



THE INSURANCE BROKER AND COVERAGE DISPUTES: EMERGING ISSUES

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I. Business and Ethical Responsibilities of Insurance Brokers

The duties and responsibilities of an insurance broker are defined, in large part, by the role the broker plays in the insurance transaction. While there are a variety of insurance agents, there are generally just two different types of brokers:

- retail brokers
- wholesale brokers

The retail brokers have a direct relationship with the insured, for whom they are seeking to place coverage. They can be a small mom and pop shop, or they can be writing tens of millions of dollars annually in premiums. They are distinguished by the fact that they are dealing directly with the insured.

The wholesale brokers (e.g., surplus lines brokers) are brokers to whom retail brokers turn for assistance in placing coverage. While retail brokers consider their clients to be the insureds, for whom they are attempting to place coverage, wholesale brokers consider their clients to be the retail brokers who seek their assistance. They will typically have a relationship with one or more insurers' underwriters, for whom they are attempting to market an insurance program.¹

Depending upon which role the broker fulfills, this will impact the duties and responsibilities of the broker with regard to both the insured and the insurer. Generally, the case law provides that while the retail broker owes the insured a duty of care in placing coverage, the wholesale broker's duties and responsibilities run solely to its client in the transaction: the retail broker. However, there is authority for the proposition that where the insured has been specifically advised that coverage will be placed through a wholesale broker, and the insured assents to the placement through same, the

retail broker can be deemed to have been acting as the agent for the insured in retaining the services of the wholesale broker.² In such instance, the wholesale broker may also be found to owe a direct duty of care to the insured with regard to placement of coverage.

Assuming the retail broker and wholesale broker are fulfilling their traditional roles, it is not uncommon for larger brokers to fill the role of wholesaler on certain transactions and retailer on others. Additionally, retail brokers may often have agent agreements with certain insurers. So it won't be uncommon for the broker involved in placing a particular type of coverage to have relationships with both the insurers and the insureds.

Assuming a claim is made under a policy placed by the broker, the broker must act as advocate for the insured. However, business realities dictate that the broker may be fighting with an insurer about claim A for client X today, and looking for a favor to have the insurer agree to coverage for client Y tomorrow, despite client Y's questionable loss history. Or the broker may ask the insurer to bind coverage for a period prior to when the coverage was originally negotiated and bound, despite the increased risk of loss presented thereby, in order to plug a gap in coverage. Additionally, to the extent a broker has a contingent commission agreement with a carrier, there may be the potential (or at least the perceived potential) for the broker to be incentivized to act in such a way as to limit loss claims and recoveries.

II. The Role Of The Broker In Litigating Or Preparing To Litigate A Coverage Dispute

When a claim comes in that appears from the outset as a claim that may be subjected to careful scrutiny by the insurer, either because of the size of the claim, the timing of the claim, or specific coverage issues which

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¹ Definitions taken from Douglas R. Richmond, *Insurance Agent and Broker Liability*, 40 TORT TRIAL & INSURANCE PRACTICE LAW JOURNAL 1 (Fall 2004).

² See 13-101 APPLEMAN ON INSURANCE § 101.1 (2009) ("there is significance in whether the client gives actual or implied-in-fact consent to the retailer's use of a wholesale broker. Where consent has not been forthcoming, the retailer will have the greatest relative obligation to the client. The retail broker is the one on whom the client relies and thus the conduct of the failing wholesaler falls within the orbit of the retailer's own responsibility. On the other hand, if the insured consents to the role of the wholesaler, [the wholesaler will assume]. . . [l]egal duties . . . to the insured [which] turn upon the wholesaler's care and skill in doing the work he or she may undertake").

