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Expert Analysis

Coverage by Estoppel? It May Depend on the Court

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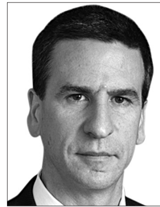

On the eve of a recent trial handled by my firm, the carrier for a client advised us that it had discovered the client was not, in fact, an insured on its policy, notwithstanding it had been providing the client with a defense for several years. Apparently, the client's third-party administrator had sent the original notice of claim to the wrong carrier, who assigned counsel without confirming coverage. When a notice of claim was forwarded to the proper carrier, it naturally disclaimed on the grounds of late notice.

We wondered whether the original carrier would be estopped from disclaiming, since it had accepted the defense of our client without reservation, and assumed control of its defense for several years only to attempt to drop coverage on the eve of trial.

While I had never litigated the issue, my assumption was that this was a textbook example of estoppel, especially given the prejudice of being left with no coverage on the eve of a trial. It was my understanding that while coverage could not be created by waiver, it could be created through estoppel.

My instinct was seemingly confirmed by the Appellate Division, Second Department, case *Utica Mut. Ins. Co. v. 215 West 91st Street Corp.*, 283 AD2d 421, 724 NYS2d 758 (2d Dept. 2001) and *Brooklyn Hosp. Center v. Centennial Ins. Co.*, 258 AD2d 491, 685 NYS2d 267 (2d Dept. 1999). However, to my dismay and surprise, I found that the Appellate Division, First Department, had held on several occasions that coverage could not be created by either waiver or estoppel, as reflected by the cases *Sedgwick Ave. Associates v. Insurance Co. of State of Pennsylvania*, 203 AD2d 93, 610 NYS2d 39 (1st Dept. 1994), *Wausau Ins. Companies v. Feldman*, 213 AD2d 179, 623 NYS2d 242 (1st Dept.1995) and *Federated Dept. Stores Inc. v. Twin City Fire Ins. Co.*, 28 AD3d 32, 807 NYS2d 62 (1st Dept. 2006).

I ultimately concluded after my review of these First Department decisions, that like a biological gene mutation that gets transmitted from generation to generation, the First Department has erroneously been transmitting a mischaracterization of the law of estoppel, for over 40 years. I traced the error back to the court's misreading of the Court of Appeals' decision in *Draper v. Oswego County Fire Relief Ass'n*, 190 NY 12 (1907), and its decision *Simpson v. Phoenix Mut. Life Ins. Co.*, 30 AD2d 265, 291 NYS2d 532 (1st Dept. 1968).

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The Second Department

In *Utica*, the Second Department was faced with a carrier that had assumed the defense of a landlord with respect to two personal injury actions commenced in 1989 and 1992 pursuant to an additional insured endorsement, without any reservation of rights. However, after reviewing its policy in 1993, Utica found that the landlord was not, in fact, an additional insured on its policy. Utica attempted to re-tender the cases to the landlord's primary carrier Atlantic Mutual, which disclaimed.

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Utica commenced a declaratory judgment action and Atlantic Mutual moved for summary judgment on the ground that Utica was equitably estopped from discontinuing its defense of the landlord.

The Second Department granted Atlantic Mutual's motion observing that

> [i]f an insurer assumes the defense of an action and controls its defense on behalf of an insured with knowledge of facts constituting a defense to the coverage of the policy without reserving its right to deny coverage, the insurer is estopped from denying coverage at a later time, even if mistaken on the requirement of coverage.

Utica, 283 AD2d at 422-423, (citing, *Schiff Assocs. v. Flack*, 51 NY2d 692; *Brooklyn Hosp. Ctr. v. Centennial Ins. Co.*, 258 AD2d 491; *Hartford Ins. Group v. Mello*, 81 AD2d 577).

The *Utica* case has since been cited repeatedly by the Second Department in *Daimler Chrysler Ins. Co. v. Zurich Ins. Co.*, 72 AD3d 730, 899 NYS2d 310, (2d Dept. 2010); *Fireman's Fund Ins. Co. v. Zurich American Ins. Co.*, 37 AD3d 521, 830 NYS2d 274 (2d Dept. 2007) and *Wise v. McCalla*, 24 AD3d 435, 805 NYS2d 658 (2d Dept. 2005).

The First Department

In contrast to the Second Department, the First Department in *Wausau v. Feldman*, when faced with a similar case, came to the opposite conclusion, notwithstanding it presented the identical classic application of the equitable estoppel doctrine as existed in *Utica*.

