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Participation in Arbitration, Recovery of Attorney's Fees

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It is well-known that the failure by an insurer served with a notice of intention to arbitrate or a demand for arbitration to make a timely application for a stay of arbitration will result in the forfeiture of the insurer's right to contest the insured's compliance with an arbitration agreement or to challenge in court the insured's failure to fulfill any conditions precedent to arbitration, and will, effectively, waive the right to stay arbitration. See CPLR 7503(c); *Steck v. State Farm Ins. Co.*, 89 NY2d 1082 (1996). Such failure cannot, however, waive the insurer's defense that no agreement to arbitrate was ever made or entered into by the parties. See *Matarasso v. Continental Casualty Co.*, 56 NY2d 264 (1982).

Failing timely to seek a stay of arbitration is not, however, the only way that an insurer may waive that right. A lesser known and/or lesser understood limitation is the one that arises as a result of the insurer's participation in the arbitration process. Indeed, under certain circumstances, the waiver that arises from such conduct may be even broader and may include a waiver of the right to argue the non-existence of an agreement to arbitrate.

Participation

It is a general rule of arbitration law — one expressed in the CPLR itself (see CPLR 7503[b]) — that only a party that has not already participated in the arbitration proceeding may apply to the court for a stay of arbitration. "[A] party otherwise entitled to a judicial determination of the arbitrability of a dispute may waive that right by actively participating in the arbitration." *Arner v. Liberty Mutual Ins. Co.*, 233 AD2d 321 (2d Dept. 1996). Thus, for example, in an uninsured motorist case, if the insurer intends to apply to the court to stay arbitration in order that a threshold issue may be determined by the court in advance of the arbitration, it should do nothing from which the conclusion could be drawn that it has participated in the arbitration proceeding. "Participation" can occur from even the slightest and perhaps unintended act.

In *Boston Old Colony Ins. Co. v. Martin*, 34 AD2d 776 (1st Dept. 1970), the court held that "The adjournment of the arbitration hearing at the request of the respondent without any reservation of rights constituted a waiver of any right to a stay of the proceedings and any objection to the proceedings."

In *Home Mutual Ins. Co. v. Springer*, 130 AD2d 493 (2d Dept. 1987), the court held that "The petitioner acquiesced in the arbitration proceeding by filing a notice of appearance and participating in the selection of an arbitrator and the scheduling of the arbitration hearing. Consequently, its right to a stay of arbitration and to raise any objection to the service of the notice to arbitrate was waived."

In *Allstate Ins Co. v. Peterson*, 226 AD2d 528 (2d Dept. 1996), the court held that the insurer's participation in the arbitration process by objecting to one or more of the arbitrators proposed by the American Arbitration Association after its motion for a stay had been denied operated as a forfeiture of its right to apply to the Supreme Court for a pre-arbitration stay.

In *Allstate Ins. Co. v. Khait*, 227 AD2d 551 (2d Dept. 1996), the court held that "By actively participating in the selection of the arbitrators and in adjourning the arbitration hearing without any reservation of rights, the petitioner ... participated in the arbitration proceeding. Consequently, its right to a stay of arbitration was waived."

And, in *Carbone/Orrino Agency, Inc.*, 210 AD2d 221 (2d Dept. 1994), the court stated, as follows: "Where a party does not move for a stay until after the statutory time period of 20 days after service of the demand for arbitration and where the party has participated in or acquiesced in the arbitration proceeding, the party waives its right to raise any objection to service of the demand. ... The appellant did not move to stay arbitration until ... approximately four months after receipt of the notice and approximately nine days after the arbitration hearing. Further, the appellants requested an adjournment of the hearing date and the parties acquiesced in the selection of the arbitrators. Therefore, the appellants participated in the arbitration process. Consequently, the appellants are not entitled to a stay of arbitration."

More recently, in *North River Ins. Co. v. Morgan*, 291 AD2d 230 (1st Dept. 2002), the court held that the insurer participated in the arbitration for more than two (2) years before it commenced an Article 75 proceeding to stay arbitration by, at a minimum, agreeing with the claimant's counsel that New York arbitration rules would be applied; agreeing that the third arbitrator would be selected by the American Arbitration Association, designating an arbitrator, receiving medical reports and records; and agreeing to reschedule the hearing to a particular date. Thus, the insurer waived any objection that there was no agreement to arbitrate.

On the other hand, it should be noted that in *Mix Centre, Ltd. v. Butler*, 221 AD2d 182 (1st Dept. 1995), the court held that the individual respondent, who was neither a signatory to nor named in the arbitration agreement, did not participate in the arbitration hearing when an attorney appeared on his behalf and "did nothing more than request an adjournment."

And, in *Cybex International, Inc. v. Fuqua Enterprises, Inc.*, 246 AD2d 316 (1st Dept. 1998), the court held that the petitioner did not waive its right to seek a stay of arbitration, noting that "its participation in arbitral discovery and in the selection of an arbitrator were done before it had received detailed specification of respondent's claims, and that once it did, it made timely attempts, including a motion before this Court, to stay the arbitration."

