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Focus

Insurance Law

Divergent Rulings Tweak Law On Insurance-Broker Liability

By Stephen L. Raucher

Since last year, two California appellate courts have taken the still-developing law regarding insurance broker liability in completely divergent directions. Ironically, those two cases — *Hydro-Mill Company Inc. v. Hayward, Tilton and Rolapp Insurance Associates Inc.*, 115 Cal.App.4th 1145 (2004), and *Century Surety Co. v. Crosby Insurance Inc.*, 124 Cal.App.4th 116 (2004) - reduce insurance brokers' exposure to their insured clients yet expand insurance brokers' duties to the carriers with whom they do business on behalf of their clients.

In *Hydro-Mill*, the 2nd District Court of Appeal significantly cut back on insurance broker liability by casting serious doubt on whether an insurance broker serves in a fiduciary capacity — and therefore whether a broker can be liable for punitive damages.

Before *Hydro-Mill*, it had been assumed in a number of appellate decisions that an insurance broker's relationship with his or her client was indeed fiduciary in nature. This was because, if nothing else, a broker serves as the client's agent, and under the normal law of agency, an agent owes principal fiduciary duties.

Thus in *Eddy v. Sharp*, 199 Cal.App.3d 858 (1988), which involved claims by an insured against his insurance broker for not obtaining adequate coverage, the Court of Appeal commented that "where the agency relationship exists there is not only a fiduciary duty but an obligation to use due care."

The *Hydro-Mill* court cast off this language from *Eddy v. Sharp* as mere dicta. Instead, the *Hydro-Mill* court settled on dicta from another case, *Kotlar v. Hartford Fire Insurance Co.*, 83 Cal.App.4th 1116 (2000), to find that "it is unclear whether a fiduciary relationship exists between an insurance broker and an insured."

The issue in *Hydro-Mill* was whether the plaintiff's claims against its broker for negligence, breach of contract, negligent misrepresentation and breach of fiduciary duty were barred by the statute of limit-ations. Hydro-Mill, a manufacturer of aircraft parts, asked its broker, Hayward, Tilton and Rolapp Insurance Associates Inc., to obtain earthquake coverage for all three of its locations, two of which were leased. However, the broker failed to obtain coverage for the two leased locations.

All of Hydro-Mill's locations, including the leased ones, sustained damage in the Northridge earthquake, and Hydro-Mill learned soon thereafter of the broker's mistake. On Dec. 9, 1994, Hydro-Mill's carrier paid for damage at the owned location but not for damage at the leased locations. Hydro-Mill filed suit against its broker on Feb. 18, 1997, more than two years later.

The Court of Appeal found that Hydro-Mill's negligence, contract and negligent misrepresentation claims were all barred by the two-year statute of limitations. See Code of Civil Procedure Section 339. The court turned to the breach-of-fiduciary-duty claim, which Hydro-Mill contended was governed by the four-year limitations period of Code of Civil Procedure Section 343.

The court began its analysis by expressing doubt about whether a fiduciary relationship between a broker and its client even exists. Ironically, the *Hydro-Mill* court's skepticism was founded in a case, *Kotlar,* that did not even involve a breach-of-fiduciary-duty claim.

In *Kotlar*, plaintiff Jack Kotlar was an additional insured under a policy purchased by Meir Produce. The policy was canceled because Meir failed to pay the premiums, but notice of cancellation was sent only to Meir, not to Kotlar.

Kotlar sued the brokers who had procured the policy for negligence in not providing him with notice of the cancellation.

The *Kotlar* court refused to impose a duty on the brokers to provide notice of cancellation to additional insureds. In doing so, the court distinguished the broker-client relationship from the attorney-client relationship in language later relied on by *Hydro-Mill*: "The relationship between an attorney and client is a fiduciary relationship of the highest character, and attorneys have a duty of loyalty to their clients. ... Thus, while an attorney must represent his or her clients zealously within the bounds of the law, ... a broker only needs to use reasonable care to represent his or her client."

