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Conflicts of Interest and Choice of Counsel in Insurance Policies: Some Recent Developments

by Barry R. Temkin and Robert Usinger

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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 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 defense 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 principles of *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 law, including attorney ethics 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. Finally, as pertains to the notion that the insurance carrier is affirmatively obligated to inform the insured of its right to independent counsel, the law is unclear in some states.

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 attorney ethics rules.[3] The Supreme Court of Hawaii, in *Finley v. Home Insurance Company*, similarly wrote:

> [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.[4]

U.S. District Judge Shira Scheindlin, of e-discovery fame, addressed and rejected an insured's choice-of-counsel conflict argument in *Executive Risk Indemnity Inc. v. ICON Title Agency, LLC*.[5] 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 issued a reservation of rights, and commenced a declaratory judgment action, arguing that the insured, in its written insurance application, had falsely denied entering into any written contracts. 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 below.[6] However, the court rejected ICON's argument, reasoning 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.[7] 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.

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. Independent counsel is paid out of the policy limits, just like insurance defense panel counsel. In cases with the potential for losses up to or in excess of the policy limits, the erosion of the policy for defense fees of independent counsel reduces funds for settlement or a judgment, thereby potentially exposing the insured to more personal liability. If independent counsel charges rates much higher than panel counsel, this will cause faster depletion of the policy. The law as to what an insurer must pay independent counsel varies from state to state.

A further, and still unresolved 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?

A New York court has held that where there is a *Goldfarb* conflict the carrier must affirmatively inform the insured of its right to select unconflicted counsel at the former's expense. *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.[8] The doctors' lawyers, who were appointed by the carrier, successfully moved to dismiss all covered claims against their individual clients, leaving the partnership exposed to vicarious liability for the nurse's negligence.[9] 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 jury awarded a verdict of $2 million against the doctors' partnership based on the negligence of their nurse.

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. In addition, 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."[10] 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.'"[11]

Not all courts have agreed with the *Elacqua* approach. For example, *Sumo Container Station, Inc. v. Evans, Orr, Pacelli, Norton & Laffan*,[12] 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."[13] 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 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 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.[14]

In Massachusetts, the law is less clear as to whether or not the insurer has to actually inform the insured of its right to self-selected counsel in the face of a reservation of rights. In *Northern Security Insurance Company, Inc. v. R.H. Realty Trust*, the court stated that in its reservation of rights letter, the carrier "failed to inform the trust… that it could retain its own counsel for which the insurance company would be required to pay reasonable attorney's fees and costs associated with the defense."[15] The court's use of the term

"failed" seems to imply that the insurer neglected to do something that it was obligated to do, (i.e. tell the insured it has a right to select its own counsel because of the reservation of rights).

Conclusion

Some jurisdictions permit 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 will trigger the insured's right to *Cumis/Goldfarb* conflict counsel. Rather, 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 even then conflict counsel 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 ensure 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, courts have been divided on the question of whether an insurance carrier (or defense lawyer) has an obligation to affirmatively inform an insured of its right to select independent counsel in the event of a *Goldfarb* or *Cumis* conflict.

The views expressed in this article are those of the authors only, and do not reflect the views of the NYCLA, Mound Cotton Wollan & Greengrass, or any other entity.

Endnotes

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

2 *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810, 53 N.Y.2d 392 (1981).

3 *Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co.*, 336 F. Supp. 2d 610, 615 (D.S.C. 2004), aff'd, 433 F.3d 365 (4th Cir. 2005).

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

5 739 F. Supp. 2d 446 (S.D.N.Y. 2010).

6 *Elacqua, v. Physicians' Reciprocal Insurers*, 860 N.Y.S.2d 299, 52 A.D. 3d 886 (3d Dep't 2008).

7 *Exec. Risk*, 739 F. Supp. 2d at 451.

8 860 N.Y.S. 2d 229, 52 A.D.3d 886 (3d Dep't. 2008); *see also Elacqua v. Physicians' Reciprocal Insurers*, 800 N.Y.S.2d 469, 21 A.D.3d 702,800 N.Y.S.2d 469 (2005), *modified by id.*

9 *Elacqua*, 52 A.D.3d at 890.

10 *Id.* at 888-89 (citation omitted).

11 *Id.* at 889.

12 719 N.Y.S.2d 223, 278 A.D.2d 169 (1st Dep't. 2000).

13 *Id.* at 170.

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

15 941 N.E.2d 688, 78 Mass. App. Ct. 691 (Mass. App. Ct. 2011).

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