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Commentary

Conflicts Of Interest And Choice Of Counsel In Duty To Defend Insurance Policies: Should There Be "Goldfarb Miranda" Warnings?

By
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In most duty to defend policies, the insurance carrier has the right to control the defense, including the appointment of counsel. Insurance carriers typically designate panels of approved law firms to defend policyholders in duty to defend cases, often at negotiated rates. Landmark decisions in New York and California obligate insurance carriers to pay for independent counsel, selected by the insured, in situations in which an insurance carrier has a conflict of interest with its insured such that the trial strategy employed by insurance defense counsel could affect coverage. As explained below, these authorities – the *Cumis* case in California,[1] and the *Goldfarb* case in New York,[2] have begotten numerous progeny over the decades which have expanded the right of insureds to select independent counsel and, in California, spawned a statute which limits and modifies the right to counsel. Moreover, recent developments in New York have raised the question of whether an insurance carrier must affirmatively advise its insureds of their right to select independent, off-panel counsel in the event of a conflict of interest.

However, not all states have adopted the rules annunciated in *Cumis* and *Goldfarb*. Indeed, some jurisdictions have taken the position that the insurance industry and the legal profession are sufficiently regulated that conflicts of interest can be resolved according to existing rules. Moreover, several courts have recently limited the reach of conflict counsel, and rejected arguments that either counsel or the carrier must affirmatively notify the insured of its right to select independent counsel.

I. Goldfarb

The seminal case on conflicts of interest arising in defending insureds on liability policies is *Public Service Mutual Insurance Co. v. Goldfarb*.[3] In that case, a dentist was simultaneously accused of negligent conduct, which was covered by his insurance policy, and intentional sexual assault, which was not covered. A verdict against the dentist on the uncovered assault claim would have been paid by the doctor out of his own pocket. Conversely, a jury verdict exonerating the dentist of intentional sexual assault yet finding him liable for malpractice would have economically benefited the doctor but obligated the carrier under the policy. This conflict between the interests of the insured and insurer triggered the insured's right to select independent counsel of his own choosing. As the court held:

> [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.[4]

However, the Court of Appeals added that not every conflict of interest would give rise to a choice of counsel by the insured. The court explained, in a footnote, that only outcome-determinative conflicts which affect coverage would empower the insured to select independent counsel:

> That is not to say that a conflict of interest requiring retention of separate counsel will arise in every case where multiple claims are made. Independent counsel is only necessary in cases where the defense attorney's duty to the insured would require that he defeat liability on any ground and his duty to the insurer would require that he defeat liability only upon grounds which would render the insurer liable. When such a conflict is apparent, the insured must be free to choose his own counsel whose reasonable fee is to be paid by the insurer. On the other hand, where multiple claims present no conflict – for example, where the insurance contract provides liability coverage only for personal injuries and the claim against the insured seeks recovery for property damage as well as for personal injuries – no threat of divided loyalty is present and there is no need for the retention of separate counsel. This is so because in such a situation the question of insurance coverage is not intertwined with the question of the insured's liability.[5]

II. The California Rule

Several years after *Goldfarb* was decided in New York, an appellate court in California decided *San Diego Navy Federal Credit Union v. Cumis Insurance Society*.[6] *Cumis* was an employment case in which the insured credit union was sued for wrongful discharge, intentional infliction of emotional distress, and breach of contract. The complaint further sought $6.5 million in punitive damages. The carrier issued a reservation of rights letter excluding coverage for the breach of contract and punitive damages claims. The carrier and insured each hired counsel, and a fight ensued over whether the carrier was obligated to pay for the legal fees of counsel retained by the insured credit union. The court concluded that, "where, as here, multiple theories of recovery are alleged and some theories involve uncovered conduct under the policy, a conflict of interest exists."[7] The California court reasoned that independent counsel was merited because the trial strategy employed could have a direct effect on insurance coverage. As the court explained:

> Here, it is uncontested [that] the basis for liability, if any, might rest on conduct excluded by the terms of the insurance policy. [Counsel appointed by the carrier] will have to make certain decisions at the trial of the [discrimination] action which may either benefit or harm the insureds. For example, it will have to seek or oppose special verdicts, the answers to which may benefit the insureds by finding nonexcluded conduct and harm either Cumis' position on coverage or the insured by finding excluded conduct. . . . Each time one of them must be made, the lawyer is placed in the dilemma of helping one of clients concerning insurance coverage and harming the other.[8]

Thus, it wasn't simply the case that any conflict entitled the insured to select its own counsel; it was only a conflict which would impact the lawyer's trial strategy and affect insurance coverage.