Wausau involved a claim for medical malpractice, where Wausau defended its insured doctor for nine years until it realized the doctor was not an insured at the time of the purported malpractice. Wausau attempted to tender the case to Travelers, the doctor's employer's malpractice carrier, which disclaimed coverage on the grounds of late notice. Despite the situation being essentially identical as in *Utica*, the First Department rejected the doctor's claim of estoppel on the grounds that "estoppel may not be used to create coverage where no insurance policy existed…" *Wausau*, 213 AD2d at 180 (citing *Zappone v. Home Ins. Co.*, 55 NY2d 131; *Employers Ins. v. County of Nassau*, 141 AD2d 496). The court stated that since "Wausau did not insure [defendant] at the time of the purported malpractice, it could not be forced to defend him in the underlying action, despite having already represented him for nine years." Id.

Likewise in *Sedgwick v. ICSP*, although the First Department acknowledged that "estoppel may lie if the insured has been prejudiced by the insurer's failure to make a timely notice of disclaimer of coverage" *Sedgwick*, 203 AD2d at 94, (citing *Hartford Ins. Group v. Mello*, 81 AD2d 577, 578), it nevertheless stated that "[w]here there is no coverage under an insurance policy because the policy was not in existence at the time of the accident, estoppel cannot be used to create coverage. Id. (citing *Nassau Ins. Co. v. Manzione*, 112 AD2d 408, 409).

Despite the First Department's unambiguous claim that estoppel could not create coverage, cracks in its resolve were apparent. If the issue was so clear cut, why did the court in *Sedgwick* spend the balance of its opinion analyzing whether the insured had suffered prejudice as a result of the carrier's erroneous defense? Indeed, after satisfying itself that the insured had not been prejudiced by the carrier's actions, the court noted "[c]learly, the doctrine of equitable estoppel is not applicable here." The court's discussion of prejudice seemed to indicate that it was no longer so confident of its past pronouncements on equitable estoppel.

The 'General Rule'

More recently in 2006, in *Federated v. Twin City*,

the First Department was faced with a carrier who had taken over the defense of a department store based on its belief that its named insured had agreed in writing to name Federated as an additional insured. When after more than a year, the carrier learned that no such agreement existed, it disclaimed coverage. Federated argued that the carrier Twin City, was estopped from disclaiming because it had accepted the defense without reservation. Although the case did not present an estoppel situation since it was missing the element that Twin City accepted the defense with knowledge in its possession that Federated was not an additional insured, the First Department nevertheless, made the observation that "as a *general rule*, estoppel cannot be used to create coverage where none exists (emphasis added) (*Federated*, 28 AD3d at 38), citing both *Sedgwick* and *Wausau*.

Although in *Federated*, the First Department continued to cling to the belief that estoppel cannot create coverage, it no longer stated it so categorically. Indeed, the court merely stated this was the "general rule." The court did not explain what the exceptions were to the general rule or what the rule's parameters were.

In fact, despite paying the "rule" lip service, *Federated* may be read as an implicit abandonment by the First Department of its position that estoppel cannot create coverage. This backing away was evident when the court discussed the Second Department's *Utica* decision. Instead of repudiating *Utica* and/or acknowledging a split between the departments, the First Department showed its approval of *Utica*, by merely distinguishing it on its facts stating that "[t]he key to th[e] holding [in *Utica*] was that the insurer certainly was in a position to know the owner was not an additional insured."

Where then are we left with regard to the "general rule" in the First Department that estoppel cannot create coverage? Apparently, estoppel does not create coverage in the First Department, unless you can actually establish the elements of estoppel, such as in *Utica*, where in that case, it will. By approving of *Utica*, the First Department arguably reversed *Sedgwick* and *Wausau*, sub silento. Notably, in the First Department's last decision involving equitable estoppel, *Liberty Insurance Underwriters Inc. v. Arch Insurance Company*, 61 AD3d 482, 877 NYS2d 44 (1st Dept. 2009), the court avoided any reference to its rule that estoppel cannot create coverage. Although the principal issue addressed was whether estoppel "should be limited to coverage disputes between insurers and insureds, and not applied to coverage allocation disputes between insurers" (id. at 482) the court's holding would appear to have created primary insurance coverage in what was otherwise an excess insurance policy.

Finding the Light

It would seem that the First Department has finally found its way back into the light with regard to estoppel. But how did it become lost in the first place?

The First Department's 1994 *Sedgwick* decision relied solely upon *Nassau Ins. Co. v. Manzione*, 112 AD2d 408, 492 NYS2d 66 (1st Dept. 1985), where the court found for the carrier because estoppel cannot be used to create coverage, citing *Zappone v. Home Ins. Co.*, 55 NY2d 131, 447 NYS2d 911 (N.Y. 1982), *Schiff Associates Inc. v. Flack*, 51 NY2d 692, 435 NYS2d 972 (1980) and *Van Buren v. Employers Ins. of Wausau*, 98 AD2d 774, 469 NYS2d 488 (2d Dept. 1983).

The citation to *Zappone* was erroneous, since the Court of Appeals did not discuss in *Zappone* if estoppel could create coverage. Rather, the issue was whether a carrier had a duty to timely disclaim where its disclaimer was based on the absence of coverage, rather than based on exclusion.

