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Madison 96th Assoc., LLC v 17 E. Owners Corp.
2014 NY Slip Op 50569(U) [43 Misc 3d 1210(A)]
Decided on April 8, 2014
Supreme Court, New York County
Kornreich, J.
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Decided on April 8, 2014

Supreme Court, New York County

Madison 96th Associates, LLC, Plaintiff,

against

17 East Owners Corp., Defendant.

601386/2003

Schoeman, Updike, Kaufman, Stern & Ascher, LLP and Reed Smith, LLP, for Madison.

Newman, Myers, Kreines, Gross, Harris, P.C., for QBE.

Shirley Werner Kornreich, J.

Motion Sequence Numbers 023 & 024 are consolidated for disposition.

Before the court are motions by QBE Insurance Corporation (QBE) and Madison 96th

Associates, LLC (Madison) concerning the report of Special Referee Ira Gammerman entered on December 16, 2013 (the Report). *See* Dkt. 517. For the reasons that follow, the matter is referred back to Referee Gammerman for clarification.

Factual Background & Procedural History

The court assumes familiarity with its order dated December 11, 2012 (the December 2012 Order), which sets forth the procedural history and factual background of this case. *See* Dkt. 359. In short, the December 2012 Order held, *inter alia*, that QBE has a duty to defend Madison against 17 East Owners Corp.'s (17 East) claims in this action.

The litigation between Madison and 17 East began in 2003. QBE refused to pay for Madison's defense costs. In 2008, Madison commenced a third-party action against QBE to obtain a declaratory judgment regarding QBE's coverage obligations. The December 2012 Order settled this dispute in Madison's favor. In an order dated July 10, 2013, the court referred the calculation of Madison's reasonable attorneys' fees to a Special Referee to hear and report. *See* Dkt. 437. Madison seeks two[FN1] categories of legal fees and costs: (1) those incurred defending 17 East's claims; and (2) those incurred prosecuting its declaratory judgment action against QBE (the DJ Fees). [*2]

A hearing was held before Referee Gammerman on October 16 and October 17, 2013. Madison initially submitted documentation substantiating that its fees and costs incurred defending 17 East's claims exceeded $1.5 million. At Referee Gammerman's direction, Madison subsequently submitted a revised fee application, which totaled $900,099.38. In the Report, Referee Gammerman awarded Madison $700,180. Referee Gammerman, however, did not explain why such amount was reasonable nor did he explain why Madison's requested fees were reduced by a further $200,000. Madison asks this court to award it $900,099.38. QBE argues that both the $900,099.38 and $700,180 amounts are unreasonable. QBE further argues that Madison's retainer agreements are void because they supposedly violate the New York Rules of Processional Conduct's prohibition on attorneys acquiring an interest in litigation.

Referee Gammerman declined to rule on whether Madison is entitled to recover the DJ Fees, deferring such decision to this court. As explained below, purported tension between

well settled and recent case law has created a climate, according to Madsion, that warrants contravening the Court of Appeals decision in *Mighty Midgets, Inc. v Centennial Ins. Co.*, 47 NY2d 12 (1979). This court will not do so.

The Report

"[A] court will not disturb the findings of a special referee where those findings are supported by the record." *Atlantic Aviation Investment LLC v Varig Logistica, S.A.*, 73 AD3d 467 (1st Dept 2010); *see also Namer v 152-54-56 W. 15th St. Realty Corp.*, 108 AD2d 705 (1st Dept 1985) ("New York courts will look with favor upon a Referee's report, inasmuch as the Referee, as trier of fact, is considered to be in the best position to determine the issues presented"), quoting *Holy Spirit Assn. v Tax Comm'n of the City of New York*, 81AD2d 64, 70-71 (1st Dept 1981). Here, however, the court cannot determine the reasonableness of Madison's legal fees because Referee Gammerman did not explain his reasoning for awarding $700,180, an amount less than requested but, nonetheless, unreasonable in the eyes of QBE. This issue is respectfully referred back to Referee Gammerman for clarification. Additionally, Referee Gammerman assumed that the parties would be capable of agreeing on the proper computation of pre-judgment interest. They did not. Referee Gammerman shall also make such calculation.

As for QBE's contention that Madison's retainer agreements are unenforceable, such argument fails because Madison's attorneys did not acquire a proprietary interest in the subject matter of this litigation — the real estate dispute between Madison and 17 East — which would contravene Rule 1.8(i) of the New York Rules of Professional Conduct.[FN2]

When QBE refused to pay Madison's legal fees, Madison's counsel agreed that, rather than Madison paying it directly, it could seek payment from QBE upon a finding that QBE is obligated to pay Madison's legal bills in this action. This court made such a finding in the December 2012 Order. Indeed, as a result of QBE's refusal to pay Madison's legal bills, such bills escalated due to the need for Madison to retain separate counsel to litigate against QBE.

