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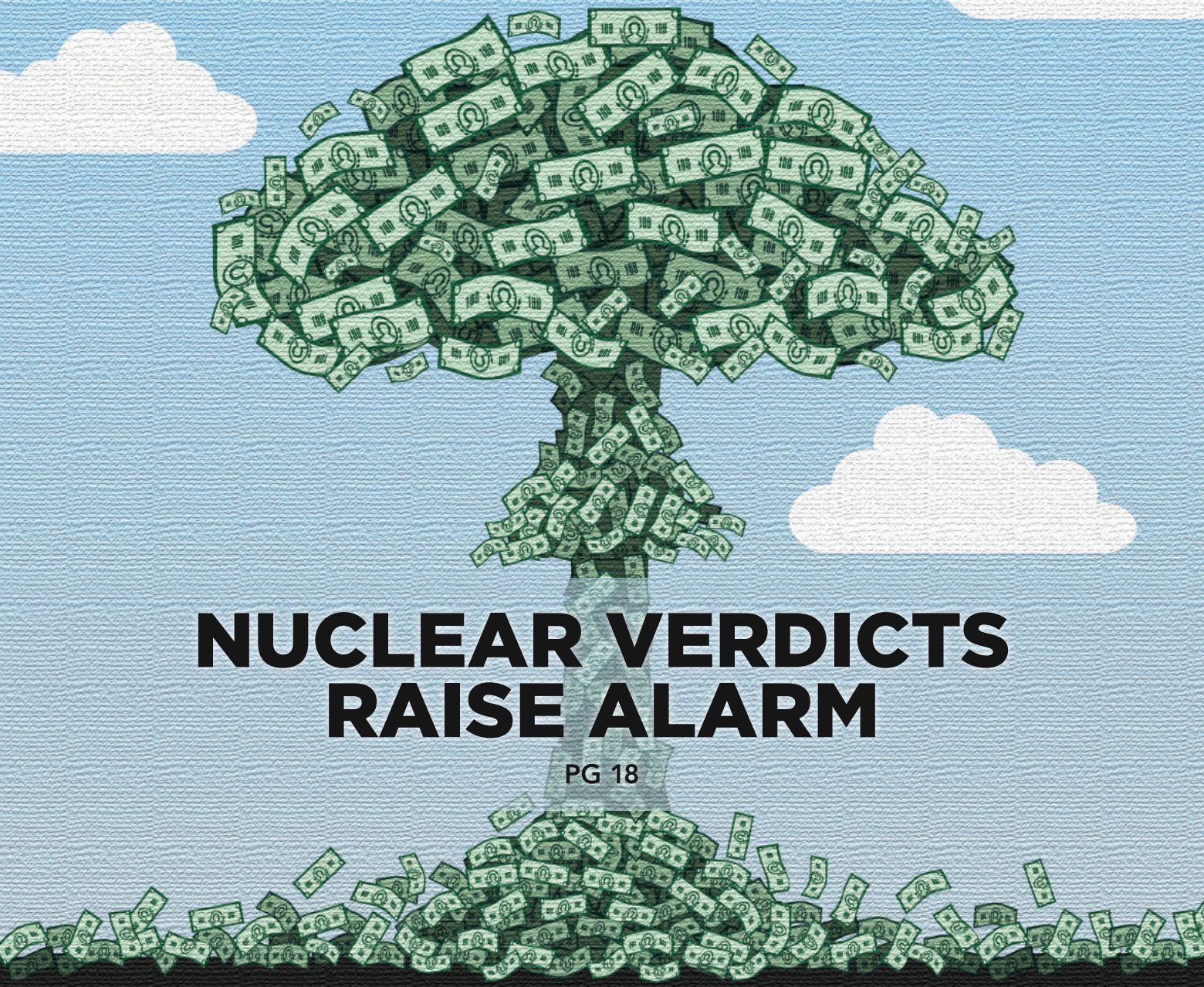

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NAVIGATING THE PRUDENT PATH:

Denying Insurance Coverage for Breach of Condition

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Denying insurance coverage is a high-stakes decision with potentially significant consequences for insurers and policyholders. This decision demands an even greater degree of prudence if an insurer denies coverage due to a policyholder's breach of a condition precedent to coverage.

Although there are differences in the manner the courts treat occurrence-based and claims-made policies as well as various conditions precedent to coverage, when a policyholder fails to comply with a policy's condition precedent, courts will scrutinize various factors in determining whether a decision to deny coverage was justified. A showing of prejudice, whether by establishing a rebuttable presumption or through other means, is a necessary first step in most, but not all, jurisdictions.

In jurisdictions like California, when a policyholder fails to comply with a condition precedent to coverage, such as the duty to cooperate, there is generally no presumption of prejudice. Instead, an insurer has the burden to show it suffered substantial prejudice due to the policyholder's failure to cooperate in his or her defense or to disclose material information and facts. [*See,*

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State Farm Fire & Cas. Co. v. Superior Ct. (1989) (a policyholder has a duty to cooperate in his defense and to disclose information and facts); *Nw. Title Sec. Co. v. Flack* (1970) ("[B]reach cannot be a valid defense unless the insurer was substantially prejudiced thereby" and the insurer has a duty to show substantial prejudice).]

These jurisdictions reason that presumptions of prejudice, whether conclusive or rebuttable, should not be created judicially unless there are compelling reasons for such a presumption. This view is a contemporary trend departing from the traditional view that prejudice to an insurer is either immaterial or at least presumed unless rebutted.

