
3 by the default judgment. It couldn't be anything else  
4 because otherwise we'd miss an element. Let's assume  
5 that's the case; they'd be liable for the two million.  
6 But by walking away - - - walking away when they had a  
7 traversable defense - - - you're not the attorney, you  
8 know, he's not your attorney - - - they walked away when  
9 the traversable defense that they had would have knocked  
10 out the underlying claim if it was true.

11 JUDGE SMITH: Okay.

12 MR. HASSEL: That's bad faith.

13 JUDGE SMITH: And as a result, they lose their  
14 policy limits, but why should they lose more than their  
15 policy limits?

16 MR. HASSEL: Because that's the consequences of  
17 turning your back - - - and - - -

18 JUDGE SMITH: You got a case that says that?

19 MR. HASSEL: - - - by the way, I offered to  
20 settle the case. What's that?

21 JUDGE SMITH: You got a case that says that?

22 MR. HASSEL: Well, Pavia says it because that's  
23 a settlement case. I offered to settle the case.

24 JUDGE SMITH: Well, there's a - - - I mean,  
25 Pavia, as I understand, that's a typical bad faith case.

1 They had a chance to settle within the policy limits, they  
2 didn't, and then they're stuck for the excess.

3 MR. HASKEL: They had that here, too, because I  
4 did offer to settle the case.

5 JUDGE SMITH: I understand, but that - - - yeah,  
6 which was very - - - which was a good idea, a clever thing  
7 to do, but does it really change the picture?

8 MR. HASKEL: I think it does. I think when you  
9 turn your back on your client - - - I mean, there are  
10 states like Arizona and so - - - and Massachusetts, if you  
11 turn your back on a client, it's a serious matter.

12 JUDGE SMITH: And don't - - - I guess what I'm  
13 saying is don't you have to prove - - - to recover under  
14 bad faith, don't you have to prove that this was a  
15 settlement offer that, on the merits as it was understood  
16 at that time, clearly should have been taken in the  
17 client's best interest, that it was an outrage to turn the  
18 settlement down?

19 MR. HASKEL: I could see that as being the - - -  
20 yeah, under Pavia that's true, but I think you have to  
21 couple that in this case with such a gross disregard  
22 coming so quickly after Moskowitz or - - -

23 JUDGE SMITH: Is it fair to say that your bad  
24 faith claim today is not directly either supported or  
25 contradicted by any case right in point?

1 MR. HASKEL: I would say that's a fair  
2 statement, Your Honor, in New York.

3 CHIEF JUDGE LIPPMAN: Okay, counselor. Anything  
4 else, counselor?

5 MR. HASKEL: No, Your Honor.

6 CHIEF JUDGE LIPPMAN: Okay. Counsel.

7 MR. KELLY: Going back to the point that was  
8 asked about the assuming a default judgment, the grounds  
9 for coverage defenses, and I cited the -- that Hough case,  
10 there are - - - the other case law is that where you've  
11 got a legal malpractice case and - - - which under the  
12 coverage grant, that doesn't preclude you from relying on  
13 exclusions here, that the salient point is that the  
14 default judgment didn't adjudicate any of the facts  
15 relating to the application of the business enterprise  
16 exclusions as was found by the dissent.

17 JUDGE PIGOTT: In other similar cases where you  
18 have this kind of conflict, don't you get a - - - you  
19 know, you let the defendant get his own counsel that you  
20 pay for and then obviously he's going to try to defend the  
21 defendant, and if it falls within your policy, you pay; if  
22 it doesn't, you don't?

23 MR. KELLY: Not in a situation where there are  
24 grounds for disclaimer because if you don't disclaim at  
25 that point, then you run the risk that you'll be - - -

1           you'll waive it.

2                   JUDGE PIGOTT: Well, you did reserve rights  
3 though, didn't you? And then all you have to do is say  
4 this doesn't fall within the policy, we're not paying.

5                   MR. KELLY: Well, if you reserve rights and you  
6 have grounds for disclaimer at that point, you run the  
7 risk that later on you will be - - - you will have waived  
8 the right to disclaim. So where you believe you have the  
9 right to disclaim, you need to disclaim.