As every New York insurance coverage practitioner knows, the failure to issue a timely disclaimer based on a policy exclusion will lead to a statutory waiver of the exclusion (see Insurance Law §3420(d)). Such waiver is however, not an estoppel, which only occurs if the carrier defends without reservation, controls the defense and then attempts to disclaim to the detriment of the insured.

The First Department's citation to *Schiff* was also erroneous. In *Schiff*, the Court of Appeals actually went to great length to explain the difference between the concepts of waiver and estoppel and ironically noted they were often confused. The court noted that the extension of coverage where none exists cannot be accomplished by waiver, but can be created in the appropriate case under the theory of equitable estoppel.

> Notably, in the First Department's last decision involving equitable estoppel, 'Liberty Insurance Underwriters Inc. v. Arch Insurance Company,' the court avoided any reference to its rule that estoppel cannot create coverage.

The third case the First Department relied upon in *Nassau Ins. Co. v. Manzione* for the rule that estoppel cannot create coverage was *Van Buren* where the court rejected an estoppel claim of a doctor against his malpractice carrier who had belatedly disclaimed after offering him an unqualified defense.

In *Van Buren*, the court relied on *Drew Chemical Corp. v. Fidelity & Cas. Co. of New York*, 60 AD2d 552, 400 NYS2d 334 (1st Dept. 1977), aff'd 46 NY2d 851, 414 NYS2d 515 (1979). In *Drew*, the court noted that the "insurance company's lateness in disclaiming precludes it from disputing coverage on principles of waiver and estoppel" in that "it is settled law that waiver or estoppel may not be invoked to create insurance coverage where none exists under the policy as written." Notably, here the court erroneously conflates the concepts of waiver and estoppel. Its authority for this dubious proposition is *Simpson v. Phoenix Mut. Ins. Co.*, 30 AD2d 265, 291 NYS2d 532 (1st Dept. 1968).

A review of *Simpson*, identifies where the estoppel wheel first fell off the wagon. In *Simpson*, the court claimed it was "settled law that waiver or estoppel may not be invoked to create insurance coverage where none exists under the policy as written." The court's authority for this "settled law" was two Court of Appeals cases, *Miller v. American Eagle Fire Ins. Co.*, 253 NY 64 and *Draper v. Oswego Co. Fire Relief Assn.,* 190 NY 12 (1907). Incredibly, *Miller* dealt with neither waiver nor estoppel. As for *Draper*, this 1907 case, like the Court of Appeals' decision in *Schiff* goes to great lengths to explain the difference between waiver and estoppel, explaining in the process that coverage may be created by estoppel.

Draper involved a loss on a fire insurance policy which provided it did not provide coverage for losses arising from any open fire built by the insured within fifty feet from any insured building. After the insured's building burned due to an open fire within fifty feet of his building, he commenced a declaratory judgment action to obtain coverage. At the trial, the judge submitted a single issue to the jury, whether the defendant had waived its right to assert the policy condition.

The decision goes into an arcane but eloquent discussion of waiver, borrowing from *Kiernan v. Dutchess County Mut. Insurance Company,* 150 NY 190 (1896), where the court notes that:

> [w]hile [waiver] and the doctrine of equitable estoppel are often confused in insurance litigation, there is a clear distinction between the two. A waiver is the voluntary abandonment or relinquishment by a party of some right or advantage… The doctrine of equitable estoppel, or estoppel in pais, is that a party may be precluded by his acts and conduct from asserting a right to the detriment or prejudice of another party who, entitled to rely on such conduct, has acted upon it. The rule, prevailing in this state, that an insurance company will not be permitted to defeat a recovery on a policy issued by it by proving the existence of facts which render it void where it had full knowledge of the 17 facts when the policy was issued (*Robbins v. Springfield F.&M. Ins. Co.*, 149 NY 477), rests rather on the doctrine of estoppel than on that of waiver.

The *Kiernan* court pointed out that the open fire condition was not exclusion, but rather a condition of coverage. As such, it could not be waived. Thus, the court held that

> [t]o recover in this case it was, therefore, necessary for the plaintiffs to establish not that the defendant waived the breach of a condition of the policy, but that in some way the obligation of the defendant was so extended as to include loss from a bonfire situated within fifty feet of the insured buildings. There is no pretense that any oral contract between the parties included such a loss, and hence there can be no right to a reformation of the policy. The only other ground on which the plaintiffs could succeed was by establishing that the defendant has estopped itself from denying that the loss fell within the terms of the policy by some action or conduct which had misled the plaintiffs to their injury." As the Court in *Draper* found no evidence of such an estoppel, it affirmed the absence of coverage.

It is thus ironic, that the ultimate case on which the First Department has been relying for 42 years for the proposition that estoppel may not be used to create coverage, stands for the exact opposite proposition. While the First Department has appeared to have come to this conclusion on its own, coverage counsel should nevertheless remain wary.

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