Excess Insurance

New York Appellate Court Rejects Excess Liability Carrier's Malpractice Claim against Policyholder's Defense Counsel, But Permits Excess Insurer to Sue Primary Insurer for Bad Faith under Direct Duty Theory

Absence of Privity or Near Privity Relationship between Excess Carrier and Policyholder Precluded Imposition of Duty on Attorney

Federal Insurance Company v. North American Speciality Insurance Co., 847 N.Y.S.2d 7, 2007 WL 3306577 (App. Div. Nov. 8, 2008)

Case at a Glance

The absence of an attorney-client relationship between an excess insurer and the attorney hired to defend a covered lawsuit against the excess insurer's insured precludes the excess insurer from suing the attorney for professional malpractice.

Under New York law, a "near privity" relationship exists between a policyholder's attorney and a third party, such as the policyholder's excess liability insurer, justifying imposition of liability on the attorney for negligent misrepresentation, if three conditions are met: (1) the attorney is aware that statements he or she makes will be used by the insurer for a particular purpose; (2) reliance by the liability insurer on the statement in furtherance of that purpose; and (3) some conduct by the attorney

evincing an understanding of that reliance. However, a malpractice cause of action based on an attorney's failure to assert a defense, resulting in liability within the excess insurer's layer of coverage is not based on a misrepresentation and therefore cannot support recovery under a "near privity" theory.

Although the absence of any damage to the insured as a result of a primary insurer's mishandling of a claim against the insured precluded an excess insurer from recovering under an equitable subrogation theory, the excess insurer could recover under a direct duty theory.

Summary of the Case

A worker ("W") fell from a scaffold. He was badly injured and sued. Since W was employed by a sub contractor, he sued the general and the owners of the building. Galaxy General Contracting Corporation ("Galaxy") was the general contractor. Galaxy had primary CGL coverage with limits of $1 million through Commercial Underwriters Insurance Company ("CUIC"). Federal Insurance Company provided Galaxy with $10 million in excess coverage. In addition, CUIC also issued Galaxy a $1 million Owners and Contractors Protective Liability Policy ("OCP"), which Galaxy had purchased for the benefit of the owners pursuant to the indemnity clause in its contract with the owners. CUIC's alleged attempts to avoid liability under the OCP policy, and thereby force Federal to incur additional liability, is the what prompted Federal to file the present lawsuit. Regrettably, the court's opinion says nothing about the language of either the OCP policy or the indemnity agreement with the owners.

Federal claims arose out of the manner in which CUIC and the attorney ("L") hired by CUIC to represent Galaxy handled the owners' successful efforts to avoid liability to W on the ground that they were not in control of the job or even present at the job site. The trial court granted summary judgment to the owners on W's claim, conditional on the validity of the owners' indemnification claims against Galaxy, and separately granted summary judgment to the owners on their cross-claims for indemnity. L and CUIC opposed the owners' motion, but did not challenge the validity of the owners' indemnity claims based on New York's so-called "anti-subrogation" defense. Under New York version of the rule, a liability insurer defending and indemnifying an insured ("D_1") may not seek subrogation recovery from a co-tortfeasor ("D_2"), if it insures both of these co-tortfeasors. Consequently, the D_2 may not seek indemnity from D_1, assuming that payments by D_2 are actually paid by the liability insurer for both tortfeasors. Allegedly as a result of the attorney's failure to invoke the anti-subrogation defense, the trial court upheld that validity of the indemnity claims, resulting in entry of summary judgment for the. The gravamen of Federal's complaint against CUIC and the attorney CUIC hired to represent Galaxy was that if the antisubrogation rule been asserted, CUIC's OCP policy would have remained exposed and its proceeds subject to execution in a judgment against both Galaxy and the owners, who were jointly and severally liable to the injured worker.

The underlying case settled for $3 million. CUIC paid its policy limits under the CGL policy, but it refused to pay anything under the OCP, presumably because the owners were not guilty of any negligence. Consequently, Federal—after trying to convince CUIC to pay more—paid the additional $2 million. The lawsuit now under discussion was its attempt to recover $1 million of the amount it paid.

Federal sued both L and CUIC. It pressed five causes of action. Three of them involved CUIC alone, while two of them involved both CUIC and L. The causes of action against CUIC alone were based on CUIC's violation of the anti-subrogation rule by allowing the owners to seek indemnity from Galaxy. Federal alleged that CUIC's conduct constituted bad faith, and sought recovery from CUIC for the resulting damage—Federal's obligation to pay the $1 million that should have been paid by CUIC under the OCP. Two of the causes of action against CUIC alone sought recovery under a direct duty theory, and the third was based on Federal's right to recovery as Galaxy's subrogee, presumably under an equitable subrogation theory. The fourth and fifth causes of action were legal malpractice claims against L—and oddly, against CUIC as well—for negligently failing to invoke the anti-subrogation rule. The fourth cause of action alleged that L owed Federal a direct duty, and the fifth sought recovery, as Galaxy's subrogee, for breach of the duty L owed to Galaxy.

