PRIDE AND PREJUDICE: PROMPT NOTICE IN REINSURANCE CLAIMS

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September 15, 2011

Notice of an insurance claim triggers a number of important obligations for the insurer, such as the duty to undertake a timely investigation of the claim, provide a determination as to coverage, and in appropriate circumstances, set reserves and undertake the defense of the insured in litigation. A failure to provide timely notice of a claim can, in certain circumstances, result in the forfeiture of coverage. The issue is, therefore, of central importance to the insurance relationship and is oft-litigated.

Court treatment of late notice defenses varies in both procedure and substance from jurisdiction to jurisdiction. Some jurisdictions require that an insurer affirmatively demonstrate that it was prejudiced by the late notice in order to prevail on the defense. Other jurisdictions interpret notice provisions more strictly according to their terms, and do not require a showing of prejudice. Still other jurisdictions utilize a hybrid approach, and place the burden on the policyholder, once late notice has been established, of demonstrating that the insurer was *not* prejudiced. These differing approaches reflect competing public policy concerns and competing contract doctrines in determining whether late notice should bar coverage.

Against this backdrop of public policy concerns and contract law, and varying treatment of the issues in different jurisdictions, still further complications arise in analyzing the issue in the reinsurance context. Certain issues that are pertinent to disputes between a primary policyholder and the insurer do not pertain to the parties to a reinsurance agreement, and this further complicates analysis of untimely notice in that context. Many jurisdictions have different notice-prejudice rules for primary insurance (and sometimes excess insurance) than they do for reinsurance.

This paper provides a brief overview of the issues raised by late notice generally, and analysis of the further complications arising in the context of reinsurance.[1]

What's the Harm?

As New York's high court put it, in summing up various court opinions on the issue: "without timely notice, an insurer may be deprived of the opportunity to investigate a claim and is rendered vulnerable to fraud . . . . late notification may prevent the insurer from providing a sufficient reserve fund. [P]rompt notice permits the primary insurer to make an early estimate of

[1] This paper does not attempt to categorize the approach of all states to the legal issues discussed.

potential exposure. . . early notice enables the insurer, *inter alia,* to exercise early control over the claim and enhances the possibility of settlement."[2]

Of course, the harm an insurer faces when it is not timely notified of a claim must be weighed against the harm to the policyholder of forfeiting coverage to which it otherwise would have been entitled. This conflict has been aptly summed up by Connecticut's Supreme Court in contract law terms:

> On the one hand, the law of contracts supports the principle that contracts should be enforced as written, and that contracting parties are bound by the contractual provisions to which they have given their assent. . . .On the other hand, the rigor of this traditional principle of strict compliance has increasingly been tempered by the recognition that the occurrence of a condition may, in appropriate circumstances, be excused in order to avoid a "disproportionate forfeiture."[3]

Following is a brief review of varying treatment of the notice-prejudice issue in the context of primary insurance.

Varying Traditional Notice-Prejudice Rules

Historically, the majority of jurisdictions generally applied notice provisions as written, under ordinary rules of contract interpretation. However, in the last half century or so – as insurance has become more ubiquitous (particularly with the advent of some mandatory coverages) and with increased application of "contract of adhesion" doctrine[4] to insurance policies – some courts have re-evaluated the issue. Many courts have, more recently, looked beyond the strict terms of the policy, requiring that the insurer affirmatively demonstrate that it was prejudiced by late notice in order to deny coverage on that basis. As Pennsylvania's high court noted:

> The rationale underlying the strict contractual approach reflected in our past decisions is that courts should not presume to interfere

[2] *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co.*, 594 N.E.2d 571, 581-82 (N.Y. 1992) (citations omitted).

[3] *Aetna Cas. and Sur. Co. v. Murphy*, 538 A.2d 219, 221 (Conn. 1988).

[4] For a helpful review of the early history of "contract of adhesion" doctrine as applied to insurance contracts, *see e.g. Steven v. Fidelity & Cas. Co. of New York*, 377 P.2d 284 (Cal. 1962).

> with the freedom of private contracts and redraft insurance policy provisions where the intent of the parties is expressed by clear and unambiguous language. We are of the opinion, however, that this argument, based on the view that insurance policies are private contracts in the traditional sense, is no longer persuasive. Such a position fails to recognize the true nature of the relationship between insurance companies and their insureds. An insurance contract is not a negotiated agreement; rather its conditions are by and large dictated by the insurance company to the insured. The only aspect of the contract over which the insured can 'bargain' is the monetary amount of coverage.[5]

Most jurisdictions now employ some form of a 'notice-prejudice' rule to primary insurance. A few jurisdictions, nevertheless, maintain the rule that late notice bars coverage as a matter of law, and prejudice need not be shown.[6] An increasingly popular approach is a 'hybrid' between the two: strict compliance with a notice provision may be excused, but the burden of demonstrating a *lack* of prejudice is placed on the policyholder.[7] As a further wrinkle, some jurisdictions recognize a distinction in treatment of late notice where timely notice is an element of the coverage grant itself, as opposed to a listed "condition." This is often true in "claims made" policies (such as E&O, D&O and other professional liability policies).[8]

With this patchwork of basic concepts involved in late notice jurisprudence in mind, a further set of issues arises in the context of reinsurance.

