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Client Alert

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Insurance Companies Must Inform Policyholders of their Right to Independent Counsel

A recent decision by a New York State appellate court emphasizes the importance of a critical but often-neglected policyholder right: The right to select independent defense counsel to be paid for by the insurance company where the insurance company's reservation of the right to deny coverage creates a conflict of interest with the insured. The court found this right so fundamental that it placed the onus on the insurance companies to inform insureds of it, and held that the failure to do so may amount to a deceptive insurance practice in violation of General Business Law § 349.

An insured is entitled to representation by an attorney of his or her own choosing, with reasonable fees of such counsel to be paid for by the insurer, when an insurer reserves its right to deny coverage creating a conflict of interest with its insured. This right is well established under New York law. In *Elacqua v. Physicians' Reciprocal Insurers*, 2008 NY Slip Op 4968, *3 (3d Dep't 2008) (*Elacqua II*), the Third Department of the Appellate Division of the Supreme Court of New York went further: The court imposed an affirmative obligation on insurance companies to inform their insureds of this right, and held that failure to do so may constitute a deceptive practice under General Business Law § 349 for which the insured may recover damages and attorney's fees.

An earlier decision of the First Department had reached a different conclusion. In *Sumo Container Station, Inc. v. Evans, Orr, Pacelli, Norton & Laffan P.C.*, the court held that an insurer had no affirmative duty to advise its insured that it is entitled to independent counsel paid for by the insurer. 719 N.Y.S.2d 223, 224 (1st Dep't 2000). In the underlying action, plaintiffs had sued both Sumo and Hertz Penske Truck Leasing Inc. (Hertz), claiming that their car was damaged by a truck Hertz leased to Sumo. Kemper, Hertz's insurer, agreed to represent both Sumo and Hertz, but reserved the right to disclaim coverage if it was determined that the truck involved in the accident was owned by Sumo. When it became clear that ownership of the truck would be a significant issue, Kemper assigned separate counsel to represent Sumo and Hertz. Hertz subsequently agreed to advance funds to settle the claim subject to a jury trial on ownership of the truck. The jury determined that the truck was, in fact, owned by Sumo. Sumo brought an action against Kemper and the law firms involved in the case, alleging, *inter alia*, that the duties owed to Sumo were compromised by conflicts of interest, that Sumo should have been advised of these conflicts and of its right to independent counsel. The court disagreed, finding that the existence of a conflict was "implicit in the correspondence" with the carrier and that Sumo was aware of its independent counsel right and elected to proceed with counsel appointed by the carrier.

The *Elacqua* decision reached a contrary conclusion. The matter arose from a malpractice claim against a nurse, two physicians, and the partnership of which the physicians were members. *Elacqua v. Physicians' Reciprocal Insurers* (*Elacqua I*), 800 N.Y.S.2d 469, 473 (3d Dep't 2005). The physicians each had an insurance policy with Physicians' Reciprocal Insurers (insurer), and the partnership was named as an additional insured on each policy. The nurse was covered by a different insurer. Initially, the insurer retained one attorney to represent both physicians and the partnership; however, when counsel perceived a conflict in his representation, the insurer retained separate counsel for each physician. Though the complaint against the nurse was settled and the complaints against the individual physicians were dismissed, a verdict was rendered against the partnership. The insurer refused to indemnify the partnership on grounds that its policy did not cover vicarious liability—the basis of recovery in the underlying action—whereupon the physicians and the partnership brought an action against the insurer for breach of contract for failure to properly defend and failure to indemnify, and for declaratory judgment.

The Supreme Court granted summary judgment in favor of the partnership, finding coverage under the

policy. Moreover, it found that the insurer failed, as a matter of law, to timely disclaim coverage as required by Insurance Law § 3420(d). The Supreme Court also rejected plaintiffs' claim that the insurer had an obligation to advise them of their right to counsel of their own choosing, feeling "reluctantly" constrained by the First Department's decision in *Sumo*. Plaintiffs appealed.

The Third Department affirmed as to coverage and reversed as to compliance with Insurance Law § 3420(d), finding that questions of fact existed with respect to the timeliness of notice of disclaimer. Disagreeing with the result in *Sumo*, the Third Department also found that an insurance company has an affirmative obligation to advise its insured of the right to independent counsel. *Id.* at 473.

Upon remand, plaintiffs amended their complaint to add causes of action for, among other things, deceptive practices pursuant to General Business Law § 349 for the insurer's failure to inform them that they had a right to select independent counsel of their choosing at the insurer's expense. *Elacqua v. Physicians' Reciprocal Insurers*, 2008 NY Slip Op 4968, *1-2 (3d Dep't 2008) (*Elacqua II*). The underlying action was settled and funded by the insurer but plaintiffs continued the action against the insurer, seeking to recover counsel fees they had incurred in compelling the carrier to indemnify them. After a bifurcated trial on the issue of liability, the trial court dismissed the complaint and plaintiffs appealed.

The Third Department again reversed, finding that plaintiffs had been injured by the insurer's failure to advise them of their independent counsel right, and had been misled by communication suggesting that plaintiffs would have to pay for such representation. The court found that the obligation of an insurance company to tender independent counsel at its own expense was particularly important in conflict situations, as 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." *Id.* at *3. This standard was not satisfied, as the attorneys representing the physicians successfully moved to dismiss the complaint against the physicians, leaving viable only the uncovered claim against the partnership for vicarious liability, without explaining to the physicians the ramifications of this action. *Id.* at *4. Further, the attorney for the partnership joined this motion, despite its consequences for the partnership and even though there were legally sufficient grounds to oppose it. *Id.* This advanced the insurer's interests while "the insured doctors' interests were, to put it mildly, not enhanced." *Id.* Such inadequate representation, combined with the insurer's failure to inform plaintiffs of their rights, constituted harm under General Business Law § 349. *Id.*

As a result of the decision in *Elacqua*, insurance companies must consider changing their standard reservation of rights letters to include notice of the right to independent counsel. By the same token, policyholders should be aware of their right to independent counsel and exercise it to ensure that they receive the uncompromised, conflict-free representation they are entitled to under the insurance contract and New York law.

New York

John H. Gross
212.969.3145 – jgross@proskauer.com

Seth B. Schafler
212.969.3660 – sschafler@proskauer.com

John E. Failla
212.969.3141 – jfailla@proskauer.com

Margaret A. Dale
212.969.3315 – mdale@proskauer.com

Chicago

Steven R. Gilford
312.962.3510 – sgilford@proskauer.com

Paul L. Langer
312.962.3520 – planger@proskauer.com

Marc E. Rosenthal
312.962.3530 – mrosenthal@proskauer.com