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may immediately present themselves, the broker will likely be involved in discussions with the insured about the claim and how to present the claim early on. However, while the broker and the insured may both view the broker as a part of the insured's "team", and wish to have the broker participate in planning and strategy discussions with the insured's coverage counsel, courts considering the effect of involving brokers in otherwise privileged communications have held that insofar as there is an attorney-client privilege, it only exists to the extent the attorney and client have engaged in private, confidential communications. The broker, in this instance, while viewed and treated as a part of the insured's strategy "team" is, in fact, a third-party to the attorney-client relationship. Accordingly, where the broker participates in what would otherwise constitute privileged attorney-client communications, the communications are deemed to be stripped of any privilege protection.³ This means, in short, that involving brokers in meetings, email exchanges, telephone conferences or other communications between the insured and its counsel runs the risk that candid admissions regarding coverage issues which would otherwise be protected from disclosure may be opened to inspection by the insurer during discovery in the event of a coverage litigation. Additionally, theories, strategy, and "game planning" may be opened up for review by the insurer's counsel as well.

In addition to concerns about possible vitiation of the privilege which would otherwise protect communications between the insured and its coverage counsel, the broker needs to show concern for the potential liability it may face in the event of a successful coverage disclaimer. Where an argument can be made, for example, that the broker failed to obtain the correct coverage, gave negligent advice regarding a coverage issue, failed to properly disclose information in applying for the coverage, or failed to timely or properly provide notice of a claim, the broker's involvement in discussions regarding strategy and planning with regard to how to handle a coverage dispute can raise both ethical and practical issues. From a purely ethical standpoint, the broker's involvement in attempting to steer a strategy or craft the claim or claims to be

presented can be problematic if the broker knows or has reason to believe it was the cause or played a contributing role in the absence of coverage. Alternatively, the broker's zealous assistance in attempting to convince the insurer to cover a claim can provide the potential for the broker to be the author of his own demise.

For example, while policy language may, in fact, exclude coverage for a particular type of claim, or an endorsement is missing which would have brought the insured within the scope of coverage, the law provides that where there is evidence of mutual mistake, the courts can "reform" the policy language to reflect the parties' true intent.⁴ So, if the broker were to show that the intent of the parties in negotiating the coverage, reviewing the risk, rating the policy, and issuing the coverage was to provide coverage for a particular type of claim or insured otherwise not covered or excluded under the policy terms, there is the possibility that the Court will look past the specific coverage language, and order that the policy be "re-formed" to reflect the parties' true intent.

The problem with the cure is that if it doesn't save the patient, it could end up killing the doctor. By committing to a reformation argument, the broker is essentially acknowledging that the policy it obtained did not match the insured's requested coverage. If the court fails to reform the policy so that it provides coverage for the claim in issue, the broker will be faced with defending an errors and omissions claim where it has admitted it failed to obtain a policy providing the specific coverage it was requested to obtain.

III. The Impact of Emerging Legal Issues Being Faced by Brokers On the Broker's Conduct and Decision-Making Process in the Context of the Coverage Dispute

Whether it is a function of the need for brokers to distinguish themselves from their competitors by making public representations of their expertise and ability to provide advice and guidance on coverage issues, whether it is a function of the increasing complexity of life in the twenty first century requiring brokers to evidence and articulate expertise on a variety of coverage issues ranging from general liability, to property, to employment and beyond for a single client,

³ See, e.g., *Sony Computer Entertainment America, Inc. v. Great American Ins. Co.*, 229 F.R.D. 632 (N.D. Cal. 2005) ("communications between attorney and client in the presence of client's insurance broker were not protected"); *International Business Insurance Co. Ltd. v. World Trade Center Properties LLC*, No. 01 Civ. 9291 (JSM), 2002 WL 1334821 (S.D.N.Y. June 19, 2002).

