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# Coverage Conflicts for Assigned Insurance Defense Counsel

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## Outside Counsel

## Expert Analysis

# Coverage Conflicts for Retained Insurance Defense Counsel

Lawyers retained by insurance carriers to represent policyholders confront unique ethical issues. Although defense counsel is frequently retained and paid by the insurance carrier, the lawyer's primary ethical duty runs to the insured, not the carrier. While there is usually a harmony of interest between the carrier and insured, counsel should be aware of potential areas of conflict.

Like the former Code of Professional Responsibility, the new Rules of Professional Conduct require lawyers to exercise independent professional judgment on behalf of their clients, particularly when somebody else is paying the fees: "Unless authorized by law, a lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal service for another to direct or regulate the lawyer's professional judgment in rendering such legal services or to cause the lawyer to compromise the lawyer's duty to maintain the confidential information of the client under Rule 1.6."<sup>1</sup> RPC 1.8(f) similarly proscribes "interference with the lawyer's independent professional judgment" when someone other than the client is paying the fees.

Under New York law, a conflict may arise between an insurer and a policyholder when some of the claims in a case are covered by the policy, while others are not. In *Public Service Mutual Ins. Co. v. Goldfarb*,<sup>2</sup> a dentist was simultaneously accused of malpractice, which was covered by the insurance policy, and intentional sexual assault, which was not. A verdict against the dentist on the uncovered assault cause of action would have been disastrous to the insured yet beneficial to the insurance carrier, which would have avoided an indemnity payment. Conversely, an award on the malpractice claim would

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benefit the doctor but cost the carrier money. According to the Court of Appeals:

[I]nasmuch as the insurer's interest in defending the lawsuit is in conflict with the defendant's interest—the insurer being liable only upon some of the grounds for recovery asserted and not upon others—defendant Goldfarb is entitled to defense by an attorney of his own choosing, whose reasonable fee is to be paid by the insurer.<sup>3</sup>

*Goldfarb* was decided as a matter of substantive insurance law, without reference to the Code of Professional Responsibility. Thus, *Goldfarb* recognizes a situation in which there is a substantive conflict between the carrier and the insured, but does not provide direct guidance to lawyers on how to resolve the conflict.

### Carriers' Obligations

In another case, a lawyer made a tactical decision to maximize insurance coverage over the objection of the insurance carrier. The insurance policy in *Nelson Electrical Contracting Corp. v. Transcontinental Ins. Co.*<sup>4</sup> covered some but not all claims arising from a construction accident. Indemnification and contribution claims were covered, but breach of contract claims were not. When the claimant moved the court for summary judgment on the covered tort claims, the insured's lawyer made a tactical decision not to oppose the motion, thereby defaulting on the covered tort claims and maximizing the client's insurance coverage. The insurance carrier disclaimed coverage, arguing that the lawyer's default on the summary judgment motion amounted to a failure to cooperate in violation of the policy.

Not so, wrote the Appellate Division, Third Department, noting that "when such a conflict exists" between the carrier and the insured, "the interests of the insured are paramount."<sup>5</sup> The court reasoned that counsel for the insured must "exercise professional judgment solely on behalf of the client...disregarding the desires of others that might impair the lawyer's free judgment."<sup>6</sup> Thus, the court upheld the lawyer's independent exercise of judgment on behalf of the client, even though it was detrimental to the carrier.

A 2008 Appellate Division, Third Department, decision held that where there is a conflict with the carrier owing to partially covered claims under *Goldfarb*, the carrier must affirmatively inform the insured of its right to select unconflicted counsel at the expense of the insurance carrier. *Elacqua v. Physicians' Reciprocal Insurers*<sup>7</sup> arose out of a medical malpractice claim against two physicians, their partnership and a nurse practitioner employed by them. The doctors' lawyers, for some reason, moved to dismiss all covered claims against their individual clients, leaving the partnership exposed to vicarious liability for the nurse's negligence:

Here, [the attorneys] successfully moved to dismiss the complaint in the [underlying injury] action against the physicians, thereby disposing of all covered claims and leaving viable only the uncovered claim against the partnership for vicarious liability based upon the negligence of [the nurse].<sup>8</sup>

The jury awarded a verdict of \$2 million against the doctors' partnership based on the negligence of their nurse. Thus, unlike the lawyer in *Nelson*, the lawyers in *Elacqua* obtained dismissal of the covered claims, yet left intact the uncovered claims.

The Third Department held that the doctors were entitled to select independent counsel at the carrier's expense, since some of the underlying claims were covered under the policy while others were not. The court further held that, "where such potential conflict exists between the insurer and the insured, the insurer has an affirmative obligation to

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inform the insured of his or her right to select independent counsel at the insurer's expense; to hold otherwise would seriously erode the protection afforded."<sup>9</sup>

In a matter of first impression, the Third Department further determined that the carrier's failure to inform the insureds of their right to unconflicted counsel could give rise to a claim under General Business Law §349, which prohibits "deceptive acts or practices in the conduct of any business, trade or commerce, or in the furnishing of any service in this state." The court opined that the carrier engaged in a deceptive practice insofar as its disclaimer letters to policyholders "failed to inform them that they had the right to select independent counsel at defendant's expense, instead misadvising that [the insureds] could retain counsel to protect their uninsured interests 'at their own expense.'"<sup>10</sup> According to the court, the misinformation in the carrier's disclaimer letters was likely to mislead consumers, and could accordingly be considered a violation of GBL 349.

