

Outside Counsel Policyholders' Rights to Recover Attorneys' Fees From Insurers

Expert Analysis

Much has been written about the 2008 New York Court of Appeals' decisions in *Bi-Economy Mkt., Inc. v. Harleysville Ins. Co. of N.Y.* and *Panasia Estates, Inc. v. Hudson Ins. Co.*¹ and their progeny, all of which permit policyholders to seek consequential damages from their insurance carriers for insurers' breach of contractual obligations. These landmark rulings have catalyzed considerable redevelopment of New York insurance law by significantly broadening the spectrum of cases in which consequential damages are available.² Recently, the U.S. District Court for the Northern District of New York illustrated the transformational nature of these decisions by declaring that *Bi-Economy* and *Panasia* "changed the landscape" to permit policyholders to recover attorneys' fees incurred in bringing an affirmative action against insurers to secure policy rights.³

Evolution of Process

Policyholders in New York have long considered their attorneys' fees to be a natural consequence of insurance coverage litigation, necessitated by their insurers' contractual breach by non-payment of covered claims. Historically, New York state law permitted a policyholder to recoup its attorneys' fees only after successfully defending against a declaratory judgment action initiated by an insurer seeking to free itself from its policy obligations.⁴ The genesis of this doctrine is found in *Mighty Midgets, Inc. v. Centennial Insurance Co.*⁵

Mighty Midgets, Inc. v. Centennial Insurance Co. In *Mighty Midgets*, Centennial denied coverage to *Mighty Midgets*, a nonprofit corporation organized



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to support boys' football teams, for a suit brought against the organization by an injured player. *Mighty Midgets* sued Centennial and sought a declaratory judgment that Centennial had an obligation to defend and indemnify. Finding that Centennial had no right to disclaim coverage, the trial court awarded *Mighty Midgets* its attorneys' fees for prosecuting the action. The Second Department, however, reversed, and the New York Court of Appeals affirmed the reversal.

'Chernish' recognized that 'Bi-Economy' and 'Panasia' allow policyholders to recover fees and expenses they incur to bring an affirmative action against an insurer to settle their policy rights as a result of the insurer's refusal to pay.

Reasoning that an insurer's duty to defend an insured "reaches the defense of any actions arising out of the occurrence," the Court ruled that attorneys' fees are recoverable when an insured party is "cast in a defensive posture by the legal steps an insurer takes in an effort to free itself from its policy obligations."⁶ Because *Mighty Midgets* had commenced the declaratory judgment action against Centennial, the Court held that recovery of its attorneys' fees was improper.

Employers Mutual Casualty Co. v. Key Pharmaceuticals. This rule was further refined in *Employers Mutual Casualty Co. v. Key Pharmaceuticals.*⁷ In that case, an individual sued Key in 1985, alleging that he suffered brain damage after taking one of the company's medications. Key eventually settled the claim for \$4.175 million. Key's primary insurer and first-layer excess insurer supplied product liability insurance of \$3 million, and Employers provided second-layer excess coverage of \$2 million for any payments exceeding \$3 million. After the settlement, however, Employers refused to pay its portion and sued Key, claiming that Key had negligently failed to resolve the matter for a figure that did not reach the second-layer excess coverage threshold.

The Southern District of New York found that Employers had a duty to indemnify Key, but denied Key its attorneys' fees for defending against Employers' action. The Second Circuit affirmed even though Key had been forced into a "defensive posture." The court distinguished *Mighty Midgets* by reasoning that *Mighty Midgets* allowed policyholders to recover attorneys' fees when the insured was "cast in a defensive posture by its insurer in a dispute over the insurer's duty to defend."⁸ Because the dispute concerned Employers' duty to indemnify Key, the Second Circuit concluded that attorneys' fees could not be awarded.

U.S. Underwriters Insurance Co. v. City Club Hotel, LLC. In *U.S. Underwriters Insurance Co. v. City Club Hotel, LLC*, New York retreated from the restrictive approach set forth in *Key Pharmaceuticals.*⁹ There, City Club, a named insured, was performing renovation work on property owned by Shelby Realty, another named insured, when a City Club employee was injured in a fall. The injured employee sued City Club, Shelby, and others.

U.S. Underwriters disclaimed coverage based on an employee exclusion in the policy, but nonetheless provided Shelby with a defense in the underlying personal injury action. But at the same time, U.S. Underwriters commenced suit in the U.S. District Court for the Southern District of New

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York, seeking a declaration that it had no duty to defend or indemnify Shelby or City Club.

The district court granted summary judgment to Shelby and City Club because U.S. Underwriters' disclaimer was untimely as a matter of law. Following the decision, Shelby and City Club moved for their attorneys' fees for defending against the suit, but the court denied the motion, finding that by paying for Shelby's defense, U.S. Underwriters did not breach its duty to defend.

U.S. Underwriters, Shelby, and City Club appealed. The Second Circuit affirmed in part, but certified to the New York Court of Appeals the question of whether a policyholder can recover attorneys' fees after prevailing in an action brought by an insurer to absolve itself of its policy obligations.

The Court of Appeals answered in the affirmative and ruled that:

[A]n insured who is 'cast in a defensive posture by the legal steps an insurer takes in an effort to free itself from its policy obligations,' and who prevails on the merits, may recover attorneys' fees incurred in defending against the insurer's action...regardless of whether the insurer provided a defense to the insured.¹⁰

The Court also ruled that:

The reasoning behind *Mighty Midgets* is that an insurer's duty to defend an insured extends to the defense of any action arising out of the occurrence, including a defense against an insurer's declaratory judgment action.¹¹

The Court predicated its ruling on the nature of the relationship between insurers and insured parties and reasoned that the litigation expenses were incurred as a "direct consequence" of the insurer's attempt to free itself of its policy obligations and were "incidental" to U.S. Underwriters' contractual duties.

