THE NOTICE-PREJUDICE RULE AND CLAIMS-MADE POLICIES

By Larry P. Schiffer

This article explores some recent court decisions construing the notice-prejudice rule in the context of a claims-made policy.

When a policyholder fails to notify its insurer of a claim or notifies the insurer of the claim well after the requirements for notice set forth in the policy, the policyholder runs the risk that the insurer will disclaim coverage because of the late claim notice. In many states and with many policies, however, mere late notice of a claim does not, in and of itself, give the insurer cover to avoid its policy obligations. To sustain a late notice defense in those jurisdictions, the carrier also has to show that it has suffered actual prejudice because of the late notice of claim from the policyholder.

This "notice-prejudice rule" has caused quite a bit of consternation in the insurance industry given the robust and clear requirements in many insurance policies requiring that the policyholder give prompt notice of any claim or lawsuit. While it is clear that the notice-prejudice rule applies to occurrence-based policies like a standard commercial general liability policy, the rule is less clear in the case of claims-made policies. This article explores some recent court decisions construing the noticeprejudice rule in the context of a claims-made policy.

The Notice-Prejudice Rule

The notice-prejudice rule requires that the insurance company can assert late notice as a defense to coverage only if the late notice has caused actual prejudice to the insurer. What prejudice means differs from jurisdiction to jurisdiction and is often factually based. An example of prejudice is the inability of the insurance carrier to investigate the claim properly because notice of the claim was provided only after important evidence was destroyed. Another example is a carrier receiving notice of a claim only after an excess of limits damages jury verdict has been entered and turned into a judgment.

The public policy behind the notice-prejudice rule is that a policyholder should not be deprived of its right to insurance protection for which premium was paid just because notice of the claim was late. If there is no real harm or prejudice to the insurance company a mere technicality should not vitiate the policy.

Claims-Made Policies

Claims-made policies were created to provide all parties with more certainty over which claims will be covered by the policy. Nearly all professional liability and directors and officers liability policies are written on claims-made forms. First year claims-made policies generally have a lower premium than would an occurrence-based policy issued at the same time. That is because the risk exposure to a new claims-made policy is much more limited than to an occurrence-based policy.

While there are many permutations to claims-made policies, the essential characteristics are that the claimsmade policy will respond only to claims made against the insured during the policy period and noticed to the insurer during the policy period. Some claims-made policies also require that the occurrence or accident take place within the policy period. A key distinction between claims-made policies and occurrence-based policies is that the policy obligation triggers when the claim is made for the claims-made policy and when the loss is incurred for an occurrence-based policy.

A claims-made policy differs from an occurrencebased policy, which may have to respond to losses reported years and sometimes decades after the loss was incurred. A carrier that issues a claims-made policy typically does not have to be concerned with latent claims showing up decades later. The claims covered by the claims-made policy typically are only those known to the policyholder and reported during the policy period.

That being said, most claims-made policies have extended reporting period options (often for additional premium) that allow the policyholder to report a claim after the policy period has expired (known as "tail coverage"). Also, mature, continuous claims-made

policies often will have retroactive dates going back to the inception of the first claims-made policy issued to that policyholder in the continuous chain, meaning that losses incurred early on in the claims-made policy relationship may be reported during a later continuous claims-made period or extended reporting period.

Recent Case Law

Templo Fuente De Vida Corp., v. Nat'l Union Fire Ins. Co. of Pittsburg, Pa.

Many commentaries have been written about a recent New Jersey Supreme Court decision that upheld a decision finding that an insurer need not demonstrate prejudice to disclaim coverage for late notice of a claim under a claims-made directors and officers liability policy issued to a sophisticated insured.[1] On its face, many have said that it looks like the New Jersey Supreme Court is bucking the notice-prejudice trend of requiring insurers to demonstrate prejudice before they can disclaim based on late notice. But in reality, New Jersey is not bucking any trend.