The courts in jurisdictions following the contemporary trend require that in order to avoid liability, an insurer must prove it suffered substantial prejudice as a result of the breach. Only when an insurer can prove actual, substantial prejudice the courts will recognize the defense of the breach of a policy's condition precedent as a valid defense. Only then may the insurer be relieved of its contractual obligations under the policy. Otherwise, without a showing of prejudice, courts view a denial of coverage for such conditions precedent as an unfair windfall to insurers.

PROVING PREJUDICE

To establish substantial prejudice, an insurer has the burden to show that it was actually hampered by the policyholder's breach of a condition precedent to coverage. For example, the insurer must show that its investigation was hindered by the policyholder's violation of the cooperation clause or that an insurer was impeded in its defense of the policyholder—i.e., a showing that absent the policyholder's breach of the cooperation clause, there is a substantial likelihood the trier of fact would have found in the policyholder's favor. [*Flack*] Substantial prejudice may also be shown by establishing that the case could have settled for a smaller sum than it was settled for by the policyholder. [*Flack*]

Not all jurisdictions treat conditions precedent to coverage identically. In some jurisdictions like Ohio, prejudice is presumed if the delay to report a claim is unreasonable. When an insurer shows that a policyholder breached a condition precedent to coverage, the burden shifts to the policyholder to show the insurer suffered no prejudice. The policyholder's breach of a policy's condition precedent for coverage creates a presumption of prejudice to the insurer unless (a) the insurer has waived its defenses, (b) the policyholder substantially complied with the provisions of the policy, (c) the policyholder is excused from complying with the policy's conditions or (d) the policyholder has another legal justification for noncompliance.

This presumption, however, is rebuttable. The policyholder may rebut the presumption by showing a legal justification for the non-compliance. Unless the policyholder makes this showing, the rebuttable presumption will prevent the policyholder from recovering against the insurer. Only upon a showing of lack of prejudice, waiver, excuse, or another legal justification, the burden will shift from the policyholder to the insurer to show actual prejudice. [*See, Zurich Ins. Co. v. Valley Steel Erectors, Inc.,* (prejudice to an insurer is presumed from unreasonable delay in giving notice of loss under the policy, and the burden is on the policyholder to show the insurer suffered no prejudice).]

In most jurisdictions, the key inquiry in establishing prejudice is directed at the factual evidence of prejudice. Therefore, a question of prejudice is ordinarily a question of fact for the jury to decide. If the facts are undisputed and the only question con-

cerns the breach of the policy due to, for example, an obvious and substantial delay in reporting a claim, the court may decide the issue of prejudice as a matter of law.

It is, however, a demanding task to prove prejudice as a matter of law. Courts generally find that the issue of prejudice is one of fact to be resolved by the jury, and therefore, summary judgment is not appropriate.

THE LAW & PREJUDICE

The law on the issue of prejudice is ever-changing. For example, New York common law provides that "[a]bsent a valid excuse, a failure to satisfy the notice requirement vitiates the policy, and the insurer need not show prejudice before it can assert the defense of noncompliance." [*Sec. Mut. Ins. Co. of New York v. Acker-Fitzsimons Corp.* (1972)] The courts reason that it is generally difficult, if not unfeasible, to determine whether an insurer has been prejudiced and that conditions precedent serve important functions to insurers such as, for instance, offering insurers an opportunity to protect themselves.

Once an insurer's breach of a condition precedent is established, the insurer is relieved of its duties under the insurance contract. Effective January 2009, New York Insurance Law section 3420(a)(5) requires that any provision in an insurance contract providing that failure to give timely notice would be a basis for denial must also require the insurer to show prejudice from untimely notice. However, section 3420 excludes certain types of insurance, and in those circumstances, the common law rule for insurance contracts is a no-prejudice rule. [*New York Marine & Gen. Ins. Co. v. Travelers Prop. Cas. Co. of Am.,* (S.D.N.Y. 2020).]

There are a handful of exceptions to the way various jurisdictions analyze whether prejudice is a necessary showing depending on the type of policy at issue. For example, while California courts consistently require a showing of substantial prejudice in occurrence-based policies, they do not always require a showing of substantial prejudice in claims-made policies.

These courts explain that the reason for this distinction is that an "occurrence policy provider will have made actuarial projections for claims beyond the policy period, but a claims-made provider will have projected risks and premiums only for claims made during the policy period." [*Serv. Mgmt. Sys., Inc. v. Steadfast Ins. Co.* (9th Cir. 2007).] Accordingly, "applying the rule to a claims-made policy would effectively 'convert' it into an occurrence policy, which is 'tantamount to an *extension of coverage* to the insured gratis."

Careful thought must be given to the notice and cooperation clauses in a policy. While different states treat these clauses differently, policyholders would be wise to notify the insurance company as soon as possible of any claim against them and to cooperate in all the reasonable requests made by the insurer, including requests for documentation of the claim, the names of individuals with knowledge of the claim, and any possible defenses. If policyholders follow these simple steps, insurers will likely not be able to deny a defense or indemnity based on these two conditions precedent.

Insurance carriers analyzing whether cooperation or notice clauses have been breached must conduct a detailed analysis of the particular requirements of the applicable jurisdiction to determine the rule and the exceptions. That includes requirements of prejudice, timing, and the precise language in the particular policy as well as the choice of law provisions and any other applicable contract terms.

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