⁴ See, e.g., *One Beacon America Ins. Co. v. Travelers Indem. Co. of Ill.*, 465 F.3d 38 (1st Cir. 2006) ("Reformation of insurance policy [by the court] was warranted on grounds of mutual mistake"); *St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp.2d 1035 (C.D. Ill. 2003).

or whether it is simply a function of society looking to shift blame from “victims” of loss towards the “professionals” who have for whatever reason failed to place coverage indemnifying the insured in whole or in part, courts have increasingly shifted from the position of viewing brokers as mere order takers to “experts.” As such, Courts have increasingly shifted from typically holding *the insured* responsible for its coverage choices and reading and understanding the coverage obtained, to holding the broker responsible for assisting in the choice and scope of coverage, and in providing expertise with regard to same. Indeed, in an oft quoted decision, the New York Appellate Division, First Department, in *Baseball Office of the Comm’r v. Marsh & McClelland*, 742 N.Y.S.2d 40, 42 (N.Y. App. Div. 1st Dep’t 2002), stated:

An insured has a right to look to the expertise of its broker with respect to insurance matters. And, it is no answer for the broker to argue as an insurer might, that the insured has an obligation to read the policy. It is precisely to perform this service as well as others that the insured pays a commission to the broker.

Going even further, one Court has suggested:

[A]n insured has the right to rely on the representations made by an insurance agent because of the agent’s expertise in a “complicated subject.” In view of the trust placed in insurance agents, it is “not unreasonable” for consumers to rely upon the representations of the expert rather than on the contents of the insurance policy itself, or to ‘pass’ when the time comes to read the policy.⁵

Not coincidentally, there has been increasing litigation brought against brokers when coverage is either insufficient for a loss, or determined not to apply at all. In fact, where it used to be fairly common for a final judicial determination to be made with regard to whether coverage applied before an action might be commenced against a broker for negligence or breach of contract in placing the coverage at issue, it is just as common now to see declaratory judgment actions against insurers seeking confirmation of coverage being combined with negligence and breach of contract claims against the broker, pled in the alternative.

Additionally, brokers have even found themselves under siege with regard to misrepresentations made on

policy applications, both by the insureds who signed the applications *and* the insurers who issued coverage based on same. On one end of the spectrum, for example, in *Ficarra v. Security Mutual Ins. Co.*, 757 N.Y.S. 2d 59 (N.Y. App. Div. 2nd Dep’t 2003), after an insured suffered a fire loss, the insurer disclaimed based upon misrepresentations made in the policy application. The insured contended that he had signed a blank application form and given correct information to the broker orally, who had then proceeded to fill out the application inaccurately. The insured sought recovery from the broker for his loss on a negligence theory, and while this seems quite an expedient argument, allowing the insured to avoid ownership of his own application, the trial court denied the broker’s motion for a directed verdict. On appeal, the court upheld the trial court’s ruling.

Similarly, in *Hebrink v. Farm Bureau Life Ins. Co.*, 664 N.W.2d 414 (Minn. Ct. App. 2003), the insured was denied coverage under his disability policy after he suffered a back injury requiring surgery. Several reasons were provided for the disclaimer, one of which was the insured’s failure on his application to make note of the fact that he had been treated by a chiropractor for back problems seven months prior to his applying for his policy with Farm Bureau Life. In the context of a coverage suit against the insurer, Hebrink also brought a claim against the insurance agent, alleging the agent filled out the application for him, was informed about the prior chiropractic back care, and told him that this information was not sought in the application. Even though the insured signed the application, and there was no allegation that he was blind, infirm or mentally incompetent, the court found that he had stated a “colorable” claim for negligence against the broker, and reversed the lower Court’s dismissal of the claim on summary judgment.

On the other end of the spectrum, in *Burlington Ins. Co. v. Okie Dokie, Inc.*, 329 F. Supp.2d 45 (D.D.C. 2004), there was a coverage dispute where the underlying claims arose under a CGL policy after an underage drunk driver who had allegedly been drinking at the insured premises struck and killed a police officer. The decedent’s estate sued the owner of the alleged “night-club”, and Burlington provided its insured with a defense. However, Burlington then brought a declaratory judgment action against its insured, seeking a declaration that it had no duty to indemnify or defend

⁵ *Drelles v. Manufacturers Life Ins. Co.*, 881 A.2d. 822, 840-41 (Pa. Super, 2005) (citations omitted). See also *Star SPA Services, Inc. v. Robert G. Turano Ins. Agency, Inc.*, 2007 WL 2821959, at *5 (M.D.Pa. 2007).

it, and rescission of the policy, on the grounds that the insured misrepresented the “nightclub” as merely a restaurant with a dance floor, which derived no more than 25% of its revenue from the sale of alcohol, and did not sponsor “Social Events”. Burlington claimed that, in fact, the business was run as a nightclub, hosted concerts, derived more than 25% of its revenue from the sale of alcoholic beverages, and regularly featured an “open bar.”