In *Tempo*, a directors and officers ("D&O") policy was issued by the insurance company to a corporate entity. The policyholder was not the largest company in the world, but nevertheless was considered by the court to be a sophisticated company in part because it used a professional insurance broker to place its D&O insurance. The D&O policy was, of course, issued as a claims-made policy, which is how most professional liability and D&O policies have been issued for the past 20 or more years.

The dispute arose after the corporate policyholder entered into a transaction that ultimately failed, which resulted in the policyholder being sued by its counterparty over the failed transaction. The policyholder settled the underlying suit and assigned its rights under its D&O policy to the plaintiff. The Plaintiff commenced suit against the insurance company seeking coverage under the D&O policy for the claim.

The D&O policy had the typical claims notice clause found in most D&O policies, which required that the policyholder provide notice of the claim as soon as practicable. There was no dispute that notice of the claim from the policyholder came more than six months after the policyholder was served with the first amended complaint in the underlying dispute and after it had retained counsel to answer the complaint. No excuse was given by the policyholder for the late notice to the insurance company.

All the courts that reviewed the case found in favor of the insurer based on the notice clause in the D&O policy. Although notice of the claim to the insurer was late, the courts all found that there was no reason under a claims-made policy that the insurer had to demonstrate prejudice before disclaiming coverage. Basically, as described by the New Jersey Supreme Court, here, where you have sophisticated parties entering into a claimsmade policy, the peril being insured is the policyholder's making of the claim within the terms and conditions of the claims-made policy. Unlike an occurrence policy, where the peril is the occurrence that may be incurred within the life of the policy coverage and the insurance contract often between a sophisticated insurer and a less than sophisticated individual insured with limited or no bargaining power, a claims-made policy is typically issued to a sophisticated insured like directors and officers, doctors or lawyers. Thus, the equitable and public policy reasons for protecting an unsophisticated individual insured against an insurance company taking advantage of late notice to disclaim coverage does not apply to most claims-made insurance policies and their sophisticated policyholders.

As the *Tempo* court said:

> In this instance we need not make a sweeping statement about the strictness of enforcing the 'as soon as practicable' notice requirement in 'claims made' policies generally. We need only enforce the plain and unambiguous terms of a negotiated Directors and Officers insurance contract entered into between sophisticated business entities. Its notice conditions contain mutual rights and obligations and a clear and unambiguous requirement that the insured report a claim to the insurer 'as soon as practicable,' pursuant to section 7, thereby preserving the insurer's rights, under section 8, to associate and influence how the litigation proceeds from its inception.

Finding that the policyholder here breached the condition precedent of timely notice and breached the contract's notice provisions, the court found in favor of the insurer.

The *Tempo* decision is a well thought out and articulate dissertation on the distinction between occurrence-based policies and claims-made policies. It is also provides an excellent analysis on the theories behind requiring insurance companies to show prejudice when their insured's are late in noticing a claim. It is worth reading whether you agree with its outcome or not because of its detailed analysis.

The court concluded by recognizing that other jurisdictions might rule differently, but stuck to its precedents and the requirement that a sophisticated insured must adhere to the clear terms of a claims-made policy.

Ashland Hospital Corp. v. RLI Ins. Co.

Shortly after the New Jersey Supreme Court's opinion in *Tempo* was released, the United States Court of Appeals for the Sixth Circuit reached the same result on an excess claims-made policy. In *Ashland Hospital Corp. v. RLI Ins. Co.*,[2] the policyholder gave notice to its primary D&O carrier of a governmental investigation on the last day permitted under the notice provision of the primary claims-made policy. But the policyholder did not give notice to the excess insurer until six months later. The excess insurer denied coverage based on the policyholder's failure to satisfy the excess policy's notice provisions.

The policyholder brought suit against the excess insurer even though it conceded that the notice of claim was late. Making the argument typically found in late notice cases, the policyholder claimed that it was entitled to coverage under the excess D&O policy because the excess insurer did not show that it was prejudiced by the policyholder's late notice. The policyholder relied on a state court case from the Kentucky Supreme Court, *Jones v. Bituminous Cas. Corp.*,[3] which held that under an occurrence-based policy the insurer must show prejudice before rejecting a claim for late notice (i.e., the noticeprejudice rule).