Of course, given the extreme length of this case, the attorneys' fees are so substantial that [*3]ensuring their payment is an essential part of any settlement calculus. Indeed, this is a

common reality of protracted litigation. Yet, QBE's accusation that Madison's fee arrangement with its attorneys is unethical because it gives them too much of a direct stake in this litigation is both wrong as a matter of law and hypocritical given that such arrangement was necessitated by QBE's actions. The cases cited by QBE bear no resemblance to the complex procedural posture of this action. *See Sauer v Xerox Corp.*, 85 FSupp2d 198 (WDNY 2000) (retainer improper because it allocated ownership of very equipment whose ownership was being litigated), and *Landsman v Moss*, 180 AD2d 719 (2d Dept 1992) (retainer improper because it effectively divested plaintiff of her interest in action). Simply put, Madison did not commence this litigation with its attorneys having a proprietary interest in it. *See generally Lawrence v Miller*, 48 AD3d 1, 22 (1st Dept 2007). Rather, the untenable mounting legal bills incurred by Madison due to QBE's failure to pay for its defense necessitated a forbearance of Madison's obligation to pay its attorneys until such time that QBE would be forced to do so. That time has come.

In any event, even if Madison's retainer agreements violate Rule 1.8(i), QBE "does not have standing to object to the fee arrangement between [Madison] and [its] attorney." *S.M. v Taconic Hills Cent. Sch. Dist.*, 2012 WL 3929889, at *6 (NDNY 2012), accord *Rozen v Russ & Russ, P.C.*, 76 AD3d 965, 969 (2d Dept 2010) and *Wilson v LaFontant*, 240 AD2d 172, 173 (1st Dept 1997); *see also S.M. v Evans-Brant Cent. Sch. Dist.*, 2013 WL 3947105, at *6 (WDNY 2013) (same).

The DJ Fees

"In this State, and indeed, in the rest of the country, the longstanding American rule' precludes the prevailing party from recouping legal fees from the losing party except where authorized by statute, agreement or court rule.'" *Gotham Partners, L.P. v High River Ltd. Partnership*, 76 AD3d 203, 204 (1st Dept 2010), quoting *U.S. Underwriters Ins. Co. v City Club Hotel, LLC*, 3 NY3d 592, 597 (2004). "However, an 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*." *U.S. Underwriters*, 3 NY3d at 597 (emphasis added), quoting *Mighty Midgets,* 47 NY2d at 21. In other words, when an insurance company brings a declaratory judgment action against its insured seeking to disclaim coverage, if the insured prevails, the insured is entitled to be reimbursed its legal fees spent defending the insurance company's lawsuit. *See Chase*

Manhattan Bank, N.A. v Each Individual Underwriter Bound to Lloyd's Policy No. 790/004A89005, 258 AD2d 1, 4 (1st Dept 1999) ("where an insurer improperly disclaims coverage, it is liable for the attorneys' fees incurred by the insured in defending a suit by the insurer to establish the insurer's non-liability for the underlying claim as well as in the liability action"). However, when an insured commences a declaratory judgment action against its insurer seeking coverage, the insured cannot recover its attorneys' fees in such action, even if it prevails. *Id.* "The rationale for this distinction is that when an insurer casts an insured in a defensive posture the liability feature of the insurance is triggered and provides coverage for defense expenses incidental to the assertion of claims against the insured." *Id.* at 5; *see also Danaher Corp. v Travelers Indem. Co.*, 2013 WL 364734, at *3 (SDNY 2013) ("recovery of counsel fees may not be had in an affirmative action by [the insured] to settle its rights.") [*4](quotation marks omitted).[FN3]

In *Danaher*, Magistrate Judge Francis observed that "in unusual circumstances, a court may look beyond the labels plaintiff' and defendant' to determine whether an insured is in an offensive or defensive position vis à vis its insurer in a dispute over the duty to defend." *Id.* at *4. Simply put, the reality of a case's procedural posture, and not the technical designation of parties as plaintiff or defendant, should determine whether the insured can recover its fees.