Not content to limit its claims to those seeking declaratory relief vis-à-vis the insured, Burlington also brought a claim for “negligent misrepresentation” against the broker in preparing the application and, in so doing, failing to advise of relevant information concerning how the establishment was run. Burlington argued that, as a result, it had issued a Policy it wouldn’t otherwise have issued, and had incurred fees defending claims and bringing a declaratory judgment action it should not have had to incur. The broker moved to dismiss, arguing that it owed no duty to Burlington, because its sole contractual relationship was with its client, the insured. However, the court held that Burlington had properly stated a claim against the broker, relying upon § 552 of the Restatement (Second) of Torts.

In making this determination, the Court noted that, pursuant to the Restatement: “One who, in the course of his business . . . supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.”⁶ The fact that the broker had no contractual privity with the insurer, in the court’s judgment, was irrelevant.

In *Century Surety Co. v. Crosby, Ins., Inc.*, 21 Cal. Rptr. 3d 115 (Cal. Ct. App. 2004) or 124 Cal. App. 4th 116, the insured had obtained a general liability policy from Century Surety Co. after submitting a policy application which included a letter purporting to be from an agent for the insured’s prior insurance carrier - - Farmer’s - - representing that the insured had had no known losses for the two year period Farmer’s had the coverage. However, it was alleged that the letter was a fake, and either the broker at the defendant brokerage (“Crosby”) had intentionally

committed a fraud by submitting it with the application, or was negligent in submitting the letter. In fact, in making out its fraud claim, Century Surety alleged that the broker at Crosby involved in procuring the coverage had allegedly had access to the Farmer’s agent’s office, obtained unauthorized samples of his letterhead, and used the letterhead to forge the letter.

Crosby sought dismissal of the fraud claim, arguing that as a matter of law an insurance company may not maintain an action against a broker based on fraud and deceit arising out of an application for insurance, and that only the insured can be held responsible for any misrepresentation in the application made by the broker. Rejecting this argument, the court concluded that “it would be an unreasonable, if not perverse, result if the law allowed an insurer no remedy against a broker who has, as is alleged in the cross-complaint, actively forged documents to support an insurance application.”⁷

While this is hardly a shocking ruling, the court went on to also sustain the insurer’s alternative claim for negligence against Crosby. In so doing, the court concluded that under the facts alleged a broker could be found to owe a duty of care to the insurer with respect to the policy application, notwithstanding the absence of any contractual privity between the broker and the insurer. In reaching this conclusion, the court noted that under California decisional law: “The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him; the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant’s conduct and the injury suffered, the moral blame attached to the defendant’s conduct, and the policy of preventing future harm.”⁸

Applying these factors, the *Century Surety* court concluded that “under the circumstances alleged” a duty of care could be found to be owed by the broker to the insurer with respect to the submission of the policy application. The court stated:

First, the transaction of applying for an insurance policy is intended to benefit the insurer as well as

⁶ See *Burlington Ins. Co.*, 329 F. Supp.2d at 48 (quoting Restatement (Second) of Torts § 552 (1977)).

⁷ *Century Surety Co.*, 21 Cal. Rptr. 3d at 121.