In the end, though, having cast serious doubt on whether the broker-client relationship is a fiduciary one, the *Hydro-Mill* court did not conclusively hold that no fiduciary duty exits. Instead, the court merely concluded that, because the plaintiff's claim sounded in professional negligence, no matter how those claims

were styled, the two-year statute of limitations applied. Thus, *Hydro-Mill's* discussion of whether a broker owes his client a fiduciary duty is itself arguably dicta.

Adding to the confusion, the *Hydro-Mill* court noted that, "whether or not the broker-insured relationship is a fiduciary one, a broker still has certain fiduciary *duties*." (Emphasis in original). The court cited as an example of such a fiduciary duty the insurance broker's obligation to safeguard funds received from his client for the payment of the premium.

Indeed, Insurance Code Section 1733 describes such funds as "fiduciary funds" and makes it a crime for a broker to divert them. The court also suggested that an insurance broker may have fiduciary duties to avoid conflict of interest and self-dealing. Although these various duties certainly would seem to denote a fiduciary relationship, the *Hydro-Mill* decision represents a growing consensus among appellate decisions that the broker-client relationship is not a fiduciary one.

Although the *Hydro-Mill* court retracted the scope of a broker's duties to his client, the 4th District Court of Appeal in *Century Surety* significantly expanded a broker's duties, finding that a broker owes a carrier a duty of care to the insurance companies with whom the broker places business, even where the broker is acting purely on behalf of his client, and therefore can be liable to the carrier in negligence.

In *Century Surety*, Baroco West Inc., a general contractor, was initially defended by Century under a general liability policy. However, Century withdrew from Baroco's defense when it determined that the insurance application prepared for Baroco by its broker, Crosby, contained false information, including a forged document purporting to show that Baroco had been insured by another carrier and had suffered no losses.

Baroco sued Century for breach of contract and bad faith, and in response, Century filed a cross-complaint against Crosby, alleging fraud and negligence, among other things. The trial court sustained Crosby's demurrers to the fraud and negligence claims, but the Court of Appeal reversed.

With respect to the fraud claim, the broker sought refuge under Insurance Code Section 33, which provides that an insurance broker — as distinct from an insurance agent, who acts on behalf of the insurer — is "a person who, for compensation and on behalf of another person, transacts insurance other than life insurance with, but not on behalf of, an insurer."

Because Crosby was acting merely on behalf of its insured client, Crosby argued that only the insured could be responsible for any misrepresentations in the application.

Not surprisingly, the Court of Appeal rejected the notion that a broker could be relieved of liability for fraud when that broker intentionally misrepresents facts in an insurance application: "[W]e conclude that California case law does not provide any basis for exempting an insurance broker for the consequences of its own fraud."

What was surprising, though, was that the court found that an insurance broker can owe an insurance company a duty of care, even though it is acting purely as the insured's agent. Acknowledging that no California court had ruled on the duty an insurance broker owes to an insurer, the *Century* court turned to *Biakanja v. Irving*, 49 Cal.2d 647 (1958), for the general factors to consider in determining whether a duty of care is owed, including "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."

Applying these factors, the *Century* court concluded that "policy reasons support imposing a duty on insurance brokers to exercise reasonable care in preparing insurance applications." The court explained that, although insurance brokers are not the guarantors of the information provided by their clients, "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."

California insurance brokers certainly will view *Century* as an instance of bad facts making bad law. Expanding the insurance broker's duty of care from its client to include its client's insurer could open the floodgates for cross-complaints by insurance companies against brokers for negligence whenever insurance companies are sued by their insureds over a coverage dispute stemming from information in the insurance application.

Thus, although they bring significant changes in the law of insurance broker liability, the *Hydro-Mill* and *Century* cases both probably raise more questions than they answer. But because the Supreme Court declined to review the *Hydro-Mill* case and refused to depublish the *Century* case, it will be some time before those questions are answered.

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