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[5] *Brakeman v. Potomac Ins. Co*., 371 A.2d 193, 196 (Pa. 1977).

[6] *See e.g. Reliance Ins. Co. of New York v. Garsart Bldg. Corp*., 131 A.D.2d 828, 828 (N.Y. App. Ct. 1987) ("Absent a valid excuse, failure to satisfy the notice requirement vitiates coverage and the insurer need not demonstrate prejudice in order to disclaim coverage.")

[7] *See Murphy*, *supra*, 538 A.2d at 224 ("the burden of establishing lack of prejudice must be borne by the insured. It is the insured who is seeking to be excused from the consequences of a contract provision with which he has concededly failed to comply.").

[8] *Compare e.g. Bates v. Vermont Mut. Ins. Co*., 950 A.2d 186, 190 (N.H. 2008) (if the policy is an "occurrence" policy, the insurer must show prejudice in order to deny coverage to a party giving late notice"); *with Bianco Professional Association v. Home Insurance Company*, 740 A.2d 1051 (N.H. 1999) ("There is no requirement that an insurance company prove it was prejudiced due to lack of notice under a claims made policy.").

Untimely Notice in the Reinsurance Context

Many factors unique to the reinsurance relationship alter the analysis of an untimely notice claim. For one, reinsurance contracts are more often manuscripted, and therefore the "contract of adhesion" doctrine generally does not apply, and the language used in notice provisions varies more widely. The parties are also typically similarly sophisticated and enjoy equal bargaining power. However, due to its removal from any direct relationship to the underlying risk, reinsurers rely on the *uberrimae fidei* – or utmost good faith – of the cedent, which can heighten the cedent's contractual obligations.[9] For a cedent, the concept of "disproportionate forfeiture" may be writ large, due to the typically higher value of risk transfer involved in reinsurance. For these reasons and others, many jurisdictions have different sets of rules concerning notice-prejudice in the reinsurance context.

A famous fight on a professional basketball court ultimately led to a California appellate decision that carved out a modified notice-prejudice rule in the reinsurance context. When Los Angeles Laker Kermit Washington punched Houston Rocket Rudy Tomjanovich, causing a concussion, broken facial bones and other injuries, the resulting lawsuits by Tomjanovich and the Rockets against the Lakers organization resulted in a large settlement. One of the insurers who paid a portion of the settlement looked to its reinsurer for reimbursement of the ceded portion of the risk. The reinsurer declined coverage due to untimely notice, some eight months after the underlying settlement. The cedent sued.

The court recognized the general rule that had already been adopted in that state, requiring an insurer to demonstrate substantial prejudice in order to prevail on a late notice defense. However, it noted "[w]e think it proper in this context to hold [cedent] Central National to a higher degree of care with respect to notice because it is an insurance company handling a claim on behalf of its reinsurer. It is evident that PruRe relied on Central National's expertise as a fellow insurer in evaluating claims."[10] Based on this rationale, the court adopted a 'hybrid' rule for reinsurers, affording them a rebuttable presumption of prejudice from untimely notice, with the burden on the cedent of proving lack of prejudice.

Similarly, New Hampshire's high court recognized the duty of utmost good faith in the reinsurance context, which it noted "obligates the reinsured 'to place the reinsurer in the same

[9] For a review of the doctrine of *uberrimae fidei* as applied to reinsurance contracts, *see* this author's paper entitled "*Uberrimae Fidei*: Contracting With the Utmost Good Faith" *ReinsuranceFocus.com* (Nov. 2010), *available at* http://02ec4c5.netsolhost.com/blog/wp-content/uploads/2010/11/Special-Focus-doctrine-of-uberrimae-fidei.pdf.