Although it was the carrier, and not the lawyers, being sued, the court noted that the lawyers' fiduciary duty to the client is implicated "where, as here, the interests of an insured are at odds with that of an insurer, in which case tactical decisions must be made by counsel whose loyalty to the insured is unquestioned and whose dedication to the interests of the insured is paramount."<sup>11</sup> The actual conduct of defense counsel in the underlying medical malpractice trial demonstrated a disregard for the interests of the insured doctors, whose assets were exposed by the decision to seek dismissal of the only claims covered by insurance.

### Lawyers' Duties

The cases discussed above primarily address the carriers' obligations to their policyholders. The lawyer's duty to advise the client about insurance coverage was discussed in *Shaya B. Pacific, LLC v. Wilson Elser Moskowitz Edelman & Dicker, LLP*,<sup>12</sup> which upheld the sufficiency of a legal malpractice complaint against a law firm for failing to investigate the existence of excess insurance and give notice to the excess carrier.

The Appellate Division, Second Department, held that whether a retained insurance defense lawyer has a duty to ascertain excess coverage is a fact-specific determination, which "would turn primarily on the scope of the agreed representation—a question of fact...."<sup>13</sup> In holding that a law firm may, at least theoretically, have such an obligation, the Second Department concluded that a legal malpractice claim may be "based upon a law firm's failure to investigate its client's insurance coverage or to notify its client's carrier of a potential claim."<sup>14</sup>

If, under *Shaya B. Pacific*, appointed defense counsel may have a duty to investigate insurance coverage, the question arises as

to whether, under *Goldfarb*, a lawyer should also advise the client of the right to consult unconflicted counsel at the carrier's expense. In other words, should insurance defense lawyers advise their clients of their rights under *Goldfarb*?

The Appellate Division partially (and inconclusively) addressed this issue in a legal malpractice case brought against lawyers who failed to advise their clients of their right to select independent counsel at the carrier's expense. The First Department, in *Sumo Container Station Inc. v. Evans Orr Pacelli Norton & Laffan*,<sup>15</sup> rejected the argument that "it was incumbent on defendants to advise [client] Sumo of those conflicts and of its right to independent counsel at [the insurer's] expense."<sup>16</sup> Rather, under the facts before the court, neither the carrier nor the appointed counsel had an affirmative duty to inform insured of its right to select its own counsel at the carrier's expense.

In that case, there was a dispute as to which company owned an injury-producing truck: Hertz or Sumo. Sumo neglected to notify its own carrier, and Hertz's carrier paid for lawyers to litigate both sides of the ownership issue. After Sumo lost, it argued that the lawyer appointed by Hertz's carrier was conflicted, since counsel was beholden to Hertz, and that he should have informed Sumo of its right to unconflicted counsel at the carrier's expense.

Lawyers must be vigilant in ascertaining potential and actual conflicts between clients and insurance carriers.

The court rejected Sumo's argument, since Sumo implicitly consented to the representation. On the specific facts before it, the court determined that there was no obligation for counsel to investigate coverage, because, "in the face of Sumo's manifest indifference to determining the identity of the insurer for its own vehicles, it can hardly be said that the law firm entering the picture over four years after the accident was legally bound to exert Herculean efforts to investigate."<sup>17</sup>

### Conclusion

The Rules of Professional Conduct instruct lawyers to exercise independent judgment on behalf of clients—especially when someone else is paying the legal fees. Lawyers must be vigilant in ascertaining potential and actual conflicts between clients and insurance carriers, which arise in a variety of situations. A case that presents both covered and uncovered claims often represents a conflict for defense counsel.

The recent pronouncements of the First, Second and Third departments are not easy to reconcile. The First Department's

decision in *Sumo* suggests that under some circumstances neither a lawyer nor a carrier has an affirmative duty to inform the insured of its rights to *Goldfarb* conflict counsel at the carrier's expense. *Elacqua* says that a carrier does have such a duty, but only indirectly addresses the obligations of counsel. And *Shaya B. Pacific* indicates that there may be some circumstances in which insurance defense counsel has an affirmative duty to advise the client about excess coverage, at least if there is not a clear written disclaimer by counsel limiting the scope of representation and eschewing responsibility for such advice.

Counsel should ensure that their clients are aware of their rights under the law. Under some circumstances, counsel may ethically seek to obtain informed consent and waiver for continued representation, consistent with the Rules of Professional Conduct. Moreover, counsel should ensure that they are not conflicted even from giving advice about conflicts with the carrier. Some counsel may not even be able to give objective, disinterested advice about coverage, in which case they should consider withdrawing from the representation.

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1. RPC 5.4(c) (22 NYCRR §1200 et seq.).
  2. 53 N.Y.2d 392 (1981).
  3. *Goldfarb*, 53 N.Y.2d at 401 (citations omitted).
  4. 231 A.D.2d 207 (3d Dept. 1997).
  5. *Nelson*, 231 A.D.2d at 209.
  6. *Id.* (citing former Code of Professional Responsibility EC 5-21).
  7. 52 A.D.3d 886 (3d Dept. 2008).
  8. *Elacqua*, 52 A.D.3d at 890.
  9. *Elacqua*, 52 A.D.3d at 888 (citations omitted) (emphasis in original).
  10. *Elacqua*, 52 A.D.3d at 889.
  11. *Id.* (citations omitted).
  12. 38 A.D.3d 34 (2d Dept. 2006).
  13. *Shaya B. Pacific*, 38 A.D.3d at 41.
  14. *Id.*
  15. 278 A.D.2d 169 (1st Dept. 2000).
  16. *Sumo*, 278 A.D.2d at 170.
  17. *Sumo*, 278 A.D.2d at 171 (citations omitted).