Following the *Cumis* decision in 1985, California amended its civil code explicitly to provide for the retention of independent counsel in conflict circumstances. The California statute imposed such a duty, defined the type of conflict that would give rise to the insured's right to select its own counsel, and also provided a waiver mechanism.

The basic obligation to provide independent counsel is set forth in California Civil Code Section 2860(a), which provides as follows:

> If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide

> independent counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to independent counsel.

The California Civil Code provides that not every reservation of rights gives rise to an insured's right to select independent counsel. Rather, the California statute only triggers a right to independent counsel when there is a reservation of rights "and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim."[9] The statute specifically excludes a claim for punitive damages as a basis for invoking *Cumis* counsel.[10] Moreover, the California Civil Code provides a mechanism for waiver of the insured's right to independent counsel upon written informed consent.[11]

III. The Alternative View

Not all states have adopted the principles set forth in *Goldfarb* and *Cumis*. Several jurisdictions have explicitly rejected these cases, reasoning that most lawyers conduct their practices ethically, and that any conflict of interest can be addressed under existing regulations. For example, a U.S. district court in South Carolina refused to adopt a broad, paternalistic rule of disqualification in conflict situations, preferring to rely upon existing ethics rules:

> This court is reluctant to predict that South Carolina would adopt a disqualification rule that appears, on the surface, at least, to be premised upon the supposition that attorneys employed by insurance carriers will always behave unethically. In other words, the argument for the per se disqualification rule is based upon the assumption that attorneys employed by insurance carriers will seek to direct the course of litigation in a manner so as to achieve success on the claims that are covered under the policy, give scant attention to the non-covered claims. . . . This court declines to formulate a rule of law based upon the notion that attorneys will violate ethical obligations when employed by insurance companies.[12]

A similar approach was adopted by the Supreme Court of Hawaii, which reasoned as follows in *Finley v. Home Insurance Company*:

> [W]e are convinced that the best result is to refrain from interfering with the insurer's contractual right to select counsel and leave the resolution of the conflict to the integrity of retained defense counsel. Adequate safeguards are in place already to protect the insured in the case of misconduct. If the retained attorney scrupulously follows the mandates of the Hawai'i Rules of Professional Conduct (HRPC), the interests of the insured will be protected. In the event that the attorney violates the HRPC, the insured has recourse to remedies against both the attorney and the insurer.[13]

Thus, some jurisdictions have adopted the *Cumis/Goldfarb* principle, while others have rejected it.

IV. "Goldfarb Miranda"

A further issue is whether an insurance carrier, upon issuing an outcome-determinative reservation of rights, has an obligation affirmatively to notify its insured of its right to select independent counsel. To coin a phrase, does an insurance carrier have to give its insured the civil equivalent of "*Goldfarb Miranda*" warnings? The courts have been divided on this. A New York court has recently 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* arose out of a medical malpractice claim against two physicians and their partnership, which was vicariously liable for the misconduct of a nurse practitioner employed by them.[14] The doctors' lawyers, who were appointed by the carrier, moved to dismiss all covered claims against their individual clients, leaving the partnership exposed to vicarious liability for the nurse's negligence. According to the court, defense counsel "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]."[15] The jury awarded a verdict of $2 million

against the doctors' partnership based on the negligence of their nurse. Thus, the lawyers in *Elacqua* obtained dismissal of the *covered* claims, yet left intact the uncovered claims, for which their clients were ultimately responsible.

The *Elacqua* court 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 wrote that, "where such potential conflict exists between the insurer and the insured, the insurer has an affirmative obligation to 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." In so doing, the court expressly rejected contrary New York precedent on the issue.