10                   Briefly, on the bad faith point, it's our view  
11 that there was no bad faith in any way, shape or form by  
12 Zurich, that there was grounds for the disclaimer. Should  
13 the court disagree with our position that there was  
14 grounds for disclaimer, under the clear facts of the  
15 complaint showing that this legal malpractice case grew  
16 out of a business enterprise by Mr. Daniels and Mr.  
17 Daniels' failure to pay personal guarantees that he owed  
18 K2, that if you disagree that the disclaimer was proper,  
19 that there were arguable bases to disclaim.

20                   JUDGE SMITH: So you say - - - you say it was a  
21 good faith disclaimer. You also say that even if it was a  
22 bad faith disclaimer you're only liable - - - you're not  
23 liable beyond the policy limits?

24                   MR. KELLY: I would agree with that.

25                   JUDGE PIGOTT: What about - - - why didn't he

1 defend himself? I mean, why didn't somebody show up to  
2 defend this thing?

3 MR. KELLY: The majority in the Appellate  
4 Division said this was questionable circumstances. In  
5 fact, they said, overall questionable circumstances, i.e.,  
6 the whole transaction was questionable; twelve percent  
7 interest being paid on the notes signed by Mr. Daniels;  
8 the overall involvement in the transaction. So the record  
9 is - - - the record doesn't contain an answer to your  
10 question, Your Honor, but in fact, the only way to find  
11 that out is to do what the dissent suggested and to remand  
12 it for discovery.

13 JUDGE SMITH: Another way would have been for  
14 you to take over the defense and the case could have been  
15 litigated and we'd know what went on.

16 MR. KELLY: We could not have done that, Your  
17 Honor, given what the complaint disclosed and the grounds  
18 for disclaimer at that time.

19 CHIEF JUDGE LIPPMAN: Okay, counselor. Thanks.  
20 Go ahead, counselor.

21 MR. HASKEL: Rucaj is a very good case. The  
22 default judgment established the facts. The Hough case  
23 that we're talking about involved an intentional act of  
24 wrongdoing. That's a public policy issue because if you  
25 have an intentional act, clearly there shouldn't be

1 coverage in any event because it's against public policy.  
2 So that's distinguishable. But there are - - - the Worth  
3 case, which is this court's case, talks about the  
4 background, in other words, facts such as he - - - there's  
5 a business relationship and so forth. Those are just  
6 background. There has to be a causal connection, and  
7 there wasn't one here. That's Westpoint.

8 JUDGE SMITH: What's the name of the case?

9 MR. HASKEL: Well, Rucaj and Worth. The Worth  
10 case involved steps where the - - - there's a contractor  
11 that built steps, and then there was an accident, but they  
12 said that the building of the steps is just a circumstance  
13 that leads ultimately to the situation where you can have  
14 coverage. That's similar to RJC Realty.

15 JUDGE PIGOTT: I think of the civil negligence  
16 cases where you've got the bar fight and there's an  
17 allegation that it's intentional and an allegation that it  
18 was unintentional, and the carrier is only going to pay if  
19 it's unintentional. And usually they give you - - - they  
20 say, you know, we're reserving our right and you go get a  
21 lawyer and we'll see how it ends up.

22 MR. HASKEL: Right. And in that case - - -  
23 here, their ability to defend and traverse this coincided  
24 100 percent with Daniels, that they could have beaten  
25 these legal malpractice. The rest of the claims don't

1 count because it's just the cause of action of legal  
2 malpractice that we're dealing with here for the coverage.

3 CHIEF JUDGE LIPPMAN: Okay, counselor.

4 MR. HASKEL: Niagara is a good case.

5 CHIEF JUDGE LIPPMAN: Thanks, counselor.

6 Appreciate it.

7 MR. HASKEL: Thank you, Your Honor.

8 CHIEF JUDGE LIPPMAN: Thank you both.

9 (Court is adjourned)

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C E R T I F I C A T I O N

I, David Rutt, certify that the foregoing transcript of proceedings in the Court of Appeals of K2 Investment Group, LLC, et al., v. American Guarantee and Liability Insurance Company, No. 106 was prepared using the required transcription equipment and is a true and accurate record of the proceedings.



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