State of New York Law

In *Chemish v. Massachusetts Mutual Life Insurance Co.*,¹² the U.S. District Court for the Northern District of New York recognized that *Bi-Economy* and *Panasia* allow policyholders to recover fees and expenses that they incur to bring an affirmative action against an insurer to settle their policy rights as a result of the insurer's refusal to pay. Early in 1987, Anne Chemish purchased a 30-year disability income insurance policy from Mass Mutual. She began to suffer various ailments soon thereafter, developing a chronic, permanent, and untreatable medical condition that doctors ultimately diagnosed as Crohn's disease.

In 1988, Ms. Chernish filed a claim under her insurance policy, which Mass Mutual contested. The contest was unsuccessful, and Mass Mutual paid benefits until approximately 2001. Chernish

renewed her claim twice, and while Mass Mutual did not deny her requests, the company failed to make additional payments or provide any justification for the delay.

Ms. Chernish brought suit against Mass Mutual in the Northern District of New York to vindicate her policy rights, claiming that Mass Mutual breached its contract and that she was entitled to damages flowing from a loss of benefits, premiums, and an "obligation for legal fees and other consequential damages as allowed by law."¹³ Ms. Chernish also alleged a second cause of action for breach of the covenant of good faith and fair dealing, and sought her attorneys' fees in connection with bringing suit. Mass Mutual moved to dismiss this second cause of action, as well as the request for attorneys' fees.

The Northern District denied Mass Mutual's motion because *Bi-Economy* and *Panasia* recognize an insured's ability to recover consequential damages including its attorneys' fees for bringing suit. Indeed, the Court of Appeals in *Panasia* explicitly stated that "consequential damages resulting from a breach of the covenant of good faith and fair dealing may be asserted in an insurance contract context, so long as the damages were 'within the contemplation of the parties as the probable result of a breach at the time of or prior to contracting.'"¹⁴

Insurers are now, more than ever, on notice that attorneys' fees are within the contemplation of the parties as the probable result of the insurers' breach of their contractual obligations to their policyholders.

To this end, the Northern District allowed Ms. Chernish's request for attorneys' fees because "the very purpose" of her disability insurance policy would have made the insurance company aware that "if it breached its obligations under the contract to investigate in good faith and pay covered claims it would have to respond in damages to [the plaintiff]" for the specific costs alleged in her complaint.¹⁵

This outcome is completely consistent with *Bi-Economy* and *Panasia*, which sought to "place the insured in the position it would have been in had the contract been performed," because without the ability to recover its attorneys' fees, an insured will not be in such a position.¹⁶ An insurer's breach of contract often forces its policyholder to initiate an insurance coverage lawsuit to enforce a policyholder's rights under the insurance policy.

Conclusion

That insurers must abide by their duty of good faith and fair dealing by paying valid claims

rather than simply denying them is self-evident. But the Northern District's decision in *Chemish*, along with the Court of Appeals' decisions in *Bi-Economy* and *Panasia*, gives some more teeth to that axiom. *Chemish*, *Bi-Economy*, and *Panasia* make sense because they render inoperative the logically inconsistent loophole in *Mighty Midgets* and *Key Pharmaceuticals* that allowed insurers to avoid being hit with a judgment for their policyholders' attorneys' fees by sitting idly by and waiting to be sued. To be sure, insurers are now, more than ever, on notice that attorneys' fees are within the contemplation of the parties as the probable result of the insurers' breach of their contractual obligations to their policyholders.

1. *Bi-Economy Mkt., Inc. v. Harleystville Ins. Co. of N.Y.*, 10 N.Y.3d 187 (2008); *Panasia Estates, Inc. v. Hudson Ins. Co.*, 10 N.Y.3d 200 (2008).

2. *Hoffman v. Unionmutual Stock Life Ins. Co.*, 51 A.D.3d 633 (2d Dept. 2008); *U.S. Fire Ins. Co. v. Bunge N. Am., Inc.*, No. 05-2192-JWL, 2008 WL 3077074 (D. Kan. Aug. 4, 2008) (applying New York law); see Robin L. Cohen & Joseph D. Jean, "State Insurer Bad Faith Law After *Bi-Economy* and *Panasia*," 239 N.Y.L.J. 4 (2009).

3. *Chemish v. Mass. Mut. Life Ins. Co.*, No. 5:08-CV-0957 (GHL) 2009 WL 385418, at *5 (N.D.N.Y. Feb. 10, 2009).

4. *Employers Mut. Cas. Co. v. Key Pharms.*, 75 F.3d 815, 824 (2d Cir. 1996) (*Key Pharmaceuticals*).

5. 47 N.Y.2d 12 (1979).

6. *Id.* at 21.

7. 75 F.3d 815.

8. *Id.* at 824.

9. 3 N.Y.3d 592, cert. granted, 2 N.Y.3d 787 (2004).

10. *Id.* at 597-98 (citation omitted).

11. *Id.* at 598.

12. 2009 WL 385418.

13. *Id.* at 1.

14. *Panasia Estates*, 10 N.Y.3d at 203 (quoting *Bi-Economy*, 10 N.Y.3d at 192).

15. 2009 WL 385418, at 4.

16. *Bi-Economy*, 10 N.Y.3d at 195.