In a matter of first impression, the Appellate Division further determined that the carrier's failure to inform the insureds of their right to unconflicted counsel could give rise to a claim under New York General Business Law § 349, which elevates damages upon proof of "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's 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.' "[16] According to the court, the misinformation in the carrier's disclaimer letters was likely to mislead consumers, and could accordingly be considered a statutory fraud in violation of New York's General Business Law.

Although it was the carrier, and not the lawyers, being sued in *Elacqua*, the court noted that a lawyer's 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."[17] The actual conduct of defense counsel in the underlying medical malpractice trial demonstrated a disregard for the interests of the insured doctors, whose personal assets were exposed by the lawyers' decision to seek dismissal of the only claims covered by insurance.

The precedential influence of *Elacqua* remains to be seen. *Elacqua* 'sreasoning does not flow inexorably from prior precedent. *Elacqua* was not a classic conflict situation, in which an insured is sued on two causes of action, one covered, the other excluded. Rather, *Elacqua* was a case in which multiple defendants were sued, and the insured doctors were vicariously liable through their partnership for the conduct of their nurse, who was not insured. The individual doctors were covered, but their partnership was not. The lawyers' conduct, in dismissing the covered claims, harmed the doctors by leaving them liable for the uncovered claims against the partnership. But this was more likely attributable to the fault of the lawyers, not that of the insurance carrier. The lawyers improperly lessened their clients' insurance coverage. Yet the carrier was faulted by the court for not giving coverage for an entity, the partnership, which was apparently not a named insured. Not every defendant in a case is a named insured; an insured may fail to request coverage for a related entity due to oversight, miscommunication, broker error, or unwillingness to pay an additional premium. But the existence of covered and uncovered entities is not the same as covered and uncovered claims. Consider the following hypothetical: Developer A buys and pays a premium for a comprehensive general liability policy naming itself, its principal and its managing agent. All these entities are named in a lawsuit covered by the CGL policy, and the carrier selects counsel from its pre-approved panel, or staff counsel. Developer A has no right to select counsel. Developer B saves money by only naming itself, and does not name its principal or managing agent as additional insureds. When all three entities are sued, there is only coverage for the developer, not the principal or managing agent. Developer B invokes its right to appoint *Goldfarb* counsel under *Elacqua*. In this hypothetical, the insured who pays the lower premium gets to select the presumably more expensive private counsel, while the presumably more diligent developer, Developer A, gets less control over its defense in exchange for its larger premium. This is an unintended consequence of finding a conflict in such situations.

Another problem can be caused by precipitous resort to conflict counsel, namely further erosion of the insurance policy limits. Most duty to defend policies are depleted by defense costs. Particularly in multiple counsel situations, adding multiple layers of lawyers, or

assigning monitoring counsel at the carrier's expense, can tend to erode policy limits.

Not all courts have agreed with the *Elacqua* approach. For example, another New York court, in *Sumo Container Station, Inc. v. Evans, Orr, Pacelli, Norton & Laffan*,[18] rejected the argument that "it was incumbent on defendants to advise [insured] Sumo of those conflicts and of its right to independent counsel at [the insurer's] expense."[19] Rather, under the facts before the court, neither the carrier nor the appointed counsel had an affirmative duty to inform the insured of its right to select its own counsel at the carrier's expense.

In *Sumo Container*, 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 insurance 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 he was beholden to Hertz, and that the lawyer should have informed Sumo of its right to unconflicted counsel at the carrier's expense. The court rejected Sumo's argument, since Sumo implicitly consented to the representation, and allowed years to lapse before raising its objection. 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."[20]

U.S. District Judge Shira Scheindlin, of e-discovery fame, recently addressed and rejected an insured's choice-of-counsel conflict argument in *Executive Risk Indemnity Inc. v. ICON Title Agency, LLC*.[21] In that case, Executive Risk insured ICON Title Agency under a professional liability insurance policy. When ICON was sued in a civil action alleging mortgage fraud, Executive Risk assumed ICON's defense. However, one of the co-defendants filed a cross-claim against ICON, alleging that it was entitled to contractual indemnification under the written subcontract. The carrier promptly issued a reservation of rights, arguing that the insured, in its written insurance application, had denied entering into any written contracts.