CUIC and L tried to end the lawsuit by means of motions to dismiss. The trial judged dismissed the malpractice claims against CUIC, but otherwise

allowed the lawsuit to go forward. CUIC and L appealed to the Appellate Division of the New York Supreme Court, First Department. On appeal, the linchpin of Federal's subrogation claims against both CUIC and L was the absence of harm to Galaxy caused by the conduct of a third party. Without such harm, Galaxy had no cause of action to which Federal could subrogate. In finding that Galaxy did not suffer any damage as a result of L's or CUIC's failure to raise the anti-subrogation defense to the owners' indemnification claims, the appellate court reasoned that any damage Galaxy sustained was a result of its own wrongdoing, not that of either of the defendants. The court pointed out that the $3 million settlement represented an amount that Galaxy reasonable owed for W's injuries. Since Galaxy was jointly and severally liable for those injuries, W could have enforced the entire judgment against Galaxy had the case gone to trial and resulted in a judgment. True, the trial court's grant of summary judgment to the owners on their cross-claims allowed the owners to seek indemnity from Galaxy had W attempted to enforce the judgment against the owners. W, however, did not do so, and the owners therefore never sought to enforce their indemnity rights. Thus, neither Galaxy nor Federal ever made any payment as a result of the CUIC's or L's failure to invoke the anti-subrogation rule.

Federal's right to recover therefore depended on its ability to show that the defendants breached a duty owed directly to it, and that it suffered harm as a result of the breach. Beginning with the malpractice claims against L, the appellate court flatly rejected Federal's contention that L owed it a duty of care. Subject to some very narrow exceptions, only clients may sue their lawyers for malpractice, and the existence of "strict privity" is a necessary condition for an attorney-client relationship. No such thing existed between either CUIC or Federal and L. It is public policy in New York state that insurance defense counsel have an attorney-client relationship only with the insured; anything else would create a web of conflicts and might impede the zealous representation of insured-clients.

Under New York law, the strict privity requirement is relaxed, permitting third parties to sue a lawyer, only when the lawyer has negligently misrepresented a proposition and knew in advance that the interests of the third party were at stake. *See, Prudential Ins. Co. of Am v. Dewey, Ballantine,* 605 N.E.2d 318 (N.Y. 1992) (attorneys may be liable to third parties for negligent misrepresentation). *See also, Credit Alliance Corp v. Andersen & Co.,* 483 N.E.2d 110 (N.Y. 1985) (accountants liable to third parties for negligent misrepresentation). To establish a claim for negligent misrepresentation against an attorney under *Prudential*, a third party must allege: "(1) an awareness by the maker of the statement that it is to be used for a particular purpose; (2) reliance by a known party on the statement in furtherance of that purpose; and (3) some conduct by the maker of the statement linking it to the relying party and evincing its understanding of that reliance" (*Prudential,* 80 N.Y.2d at 384). In such circumstances, the relationship between the third party and the attorney is said to be "so close as to touch the bounds of privity" and the public policy reasons for enforcing a strict privity requirement have less force. (*Allianz Underwriters Ins. Co. v. Landmark Ins. Co.* 13 A.D.3d 172,175, 787 N.Y.S.2d 15). Federal, however, was unable to point to facts supporting a "near privity" relationship between L and itself. The appellate court pointed out that Federal's decision to settle W's lawsuit was not based on any affirmative representation by L upon which Federal relied. Rather, it settled the action because the case against its insured was clear and the settlement amount was reasonable.

The court, however, found that CUIC owed Federal a duty of good faith, and that triable issues of fact existed regarding whether CUIC breached that duty. Federal claimed that CUIC "manifested a 'conscious disregard' for Federal's rights by allowing one of its insureds, the owners, to escape liability in violation of the antisubrogation rule thereby removing one of its policies (OCP) from the layer of coverage that had to be exhausted before triggering Federal's excess coverage[.]" This was sufficient, in the court's view, to state a claim for insurer bad faith. See *Pavia v. State Farm Mut. Auto. Ins. Co.,* 626 N.E.2d 24 (N.Y. 1993)

Comment

What is odd about this decision is that the "Anti-Subrogation Rule" probably had nothing to do with the case. If the owners had liability, CUIC would have had to indemnify them, and its lack of subrogation rights when it came to Galaxy and the owners would

have had nothing to do with this obligation. CUIC could not have refused to pay Galaxy's indemnity obligation to the owners because of this Rule. The rule in question is not an "Anti-Indemnity Agreement Rule."

It is also hard to see why the judge granted the owners summary judgment only if they had indemnity rights. If the owners were gone from the case by a final judgment finding no liability, then the injured worker could not sue them anyway. As a consequence, neither could Galaxy or its subrogee, since the owner had already been found to be innocent of responsibility.

The appellate court's finding of triable issues of fact with respect to Federal's claim against CUIC for having defense counsel get the owners out of the case is even more confusing. One of two alternative explanations is probably true. First, if Federal is trying to prove that getting summary judgment for the owners was a kind of intentional cheating that would be one thing. Federal's idea here would go like this. The owners were negligent. They should not have been allowed out of the case. The plaintiff did not really care, once his lawyers realized that there was plenty of coverage for Galaxy. Hence, there was a motion for summary judgment on behalf of the owners; there was not really serious opposition by the plaintiff; consequently, a liable party-group was discharged from the case—a party-group whose liability would have been paid by CUIC (at least at first), not Federal. Now for the second alternative. Federal suggested that primary carriers should not try to get their insureds out of lawsuit under any circumstances, if the absence of those insured parties would expose the excess carrier to greater liability than it would face if the presence of the party-group might decrease the exposure of the excess carrier and hence perhaps save the excess carrier some money. If the former of these two theories—the Quinn Theory—is correct, then the excess carrier has something to complain about. Alas, there are no facts cites in the opinion which suggest—or so much as hint—that Federal might be right. If the second of these two theories—the DiMungo Theory—is correct, then this opinion is a very radical opinion, since it creates a new—and very odd—duty requiring a primary carrier to take more care of an excess carrier than it provides its insured. Either way, something is missing from this opinion, and the gap proposed by the DiMugno Theory will provide inventive lawyers with ways to argue for a new duty owed by primary carriers to excess carriers. The opinion creates this new argument no matter which of the two theories is correct. // Quinn/DiMugno