In reaching its decision, the federal district court predicted that the Kentucky Supreme Court would not extend the notice-prejudice rule to a claims-made policy like the excess D&O policy, which contained unambiguous notice requirements as a condition precedent to collecting under the policy. In a leap day decision, the Sixth Circuit agreed with the district court and affirmed dismissal of the policyholder's action.

The case report is not long and the reasoning is not elaborate. Yet, it is another example of a situation where a claims-made policy is issued to a sophisticated insured with unambiguous notice requirements that act as a condition precedent to coverage. Under those circumstances, the Sixth Circuit agreed that the insurer does not have to show prejudice to prevail on a late notice disclaimer.

Analysis

In a notice-prejudice state it is very easy to knee-jerk react to an insurer's disclaimer based on late notice. What these cases teach us, however, is that there is a real public policy behind the notice-prejudice rule, which may not apply to every type of insurance policy and every type of insured.

Two factors distinguish these cases from the typical notice-prejudice case. First, claims-made policies are very different from occurrence-based policies. The whole point of a claims-made policy is that coverage triggers on the making of a claim, not when the loss was incurred. If the trigger for coverage is when the claim is made then the provisions for when and how a policyholder has to give notice of a claim to trigger coverage is all that more important. Notice is not just so the insurance carrier can investigate and defend as early as possible, but is required primarily to trigger the policy's coverage obligations in the first instance.

New York, for example, recognized this distinction when it created a statutory notice-prejudice rule, but carved out claims-made policies.[4] Section 3420(a) requires that liability insurance policies issued in New York must contain certain provisions, including a noticeprejudice provision. Section 3420(a)(5) distinguishes claims-made policies as follows:

> A provision that failure to give any notice required to be given by such policy within the time prescribed therein shall not invalidate any claim made by the insured, injured person or any other claimant, unless the failure to provide timely notice has prejudiced the insurer, except as provided in paragraph four of this subsection. *With respect to a claims-made policy, however, the policy may provide that the claim shall be made during the policy period, any renewal thereof, or any extended reporting period, except as provided in paragraph four of this subsection.*[5]

Second, a sophisticated insured, which, according to the New Jersey Supreme Court, is the kind of insured that purchases a claims-made policy, does not need the protections that an individual unsophisticated insured needs when dealing with complex insurance issues. Sophisticated insureds have risk management departments, insurance buyers and use professional insurance brokers to obtain insurance coverage. Sophisticated policyholders understand notice provisions and also understand that under a claims-made policy notice of claim is a condition precedent to coverage.

Another factor is also important. That factor is contract wording. Notice provisions in insurance contracts need to be clear and unambiguous. Both courts in the cases discussed above found no ambiguity in the provisions requiring prompt notice of claim. Where a notice provision is ambiguous, then a disclaimer based on late notice of claim may be problematic. Where the notice provision is clear, only the notice-prejudice public policy argument in those states where it exists can intercede. But where the policy is a claims-made policy issued to a sophisticated insured, that public policy argument may not apply.

(Endnotes)

1. *Templo Fuente De Vida Corp., v. Nat'l Union Fire Ins. Co. of Pittsburg, Pa*, No. A-18-14 (074572), 2016 N.J. LEXIS 144 (N.J. Feb. 11, 2016).
2. 632 Fed. Appx. 271 (6th Cir. 2016), *available at* http://www.ca6.uscourts.gov/opinions.pdf/16a0114n-06.pdf.
3. 821 S.W.2d 798 (Ky. 1991).
4. N.Y. Ins. Law § 3420(a)(5).
5. Emphasis added.

About the Author

Larry P. Schiffer is a partner in the New York office of **Squire Patton Boggs (US) LLP**, practicing in the areas of complex commercial, insurance, and reinsurance litigation, arbitration, and mediation. He also provides advice on coverage, insurance insolvency, and contract wording issues for a wide variety of insurance and reinsurance relationships. Mr. Schiffer may be contacted at larry.schiffer@squirepb.com.

This article was published in the Summer 2016 Insurance Coverage Law Report.