[10] *Central Nat. Ins. Co. of Omaha v. Prudential Reinsurance Co.*, 196 Cal. App.3d 342, 241 Cal. Rptr. 773, 786 (Cal. Ct. App. 1987).

situation as itself and to give to the reinsurer the same means and opportunity of judging the value of the risks.' Because the reinsurer relies on the reinsured for information in order to properly assess the risks, the [heightened] good faith standard particularly applies to reinsureds timely notifying reinsurers of potential claims."[11] The court held that the reinsurer was not required to demonstrate prejudice (despite New Hampshire's general rule requiring a showing of prejudice with primary, occurrence-based policies), because the cedent had breached its heightened duty of good faith, by its "gross negligence" in failing to have in effect a reasonable policy of notifying reinsurers of potential claims.[12]

In New York, the opposite is true. Recall that New York remains one of the relatively few jurisdictions to apply notice provisions as written, barring coverage without requiring any demonstration of prejudice on the part of a primary insurer.[13] However, New York's high court has held just the opposite in the context of reinsurance, based in large part on the "follow the fortunes" provision typical in reinsurance contracts. "The New York 'no prejudice' rule for primary insurers. . . is a limited exception to two established rules of contract law: (1) that ordinarily one seeking to escape the obligation to perform under a contract must demonstrate a material breach or prejudice; . . . and (2) that a contractual duty ordinarily will not be construed as a condition precedent absent clear language showing that the parties intended to make it a condition."[14] The court found, however, that the same rules do not apply in the reinsurance context:

> A reinsurer is not responsible for providing a defense, for investigating the claim or for attempting to get control of the claim in order to effect an early settlement. Unlike a primary insurer, it may not be held liable to the insured for a breach of these duties. Settlements, as well as the investigation and defense of claims are the sole responsibility of the primary insurer; and settlements made by the primary insurer are, by express terms of the reinsurance certificate, binding on the reinsurer. Thus, failure to give the required prompt notice is of substantially less significance for a reinsurer than for a primary insurer. . . Moreover, the interests of a reinsurer and the ceding primary insurer with respect to a pending claim are generally identical. The "follow the fortunes" clause in

[11] *Certain Underwriters at Lloyd's London v. Home Ins. Co.*, 783 A.2d 238, 240 (N.H. 2001)

[12] *Id*.

[13] *See e.g. Reliance Ins. Co. of New York v. Garsart Bldg. Corp*., *supra*, 131 A.D.2d at 828.

[14] *Unigard Sec. Ins. Co., Inc. v. North River Ins. Co*., 594 N.E.2d 571, 573 (N.Y. 1992) (citations omitted).

> most reinsurance agreements leaves reinsurers little room to dispute the reinsured's conduct of the case. In addition, the interests of both parties are furthered through the primary insurer's efficient investigation and defense of the claim and through the resolution of the claim on the best terms possible . . . This is not to suggest that a reinsurer may never assert late notice as a ground for avoiding its obligations under a reinsurance contract. All we hold here is that the reinsurer must demonstrate how it was prejudicial and may not rely on the presumption of prejudice that applies in the late notice disputes between primary insurers and their insureds.[15]

Thus, a review of three states to have treated the issue in both the context of primary insurance and reinsurance reveals: (1) in California, notice-prejudice applies in the primary insurance context, but the burden switches to the cedent to prove lack of prejudice in the reinsurance context; (2) in New Hampshire, prejudice must be demonstrated by a primary insurer to prevail on a late notice defense, but a reinsurer may not have to demonstrate prejudice; and (3) in New York, a primary insurer need not demonstrate prejudice to prevail, but a reinsurer must.

What Are The Implications Of This Contradictory Patchwork?

Given the number of competing public policy concerns, contract doctrines, differences between lines of primary insurance, excess insurance, and reinsurance, and the widely varying treatment of all these issues from jurisdiction to jurisdiction, it is important from both a drafting perspective and from the claims/litigation perspective to have a handle on all potentially applicable notice-prejudice rules.

First and foremost, these issues highlight the importance of choice-of-law provisions, and of understanding the conflict of laws rules of various jurisdictions involved, because there is a strong likelihood that different jurisdictions will treat the issues differently. It is important to understand that different rules may be applied in the reinsurance context than are applied to primary insurance. If there are no appellate rulings on the issue in the context of reinsurance in a given jurisdiction, one should therefore be wary of relying on the rules as applied in the context of primary insurance. The language used in drafting the notice provision, and even its placement in the contract, can alter the analysis. Contract doctrines peculiar to reinsurance contracts, such as "uberrimae fidei" and "follow the fortunes" may result in different treatment as well.

[15] *Id*. at 574-75 (citations omitted).

Thus, whether drafting or negotiating a notice provision, or analyzing an untimely claim for coverage, careful research on the complicated issue of notice-prejudice is essential, particularly in the context of reinsurance, where the stakes of forfeiture of coverage are typically much higher.

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This article was first published in *LexisNexis® Mealey's™ Litigation Report Reinsurance* Volume 22, Issue #10 · September 16, 2011

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