Insurers May Consider Extrinsic Evidence “Irrelevant to the Principal Merits” in Evaluating the Duty to Defend

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For third-party liability insurers, no single phrase is more paramount (and vexing) than “the duty to defend is broader than the duty to indemnify.” The duty to defend is one of the most fundamental concepts in insurance coverage. Although seemingly straightforward, the question of whether the duty to defend is triggered is rife with challenges and consequences.

But exactly what type of evidence may an insurer consider when evaluating the duty to defend? Is the insurer limited to the so-called “eight corners” of the insurance policy and the complaint? Or can the insurer consider extrinsic evidence outside the policy and the complaint? The issue of what evidence an insurer may consider in determining the duty to defend is critical because it is often outcome-determinative; extrinsic evidence can negate the duty to defend.

The “extrinsic evidence rule” varies by state – in some states, an insurer can look beyond the policy and the complaint, while in other states an insurer is limited to the “eight corners.” Still in other states, like New York, the rule is not so clear; an insurer may consider extrinsic evidence, but only in limited circumstances. See Stein v. Northern Assurance Company of America, 617 F. App’x 28, 31 (2d. Cir. 2015) (“We have previously recognized that New York law is unclear regarding the circumstances in which a court may consider extrinsic evidence in making coverage determinations.”); quoting International Business Machines Corporation v. Liberty Mutual Insurance Company, 363 F.3d 137, 148 (2d. Cir. 2004) (“There is no consistent rule from New York’s lower court [as to] whether New York allows reference to extrinsic evidence in determining the duty to defend.”).

Despite years of inconsistency, two recent cases applying New York law clarify when an insurer may consider extrinsic evidence in evaluating the duty to defend. As confirmed by these recent decisions, duty to defend insurers in New York may consider extrinsic evidence “irrelevant to the principal merits” of the underlying action.

In City of New York v. Liberty Mutual Insurance Company, 2017 U.S. Dist. LEXIS 164134 (S.D.N.Y. Sept. 28, 2017), the United States District Court for the Southern District of New York addressed the extrinsic evidence rule in connection with three underlying personal injury actions. The plaintiffs in the underlying actions alleged that the New York City School Construction Authority (the “Authority”) owned and maintained a public school where the plaintiffs were allegedly injured. The insurance policy provided coverage for the Authority as an Additional Insured, but only in connection with premises owned by or rented to the Authority. The insurer denied coverage, citing extrinsic evidence establishing that the Authority did not own the premises where the plaintiffs were allegedly injured.
The court noted that although “there is some ambiguity as to the precise contours of the extrinsic evidence rule under New York insurance law,” the extrinsic evidence relied on by the insurer “does not affect [the insurer’s] duty to defend in this case.” *City of New York* at 37. The court noted that “the question of when facts extrinsic to a complaint may either prevent the attachment of a duty to defend or terminate that duty . . . remains somewhat unclear under New York law.” *Id.* The court also acknowledged that “extrinsic evidence may terminate the duty to defend in certain circumstances.” *Id.* at 38. Notwithstanding, the court held that in this specific case, the extrinsic evidence did not negate the duty to defend because:

> [T]he extrinsic evidence the Defendant has presented goes to an issue relevant to the merits of the underlying complaints. Under clearly established New York law, then, such evidence cannot justify Liberty's refusal to defend or provide a basis, in a collateral proceeding, for a declaration terminating that duty. *Id.* at 39.

The court held that the insurer “cannot rely on extrinsic evidence in a collateral proceeding to defeat or terminate its duty to defend when the facts it seeks to establish are related to the merits of the underlying action.” *Id.* at 45. In explaining the rationale for the holding, the court noted that:

> Such a rule follows from the basic structure of the duty to defend. That duty, which is broader than the duty to indemnify, includes the duty to defend against meritless suits. If an insurer could defeat its duty by proving, in a collateral action, the existence of a fact that is relevant to the merits of the underlying suit, it would follow that the insurer could subvert its obligation to defend against meritless suits. Worse, such a posture would place the insured in an untenable position: the insured would have to argue, in the declaratory action, that the fact in question is disputed, even as the insured made the opposite argument in the underlying action to try and defeat its own liability. Such an outcome would be clearly contrary to New York law. *Id.* at 47-48.

By contrast, in *Striker Sheet Metal II Corporation v. Harleysville Insurance Company* 2018 U.S. Dist. LEXIS 15892 (E.D.N.Y. Jan. 31, 2018), the United States District Court for the Eastern District of New York addressed whether an “auto exclusion” in a Commercial General Liability insurance policy barred coverage for an underlying litigation arising out of an injury to an employee at a construction site. The insurer denied coverage based on the auto exclusion, despite the fact that the complaint was “largely devoid of any of the specific factual circumstances surrounding the incident.” *Striker Sheet Metal II Corp.* at 24. The Insured argued that “the failure of [the employee’s] allegations to mention the factual circumstances surrounding the auto exclusion preclude the Defendant from shirking its duty to defend.” *Id.* The court disagreed, and held that “the existence of extrinsic evidence which excluded the possibility that [the Insured] was covered by [the policy] releases [the insurer] of its duty to defend . . .” *Id.* Specifically, the court noted that:

> While the Second Circuit has acknowledged that the precise delineations of the use of extrinsic evidence to prevent an insurer from exercising its duty to defend are unclear under New York law, it has recognized that extrinsic evidence may be used to abandon the duty in certain situations. *Id.* at 25.

Prior to the filing of the complaint, the insurer received an email from the Insured that informed the insurer that the employee was injured “during the unloading process” involving a truck owned by the Insured. *Id.* at 27. The court
therefore determined that the insurer “had knowledge of facts through extrinsic evidence that the claim was definitely excluded from the policy’s coverage.” *Id.* Moreover, the court noted that “the issues and extrinsic evidence present are wholly irrelevant to the principal merits of the Underlying Action, as required by the Second Circuit to disclaim the duty.” *Id.* Therefore, the court held that “the extrinsic evidence, from the insured, conclusively establishes that no possible factual or legal basis on which [the insurer] might eventually be obligated to indemnify its insured . . .” *Id.* at 28.

Duty to defend insurers must act quickly. Therefore, it is critical that insurers have a clear understanding of what information is “fair game” in evaluating whether the duty to defend is triggered. Both *City of New York* and *Striker* clarify that under New York law, an insurer may consider extrinsic evidence “irrelevant to the principal merits” of the underlying action. Therefore, in addition to the coverage issues, insurers must also have a clear and thorough understanding of the issues and merits central to the underlying litigation – in other words, for duty to defend insurers in New York, the merits matter.

If you have questions or would like additional information, please contact Greg Steinberg (steinbergg@whiteandwilliams.com; 212.714.3066) or Andrew Lipton (liptona@whiteandwilliams.com; 212.631.1252).

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