⁸ *Id.* at 124 (citing *Biakanja v. Irving*, 320 P.2d 16, 19 (Cal. 1958)).

the insured and is designed to influence the insurer's conduct in issuing an insurance policy. Second, harm from misrepresentations in an insurance application, such as the precise harm alleged to have occurred in this case, is easily foreseeable. Third, injury is certain in that the insurer incurred costs in defending an insurance claim on a policy that would not have issued but for the misrepresentations in the application. Fourth the misrepresentations in the application were material to the insurer's decision to issue the policy and thus were closely connected to the ensuing injury. Fifth, under the circumstances alleged, the factor of moral blame supports a finding of duty. Finally, imposing liability on insurance brokers for misrepresentations in insurance applications would act as a deterrent in preventing future harm.⁹

While emphasizing that its "holding should not be construed as treating an insurance broker as a guarantor of information in an insurance application or as imposing a duty on a broker to independently investigate information provided by the insured," the court stated that "when the broker knows of actual misstatements, the broker may be held liable for transmitting those misrepresentations in an insurance application knowing the insurer will reasonably rely on them."¹⁰

IV. The Conflict Between the Broker and the Policyholder Attorney

Viewed from the vantage point of the policyholder-coverage attorney, insurance brokers are part of an integrated corporate insurance world. Brokers easily move back and forth between jobs at insurance brokers and jobs at insurance companies. Corporate risk managers also frequently come from either insurance brokers or insurance companies. As a result, insurance brokers, risk managers and personnel at insurance companies are enmeshed in a web of business and social relationships. Additionally, they often share a vision of the insurance world - of what should and should not be covered. From the vantage point of the policyholder attorney, the broker's relationships can be useful in pursuing a coverage claim with an insurer - up to a point. However, these relationships can also be seen to act as constraints. As a result, policyholder attorneys question whether an insurance broker can always be a good coverage advocate for its clients.

Insurance brokers and insurance company claims handlers deal with each other on a regular basis. The question a policyholder attorney may ask is: What if an insurance broker has a debatable coverage claim for its best client, and pleads with the insurance company claims person for coverage, an individual whom the broker has worked with for years and with whom the broker has a friendly relationship? Does the insurance company claims person say - we will provide coverage for this debatable claim as an accommodation, but you owe us one? And if so, does this mean that on the next close case for a different client, the insurance broker must concede that there is no coverage?

From the policyholder attorney's perspective, he/she must vigorously pursue *every* claim for *every* client. There are no nuances to this. Obviously, some claims are stronger than others. The attorney must advise his or her client on the strength of the claim. But the client makes the decision whether to pursue it. Frequently, a client will want to pursue a relatively weak claim. For example, if a client has a loss of \$10,000,000, it might want to invest \$100,000 (or even \$1,000,000) in attorneys' fees to try to procure even a partial settlement. This is the client's decision. Some clients are risk takers, and some are not. But the issue is a largely cost-benefits analysis as to *this* specific claim. And if the policyholder wants to pursue the claim, it is the policyholder attorney's job to pursue it as vigorously as possible, regardless of whether the claim may be weak.

But can the broker pursue a weak claim? While the answer of the insurance broker will invariably be "of course", what happens when the insurance company claims handler says, "we both know that this is a weak claim, let's drop it"? If the broker proceeds to pursue the claim, does it harm its overall relationship with the insurance company? Moreover, it is the role of the coverage attorney to be innovative and find new arguments to seek coverage. If the broker and the claims handler share the same vision of the insurance world (and particularly if the broker had previously been with an insurance company), will the broker pursue innovative coverage arguments and think outside of the box?

Another concern of policyholder coverage attorneys is that, particularly with smaller brokers, direct financial conflicts can exist. Many brokers receive contingent fees based not on the gross premiums that they

⁹ *Century Surety Co.*, 21 Cal. Rptr. 3d at 124-25.

¹⁰ *Id.* at 125.

provide to the insurer, but on a net basis - premiums minus claims expense. Thus, if the insurer has to defend or pay on a coverage claim brought and pursued by the broker, the broker makes less money. Also, many brokers are agents for a small number of insurance companies, and the broker's relationship with that insurer may be more important than its relationship with a single insured. In such a circumstance, can the broker vigorously pursue a claim in the face of determined opposition by the insurer?