Nonetheless, it has been black letter law since *Mighty Midgets* was decided in 1979 that where, as here, the insured (Madison) commenced a declaratory judgment action against the insurance company (QBE), the insured cannot recover it attorneys' fees in such action. Over the years, countless [*5]insureds have sought to challenge the logic of this rule — which creates a "perverse incentive because allowing fees under these circumstances would create an incentive for the insurer to refuse to defend in the underlying suit, thereby leaving it up to the insured to bring a declaratory action seeking coverage.'" *See Folksamerica Reinsurance Co. v Republic Ins. Co.*, 2004 WL 2423539, at *2 (SDNY 2004) (Baer, J.), quoting *U.S. Underwriters Ins. Co. v City Club Hotel, LLC*, 369 F3d 102, 110 (2d Cir 2004). However, courts in this state have steadfastly refused to depart from or expand the *Mighty Midgets* doctrine. Thus, in *Estee Lauder Inc. v OneBeacon Ins. Group, LLC*, 31 Misc 3d 379, 392-93 (Sup Ct, NY County 2011), Justice Edmead noted:

The Court is mindful of the strong policy reasons against adopting a rule of law that would

reduce the incentives for insurance companies to defend in the underlying tort actions and that would likely shift the burden of obtaining a declaratory judgment from the insurance company to the insured. Insurers could simply deny defense as a matter of course, and wait for impending actions by their insureds, without risk of incurring any liability for the insureds' defense costs in resulting litigation. There is the potential that insurers might shrink from their defense obligations under their policies and categorically deny their insureds' tenders of defense in an effort to reduce their financial exposure, without risk of incurring any additional liabilities or expenses associated with issuing and maintaining policies. However, until the legislature determines otherwise, this Court is constrained to interpret the law as it currently stands.

(citations and quotation marks omitted).

Madison argues that the legal landscape is changing, and believes that the Court of Appeals, if given the opportunity, would expand the *Mighty Midgets* doctrine to apply to declaratory judgment actions brought by insureds. Madison's primary basis for this inclination is the Court of Appeals' dual decisions in *Bi-Economy Market, Inc. v Harleysville Ins. Co. of NY*, 10 NY3d 187 (2008) and *Panasia Estates, Inc. v Hudson Ins. Co.*, 10 NY3d 200 (2008), which evidence a willingness to rethink how the law should treat recalcitrant insurers. In *Bi-Economy* and *Panasia*, the "Court of Appeals considered whether an insured could assert a claim for consequential damages in the context of a breach of contract claim against an insurer." *See Orient Overseas Assocs. v XL Ins. Am., Inc.*, 2014 WL 840416, at *2 (Sup Ct, NY County 2014) (Schweitzer, J.). The Court held that an insured can recover consequential damages arising from the insurer's bad faith breach of the policy, "and that such damages [include those that are] reasonably foreseeable and contemplated by the parties at the time of contracting.'" *Id.*, quoting *Bi-Economy*, 10 NY3d at 191.

In this case, Madison fails to properly assert a *Bi-Economy* claim, since it does not contend that QBE's failure to provide coverage was a product of bad faith. Consequently, the court will not reach the novel issue of whether attorneys' fees in an insured-commenced declaratory judgment action might be considered "consequential damages" as described in *Bi-Economy*. Madison, instead, concedes that, as the law currently stands, it has no entitlement to recover the DJ Fees. *See* Dkt. 560 (3/11/14 Tr.) at 14 ("The reality, Your Honor, is that if you grant this, you're going to be making new law in New York").

This court is bound by the *Mighty Midgets* doctrine. Despite this court's agreement that *Mighty Midgets* creates the "perverse incentives" described by other judges, only the Court of Appeals may undo its own precedent. Though some trial courts have implicitly assumed that *Mighty Midgets* was effectively abrogated by *Bi-Economy* [*see, e.g, Whiteface Real Estate Dev. & Const., LLC v Selective Ins. Co. of Am.*, 2010 WL 2521794, at *5 (NDNY 2010)], most post-*[*6]Bi-Economy* courts continue to recognize that "[i]t is well-settled that an insured may not recover the expenses incurred in bringing an affirmative action against an insurer to settle its rights under the policy.'" *Handy & Harman v Am. Int'l Group, Inc.*, 2008 WL 3999964 (Sup Ct, NY County 2008) (Cahn, J.), quoting *NY Univ. v Continental Ins. Co.*, 87 NY2d 308, 324 (1995); *see also Strauss Painting, Inc. v Mt. Hawley Ins. Co.*, 105 AD3d 512, 514 (1st Dept 2013); *Silva v F.R. Real Estate Dev. Corp.*, 58 AD3d 449, 450 (1st Dept 2009); *O'Keefe v Allstate Ins. Co.*, 90 AD3d 725, 726 (2d Dept 2011); *Brother Jimmy's BBQ, Inc. v Am. Int'l Group, Inc.*, 2011 WL 1967700 (Sup Ct, NY County 2011); *Harriprashad v Metro. Prop. & Cas. Ins. Co.*, 2011 WL 6337699, at *3 (EDNY 2011); *cf. Liberty Surplus Ins. Corp. v Segal Co.*, 420 F3d 65, 70 (2d Cir 2005) ("We decline to expand the *Mighty Midgets* exception to the point that it swallows the rule").