The carrier then commenced a declaratory judgment action against ICON, arguing that it was entitled to rescind the insurance policy due to misrepresentations in the insurance application. Not to be outdone, the insured counterclaimed against the carrier, alleging that the carrier had a conflict of interest and was required to pay for independent counsel in the underlying action, citing the *Elacqua* case discussed above.[22] However, the court rejected ICON's argument and dismissed its counterclaims as a matter of law, holding that ICON had not alleged an injury to itself as a result of the purported conflict. The court reasoned that the only injury alleged by ICON was the fact that insurance defense counsel appointed by the carrier had disclosed to the carrier the existence of ICON's indemnity agreement with its subcontractor, thus permitting the carrier to disclaim coverage.[23] The court held that this injury was impermissibly speculative because the subcontractor's cross-claim explicitly quoted the indemnification clause in the agreement and that the carrier would have inevitably learned of the agreement in the course of the litigation. The offending subcontract would have been produced in discovery in any event, and thus the carrier would have learned of it. Accordingly, the court dismissed ICON's counterclaim.

The facts in *Executive Risk Indemnity* are different from those in a classic *Goldfarb* or *Cumis* situation. A typical *Goldfarb* conflict would be a single complaint alleging two causes of action, one covered, the other not. A classic example is a pleading alleging negligence against a contractor (which is covered) and a breach of contract claim which is not covered.[24] In the *Executive Risk Indemnity* case, there was no complaint alleging two claims, one covered, the other not. The grounds for disclaimer referred to conduct by the insured that antedated the conduct alleged in the complaint; namely, the nondisclosure of a contract for indemnity, which was denied in the insurance application. The existence or not of such an indemnity agreement might be relevant to coverage, but it would not inform the strategic or tactical decision at trial such that trial counsel could be tempted to push liability in one direction or the other. Accordingly, the *Executive Risk Indemnity* case was, as the court found, a weak candidate for *Goldfarb* treatment.

The court in *Executive Risk Indemnity* brushed aside ICON's contention that counsel had a conflict of interest, assuming that the carrier would have ultimately

learned of the existence of the insured's indemnity contacts which permitted the carriers disclaimer. It is probably true that the carrier would have learned, as a practical matter, of the cross claim and indemnity contract. But the court gave short shrift to the conflict of interest in which counsel found himself being possessed of information which could have led and in fact did lead to denial of coverage for the insured. Prior authorities had recognized that under similar circumstances, insurance defense counsel may indeed be in a bind requiring withdrawal from the representation.[25] The coverage problem, then, might have justified a more careful consideration of the conflict issues.

A different result was obtained in a recent California case involving a coverage conflict under *Cumis*. The insured in *Sierra Pacific Industries v. American State Insurance Company*, was a logging company which entered into a subcontract with a subcontractor which agreed to indemnify and defend the insured logger from liability and damages arising out of their timber harvest.[26] The insured logger was named as an additional insured on the subcontractor's policy. The additional insurance coverage, however, excluded any liability for damages caused by the insured logger's independent negligence. Following a major fire, the insured logger was sued in seven law suits, some of which alleged that the insured logger's independent negligence caused the fire. In the confusion at the beginning of the multiple suits, both the insured logger and the insurer appointed counsel. The insurer, for some reason, told the insured logger that it was appointing panel counsel which had never before handled a major, complex wild fire case, but was willing to bill at an hourly rate of $150.[27] Less than reassured by this faint praise, the insured logger sought compensation from the carrier for the legal fees of its independent counsel. The court ruled that there was a conflict between the interests of the carrier and the insured logger which was outcome determinative within the meaning of California Civil Code Section 2860, thereby triggering the insured logger's right to select independent counsel. In fact, the court found that the case presented a classic conflict necessitating the appointment of independent counsel, because an important issue in the case was whether the fire was caused due to the negligence of the insured logger or the plaintiff's subcontractor. If the court were to find that the former was the case, then the insured logger would lose its coverage. In the event that the fire was exclusively the fault of the subcontractor, then there would be coverage. According to the court, since "[t]hese conflicting interests cannot be reconciled, and may be sufficient to preclude the insurer-appointed counsel from presenting a quality defense for the insured, entitling Plaintiff to independent counsel."[28] Thus, the case presented a genuine dispute pursuant to which defense counsel's trial strategy could directly affect the insured's coverage, thereby entitling the insured logger to independent counsel at trial.

