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Strengthening The Slingshot

Policyholders May Assert Claims For Insurers' Failure To Disclose The Right To Independent Defense Counsel

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Policyholders in New York and other states have long had a right to independent defense counsel paid for by their liability insurance company when an insurance company's reservation of rights creates a conflict of interest. Such independent counsel often are termed "*Cumis* counsel," after the 1984 California case of *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc*., but the right to independent counsel was widespread long before *Cumis*; for example, New York's highest court recognized it in 1956, in *Prashker v. United States Guarantee Co.*, and Massachusetts followed suit in 1964 in *Magoun v. Liberty Mutual Insurance Company*.

Yet as long as this right has existed, insurance companies have tried to honor it mostly in the breach by leaving policyholders to their own devices to demand independent counsel when there is a conflict of interest giving rise to the right. Recently, in *Elacqua v. Physicians' Insurers*, a New York appellate court made clear that insurance companies not only must provide independent counsel, but also must inform policyholders of that right, at the risk of treble damages and other penalties.

When The Conflict Arises

Typically, a conflict of interest requiring independent counsel arises when an insurance company has a duty to defend an underlying action which a third party has brought against the policyholder and different outcomes in the underlying action would affect the coverage interests of the insurance company and the policyholder. For example, if the underlying action alleges some grounds for recovery or remedies that are covered, such as negligence claims, and some that are not, such as purely intentional torts or claims for injunctive relief, then defense counsel selected by the insurance company faces a conflict. He or she may be tempted to favor the insurance company's interest in defeating indemnity coverage by failing to vigorously defend the intentional tort or injunctive relief claims. By defending in a manner that leads to verdicts or settlements that are not indemnified under the insurance policy, defense counsel selected and paid by the insurance company can favor the financial interests of the insurance company, to the disadvantage of defense counsel's true client, the policyholder, who then faces uncovered liabilities. There also is a temptation to do so, because the policyholder is not likely to be a repeat client, while the insurance company may produce a steady flow of future cases to defend.

Such conflicts are increasingly prevalent, because insurance companies increasingly reserve rights on every conceivable coverage defense. Under the principles stated in *Prashker*, *Cumis*, and similar authorities in most other states, when the coverage defense creates a conflict of interest, the insurance company must pay for an independent defense for the policyholder. The independent defense counsel is to be selected by the policyholder and paid by the insurance company, and if any claim against the policyholder is potentially covered under the liability insurance policy, the policyholder deserves an independent defense of all claims. The sole purpose of independent defense counsel is to protect the policyholder, not the insurance company; the true "independence" of the arrangement is apparent given that independent defense counsel even may be able to admit liability on a covered claim for tactical reasons (i.e., to avoid uncovered liability), with no breach of the cooperation clause or other impairment of insurance rights. In short, for independent counsel, the interests of the policyholder are paramount.

Unfair and Deceptive Business Practice

As coverage counsel, we have seen many instances in which insurance companies seek to avoid the extra cost of independent counsel and maintain improper control of the underlying defense, despite a conflict of interest. Insurance companies frequently instruct policyholders to hire defense counsel at their own expense to defend against uncovered claims, stating that the insurance company will only defend the covered claims. Many unrepresented policyholders accept that instruction, overly grateful for the insurance

company's partial performance and failing to realize that they actually are entitled to a full and independent defense.

The *Elacqua* decision breaks new ground in New York by recognizing that this tactic constitutes an unfair and deceptive business practice under New York's consumer protection laws, which are similar to unfair trade statutes found throughout the nation. In particular, the *Elacqua* court held that an insurance company had engaged in a "deceptive practice" under New York's consumer protection statute by routinely failing to inform policyholders of their right to independent counsel and suggesting instead that they retain counsel at their own expense to defend uncovered claims. The Elacqua court held that this practice was actionable under the state's consumer protection laws, insofar as it harmed policyholders by depriving them of the undivided and uncompromised conflict-free representation to which they were entitled.

Ruling's Practical Significance

The *Elacqua* decision has tremendous practical significance to policyholders in New York and elsewhere. Persons who are injured by reason of willful or knowing deceptive practices may seek recoveries of up to three times their actual damages, along with attorneys fees, under New York's consumer protection laws, and similar "extracontractual" relief may be sought under other state's unfair competition and consumer protection laws. Insurance companies would be hard-pressed, after *Elacqua*, to deny knowing that they not only must provide independent counsel when their reservation of rights creates a conflict of interest for counsel defending a potentially-covered claim against the policyholder, but also must disclose that right to the policyholder in the first place.

While *Elacqua* clearly is an important milestone, it does not stand alone. Courts throughout the country have found bad faith or imposed other consequences for insurance companies' failures to inform policyholders of a variety of insurance policy rights. A California court, for example, found that an insurance company had waived its right to demand arbitration by failing to advise policyholders of their rights to arbitrate disputes. Courts in many jurisdictions reject an insurance company's reliance on the statute of limitations if it does not inform policyholders that they should challenge their claims denials within the limitations period. Likewise, insurance companies have an obligation to identify coverage issues and to expressly assert coverage defenses, or risk waiving the defenses.

Elacqua is consistent with these cases by requiring insurance companies to inform policyholders of an important right: the right to independent defense counsel. This requirement is fair and appropriate because the right does not appear on the face of the policy and it carries out critical promises in liability insurance policies — the duty to defend — and critical principles of legal ethics — the duties of loyalty and zealous representation. Unlike their policyholders, insurance companies are in the business of insurance and the business of litigation. Thus they are far better situated than policyholders to be aware of the parties' implicit rights and duties in the various scenarios which may arise in an insurance claim, including the right to independent counsel.

Conclusion

Accordingly, when insurance companies fail their obligation to inform policyholders of their rights to independent defense counsel or other important rights, policyholders and their coverage counsel should strive to determine if the failure was an isolated instance or, more likely, part of an ongoing business practice. If the latter is the case, then policyholders have a potentially powerful new weapon in their arsenal. As always, it will be a battle of David versus Goliath, but treble damages and attorneys fees certainly strengthen the slingshot.

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