Here, even absent bad faith, public policy strongly militates in favor of forcing QBE to pay the DJ Fees. The court encourages Madison to appeal this decision so its counsel can find out if its purported foresight is correct or if the penumbras of *Bi-Economy* and *Panasia* are illusory. *See* Dkt. 560 (3/11/14 Tr.) at 14 ("I believe that the next case that goes to the Court of Appeals will be the one where the Court of Appeals gets rid of *Mighty Midgets* and says When a policyholder prevails in a coverage dispute against its insured, it cannot be made whole unless it gets its fees.'"). Accordingly, it is

ORDERED that the calculation of Madison 96th Associates, LLC's (Madison) reasonable attorneys' fees, including interest, is respectfully referred back to Special Referee Ira Gammerman to hear and report in accordance with this decision; and it is further

ORDERED that a copy of this order with notice of entry shall be served on the Clerk of the Reference Part (Room 119) to arrange a date for the reference to a Special Referee and the Clerk shall notify all parties of the date of the hearing before the Special Referee; and it is further

ORDERED that the denial of Madison's claims for attorneys' fees incurred in its successful declaratory judgment action against QBE Insurance Corporation (QBE) is hereby severed from this litigation, and the Clerk is directed to enter judgment in favor of QBE, denying Madison such fees, so Madison may pursue an appeal based on the issues discussed in this decision.

Dated: April 8, 2014ENTER:

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J.S.C.

Footnotes

Footnote 1: A third category relating to the air conditioner dispute was withdrawn by Madison. *See* Dkt. 560 (3/11/14 Tr.) at 5-6.

Footnote 2: This prohibition was previously codified as Disciplinary Rule 5-103, which applies to attorney conduct before April 1, 2009. *See Rozen v Russ & Russ, P.C.*, 76 AD3d 965, 969 (2d Dept 2010).

Footnote 3: Magistrate Judge Francis explained the oddity of this rule:

The rule has its peculiarities. As I have noted before, "It seems anomalous for the entitlement to fees to turn on the fortuity of whether a party to an insurance contract is cast as the plaintiff or defendant." [*Cowan v Ernest Codelia, P.C.*, 2001 WL 30501, at *3 (SDNY 2001)]. But courts have made clear that in certain cases the rule need not be quite so mechanically applied. In [*City of New York v ZurichAmerican Ins. Group*, 5 Misc 3d 1008(A) (Sup Ct, NY County 2004)], the City filed an action seeking a declaration that its insurer was obligated to defend and indemnify it in an underlying tort action. After the court ruled, on summary judgment, that the insurer had a duty to defend and indemnify, the City's answer in the underlying tort action was stricken for failure to comply with its discovery obligations. [*Id.* at *1-2]. The insurer then moved both to amend its answer to assert an affirmative defense that the City breached its duty of good faith and for a declaration that it was not obligated to defend in the underlying action. [*Id.* at *2]. The City again prevailed, and thereafter sought attorneys' fees for defending itself against the defendant's motion. [*Id.* at *5-6]. Notwithstanding the fact that the City had originated the action, the court granted its motion for attorneys' fees. It reasoned that, when the insurer filed its motion after the declaratory judgment action was already resolved, it "placed the City in a defensive posture by

affirmatively requiring the City to relitigate anew the declaration of coverage issue based upon a new theory." [*Id.* at *6]. Thus, the insurer's motion was "tantamount to an action brought by the insurer seeking to free itself from its policy obligations." [*Id.*, citing *Mighty Midgets*, 47 NY2d at 21; *see also Estee Lauder Inc. v OneBeacon Ins. Group, LLC*, 31 Misc 3d 379, 388-89 (Sup Ct, NY County 2011) (discussing *Zurich-American*)].

In [*Hurney v Mattson*, 59 AD2d 934 (2d Dep't 1977)], the insureds, who were defendants in a negligence action, filed a third-party action against their insurer seeking defense and indemnity. The insurer counterclaimed, seeking a declaration that it had no duty to defend or indemnify. [*Id.*]. The counterclaim was tried separately, and the insureds prevailed. [*Id.* at 934-35]. The appellate court found that the insureds were entitled to their attorneys' fees incurred as a result of the insurer's counterclaim, because in that separately-tried dipute, the insured's "posture in the counterclaim ... was that of defendants." [*Id.* at 935; *see also Estee Lauder*, 31 Misc 3d at 392 (discussing *Hurney* and emphasizing that counterclaim, in which insureds were in defensive posture, was separately tried)].

Danaher, 2013 WL 364734, at *3-4.

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