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Strengthening the Slingshot

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

By Ted Stein


Ted Stein

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

> ***"Policyholders (now) have a potentially powerful new weapon in their arsenal …"***

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A Note from the Editor


Mark Garbowski

2008 is turning out to be a very good year for policyholders in New York.

In their dealings with policyholders, insurance companies all too often seek any excuse to deny coverage, fail to provide policyholders filing claims with crucial information, and drag out coverage disputes over years. This year, three developments in New York look to provide policyholders with recourse on all three fronts.

The first piece of good news was the *Bi-Economy* decision (discussed in our March *Policyholder Advisor Alert*) finding that policyholders can seek consequential damages when their businesses collapse as a result of the insurance company's failure to fulfill its contractual obligations. That decision accorded to New York businesses a right long enjoyed by policyholders in other jurisdictions.

The second positive development is the *Elacqua v. Physicians' Insurers* decision, discussed in the main article of this issue. In *Elacqua*, the New York appellate court ruled that the insurance company's failure to advise a policyholder of a right to independent counsel violated New York's deceptive

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business acts and practices law, specifically General Business Law § 349. In addition to affirming policyholders' right to independent counsel, this decision is notable because New York courts have almost never ruled that any insurance company action has violated this statute. This case could represent a breakthrough for policyholders seeking recourse from various types of insurance company deception.

The last development is pending as we go to press. New York has long had one of the nation's most draconian standards for enforcement of "timely notice" provisions in insurance contracts, which stipulate that policyholders may forfeit coverage if they provide late notice of a claim. Last year, the New York State legislature passed a bill that would have required insurance companies to show that they were prejudiced by late notice in order to deny coverage on those grounds. Governor Spitzer vetoed that bill because of unrelated insurance provisions he deemed unacceptable. Last month, the Legislature passed the bill again, in a revised version, without the unrelated provisions that prompted last year's veto, and reports indicate that Governor Paterson is likely to sign it. If that does happen, New York will join the majority of states in imposing a prejudice standard for late notice denials. We will monitor this legislation and keep you informed.

Together, these separate items create a much more favorable environment for policyholders in New York. Indeed, they could even have a positive effect on policyholders nationwide, as insurance companies will have less motivation to sue their policyholders in New York to take advantage of New York law favorable to insurance companies.

—Mark Garbowski

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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

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Consortium of Law Firms in 20 Countries

Anderson Kill has joined Interleges, a pre-eminent consortium of law firms in some 20 different countries. It is one of two Interleges members in the United States, and the only American firm to provide comprehensive representation.

Interleges brings together firms that do not maintain their own offices outside their country of origin, so as to enable each firm to maintain its concentration on its national law and practices while providing its clients with access to highly skilled representation in most parts of the world. Matters that frequently lead to referrals include contract disputes, intellectual property issues, and insurance coverage disputes.

Jeffrey Glen, a senior shareholder in Anderson Kill, is the designated representative to Interleges, and he is a member of the Interleges Executive Committee. At the Interleges 2008 Annual General Meeting held in May in Rome, he reports, there were presentations by members from Italy, Switzerland, and the Czech Republic on a set of intellectual property issues that come up frequently in the U.S. These included analysis of the law of different European Union countries of designation of origin, and of geographic attribution. An example of the first is the mark "Made in Italy" on shoes designed in Milan but sewn in Vietnam. An example of the second is the use of the name "Prosciutto de Parma" on hams cured in Canada. Both examples have been litigated in different countries with different results; both issues are often presented by foreign exporters to the US and US exporters to EU member states.

Upon his return from the Annual General Meeting, Glen said, "through its membership in Interleges, Anderson Kill will provide the same level of individualized representation to its American clients abroad as it does here at home. Anderson Kill lawyers and I know the lawyers at our Interleges affiliates abroad who will handle our clients' affairs, and we can integrate the representation in a cost effective and personalized way."

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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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