Finally, it should be noted that it is well-settled that a party may waive the right to appeal from an order denying a petition to stay arbitration by proceeding to and actively participating in the arbitration hearing without first seeking (even if unsuccessful in obtaining)

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a temporary stay of the arbitration pending the determination of the appeal. See *Commerce & Industry Ins. Co. v. Nester*, 90 NY2d 255 (1997); *One Beacon Ins. Co. v. Bloch*, 298 AD2d 522 (2d Dept. 2002).

Recovery of Attorney's Fees

The New York courts have carved out a "narrow exception" to the general "American" rule that a prevailing party cannot recover attorney's fees. Under this exception, an insured who prevails in a declaratory judgment action brought by an insurance company seeking to deny a duty to defend and indemnify is allowed to recover fees expended in defending against that action. The insured is allowed fees "when he has been cast in a defensive posture by the legal steps an insurer takes in an effort to free itself from its policy obligations." *Mighty Midgets Inc. v. Centennial Ins. Co.*, 47 NY2d 12 (1979). On the other hand, "such a recovery may not be had in an affirmative action brought by an assured to settle its rights. ..." Id.

Although this rule has been stated so many times it has become axiomatic, it nevertheless continues to raise questions.

One question, which has been dealt with by several courts, with conflicting results, is whether, in a case in which an insurance company has brought a declaratory judgment action to determine that it does not have an obligation to defend or indemnify its insured under the policy, but the insurer has actually defended the underlying suit, an insured prevailing in the declaratory judgment action should be awarded attorney's fees expended in defending against that action?

Most recently, in *U.S. Underwriters Ins. Co. v. City Club Hotel LLC*, 369 F.3d 102 (2d Cir. 2004), the U.S. Court of Appeals for the Second Circuit addressed this "important" and "unsettled" question. As the court noted, the question of whether the attorney's fee exception applies in cases where the insurer, who sought a disclaimer of liability and lost, had earlier discharged its duty to defend the insured in the underlying action was not discussed in *Mighty Midgets*. Placing the issue in appropriate context, the court observed that "Most federal district courts have expressed concern that 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 judgment action seeking coverage." Since, under *Mighty Midgets*, an insured, even though it prevails, is not entitled to attorney's fees in any declaratory judgment action that it initiates, "An insurance company focused on avoiding attorneys' fees might therefore refuse to defend in the underlying state suit and force the insured to bring the declaratory action."

...only a party that has not already participated in the arbitration proceeding may apply to the court for a stay of arbitration.

For this reason, a number of federal district courts have concluded that in cases where it was clear that the insurer had discharged its duty to defend in the underlying action, the New York Court of Appeals would retreat from its categorical statement in *Mighty Midgets*, and would refuse to award attorney's fees to the insured. See *Nationwide Mutual Ins. Co. v. Welch*, 988 F. Supp. 629, 630 (S.D.N.Y. 1997) (reasoning that allowing attorney's fees in such a case 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"); *Mount Vernon Fire Ins. Co. v. Congregation Kehilath Yakov*, No. 95-CIV-7973, 1999 WL 1072484, at *2 (SDNY 1999); *Safeguard Ins. Co. v. Angel Guardian Home*, 946 FSupp 221, 233 (EDNY 1996); *Great Northern Ins. Co. v. Dayco Corp.*, 637 FSupp 765, 788 (SDNY 1986); C.f., *Aetna Cas. & Surety Co. v. Dawson*, 84 AD2d 708 (1st Dept. 1981), affd. 56 NY2d 1022 (1982).

On the other hand, several appellate divisions and at least one federal district court have concluded that *Mighty Midgets* requires the awarding of fees whenever the declaratory action has been brought by the insurer — even when an insurer has not breached its duty to defend in the underlying suit. See *USF&G Co. v. New York, Susquehanna & W. Ry. Corp.*, 277 AD2d 1026 (4th Dept. 2000) (holding that "[t]he fact that plaintiff initially paid the cost of defendant's defense in the underlying action is of no moment"); *U.S. Underwriters Ins. Co. v. Mesiftah Eitz Chaim of Bobov*, 210 AD2d 218 (2d Dept. 1994) (awarding attorney's fees to an insured where the insurer abandoned prosecution of the declaratory action and defended in the underlying action); see also, *National Grange Mutual Ins. Co. v. Udar Corp.*, No. 98-CIV-4650, 2002 WL 373240 (SDNY 2002).

In view of this division in interpreting New York law "between the majority of New York lower courts, and the majority of federal district courts (which could not seek guidance from the New York Court of Appeals through certification of the question, 22 NYCRR §500.17)," which "has created an unusual, and undesirable, degree of uncertainty in cases of this sort," the Circuit Court certified the following question to the New York Court of Appeals: "whether, in a case in which an insurance company has brought a declaratory judgment action to determine that it does not have policy obligations but defended in the underlying suit, a defendant prevailing in the declaratory judgment action should be awarded attorneys' fees expended in defending against that action?"

On May 11, 2004, the Court of Appeals accepted certification, and is thus expected to provide its guidance on this important question. We will follow for the Court's decision and keep our readers informed.