An additional consideration is the natural inclination to presume that if the coverage issue is or may be the result of broker negligence, the broker may not be inclined to examine this possibility, or own up to its mistakes. Conversely, whenever a policyholder attorney reviews a claim that the insurer has denied, he or she not only must question whether the denial is the result of broker malpractice, but will review this possibility unencumbered by any concerns as to what may be learned. This is a critical concern today because, in the "good old days," the broker often had only to schmooze with its clients and sell them a standard comprehensive general liability policy. Now, the world has changed. In many instances, the broker will say to its client: "we will review your operations and tell you what insurance you need." In such circumstances, courts take the promise by the broker very seriously, and the broker can often become a virtual risk manager for the client. Instead of a standard CGL policy, the broker who promises to review and identify the necessary coverages for the insured to have in place may find that he/she must also consider employment insurance, D&O insurance, IP insurance, privacy

insurance, web insurance, environmental insurance, etc. Moreover, these policies are increasingly non-standardized, so that the broker needs a much broader knowledge basis. It is not unusual for a D&O policy to have fifty or more endorsements. Many brokers simply cannot keep up. Even at more sophisticated brokers, it can be impossible to consider every possible issue. It is often easy for the policyholder attorney to say to the client: you may have had coverage if your broker had procured a better policy for you. Obviously, some brokers do own up and admit mistakes, but do all? Will the broker perform the same comprehensive review for possible malpractice that the attorney will?

IV. CONCLUSION

What this all tells us is that the insurance broker's role, responsibilities, and potential liabilities in the event of a coverage dispute are all being re-defined and expanded in ways that create a number of issues the broker will have to very carefully navigate in the course of attempting to address coverage issues as they may arise. And the issues are complicated by the increasing demands and expectations being placed upon brokers, while they try to operate as an intermediary between their client insureds and the insurers with whom they work on a daily basis, and are viewed with a healthy dose of skepticism about their role in the claims resolution process by policyholder coverage attorneys, who question both their ability to fully and aggressively pursue all claims, and their potential responsibility for the absence of coverage. In considering these issues, four key considerations rise to the fore.

First, to the extent there is any possible argument that can be made that the insured was relying particularly on the broker's expertise in regard to the coverage issues in question, the broker must be alert to this, and be very careful in its dialogue with both the insured and the insurer about the coverage issue. Insureds and insurers, for their part, need to be aware of this, as well, and understand that communications from the broker may be tempered by this concern.

Second, to the extent there is an anticipation, immediately upon making a claim, that there is likely to be some question raised by the insurer regarding whether coverage applies, the broker needs to understand that it will immediately be identified as a "person of interest" by the policyholder's coverage attorney, who will be looking not just at the best angles to argue the coverage issue, but for bases for bringing a breach of contract or broker malpractice suit against the broker in the alternative.

Third, as the broker and policyholder attorney work cooperatively to present the claim, the broker's participation in the strategy discussions with the insured and its counsel is something that will put such discussions at risk of full disclosure to the insurer in an ensuing coverage litigation. Counsel who represent insureds in coverage disputes need to be particularly cognizant of this, and work to insulate the broker from privileged communications, while still taking advantage of their

knowledge of critical fact issues and discussions regarding policy intent, and making an effort to allow the broker to feel (and be) a part of the process. Insurers, in the course of discovery in coverage litigations, for their part, need to search for and ferret out information in investigation and discovery that might lead to discovery of otherwise privileged information based upon inclusion of the broker in what would otherwise have constituted privileged communications.

Finally, where there has been a misrepresentation or material omission on a policy application, brokers need to be aware that in certain circumstances courts may find that they own it or at least must bear some of the responsibility for the misrepresentation/omission. This means that, consequently, their due diligence with regard to the policy application process must be that much more careful. And insurers may find that in certain circumstances, where a broker clearly knew or should have known about a misrepresentation or material omission in a policy application, they may have the right to seek recompense from the broker for the cost and expense in having to provide a defense and/or litigate a coverage dispute where they might validly contend that they would never have provided the coverage in issue had the broker exercised greater diligence and care in preparing and submitting the application. 