V. Conclusion

New York and California, along with several other jurisdictions, have embraced precedents permitting a policyholder to select its own counsel, at the carrier's expense, provided that there is a conflict of interest affecting coverage. Not just any conflict of interest would trigger the insured's right to *Cumis/Goldfarb* conflict counsel. Rather, the courts have held that an insured is only entitled to select independent counsel when the complaint alleges multiple theories, some of which are covered by insurance and others are not. Moreover, precedent in both New York and California suggests that conflict counsel even then should only be available when strategic decisions made by defense counsel can affect the insured's coverage.

Not all jurisdictions have adopted this analysis, and several have held that both the insurance industry and the legal profession are sufficiently regulated to insure the avoidance of conflicts of interests. *Cumis* counsel, while sometimes appropriate, should be invoked judiciously, as excessive or multiple counsel can erode the policy. Particularly where *Cumis* counsel is duplicative or requires considerable time to get up to speed, the net result may be to reduce insurance coverage.

Finally, the courts have been divided on the question of whether an insurance carrier (or defense lawyer) have an obligation affirmatively to inform an insured of its right to select independent counsel in the event of a Goldfarb or Cumis conflict.

Endnotes

1. San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc., 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (Cal. Ct. App. 1984).

2. Pub. Serv. Mut. Ins. Co. v. Goldfarb, 53 N.Y.2d 392 (1981).

3. *Id.*

4. *Id.* at 401 (citations omitted).

5. *Id.* at 401 n. 1.

6. 152 Cal. App. 3d 358, 208 Cal Rptr. 494 (Cal. Ct. App. 1984).

7. *Id.* at 369.

8. *Id.* at 365.

9. Cal. Civ. Code § 2860(b).

10. *Id.*

11. *Id.* § 2860(e).

12. Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co., 336 F. Supp. 2d 610, 615 (D.S.C. 2004).

13. Finley v. Home Ins. Co., 975 P. 2d 1145, 1151-52 (Haw. 1998).

14. 52 A.D.3d 886 (3d Dept. 2008); *see also* Elacqua v. Physicians' Reciprocal Insurers, 21 A.D.3d 702, 800 N.Y.S.2d 469 (2005).

15. Elacqua, 52 A.D.3d at 890.

16. *Id.* at 889.

17. *Id.* at 889-90 (citations omitted).

18. 278 A.D.2d 169 (1st Dept. 2000).

19. *Id.* at 170.

20. *Id.* at 171 (citations omitted).

21. 739 F. Supp. 2d 446 (S.D.N.Y. 2010).

22. Elacqua, 52 A.D. 3d 886.

23. 739 F. Supp. 2d at 451.

24. *See* Nelson Electrical Contracting Corp. v. Transcontinental Ins. Co., 231 A.D. 2d 207, 660 N.Y.S.2d 220 (3d Dept. 1997).

25. *See, e.g.*, New York County Lawyers Association Ethics Opinion 669 (holding that insurance defense counsel may not reveal confidential information to carrier when disclosed in confidence by client) ("The fact that the friend did not have the permission of the car owner is a secret of the car owner under DR4-101(A), if the client has requested that it not be revealed or its revelation would be embarrassing or detrimental to the client.").

26. Sierra Pac. Indus. v. Am. State Ins. Co., No. 2:11-cv-00346-MCE-JFM, 2011 U.S. Dist. LEXIS 77756 (E.D. Cal. July 18, 2011).

27. *Id.* at *4.

28. *Id.* at *15 (citations omitted). ■

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