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THE POLICYHOLDER ADVOCATE/IP COUNSELOR

NEWSLETTER

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"CLAIMS MADE" COVERAGE AND LATE NOTICE

I. INTRODUCTION

A number of new policy forms for cyberspace and multimedia are issued on a "claims made," not "occurrence," basis. One aspect of such policies that is often not a primary focus in their acquisition is the fact that notice obligations under "claims made" policies are less favorable than for "occurrence" based policies.

Some risk managers believe that, so long as notice is provided of either a claim or notice of circumstance within the pertinent policy period of a "claims made and reported" policy or within the either statutorily prescribed or contractually endorsed extension for provision of such notice, the notice will be deemed timely. This, despite whatever other provisions in the policy may exist requiring the insured to give notice as soon as practicable, immediately, or within some other prompt time frame.

Carrier coverage counsel emphatically disagree with this view, as do the majority of the courts to address this issue.[1] Even more problematic, where a policyholder has a self-insured retention that is significant and the policy form is one requiring the carrier only to reimburse defense fees, not provide a duty to defend, case law has to date not recognized these distinctions as grounds for avoiding prompt notice of a lawsuit or claim within the policy period.

II. THE "TRIPLE TRIGGER" OF "CLAIMS MADE AND REPORTED" POLICIES

"Claims made and reported" policies with an "as soon as practicable" provision have a triple trigger. **First**, the lawsuit or claim must arise within the policy period. **Second**, they must be reported to the insurer within the policy period and any extended reporting period. **Third**, this notice must be provided as soon as practicable, even if the policy has not yet expired.

These principles appear counter-intuitive to many corporations. They have secured freedom to operate in providing their own defense for matters that may fall within the self-insured retention. They thus presume, on occasion

[1]*Thoracic Cardiovascular Assocs., Ltd. v. St. Paul Fire & Marine Ins. Co.*, 181 Ariz. 449, 891 P.2d 916 (Ct. App. 1994); *Heydar v. Westport Ins. Corp.*, No. 04-55262, 2005 WL 3159718 (9th Cir. Nov. 29, 2005); *American Home Ins. Co. v. Abrahams*, 69 App. Supp. 2d 339 (D.C. Ont. 1999); *Southridge Capital Management, LLC v. Twin City Fire Ins. Co.*, No. X04CV020103527S, 2006 WL 2730312 (Conn. Super. Ct. Sept. 8, 2006); *Florida Physicians Ins. Co. v. Stern*, 563 So. 2d 156 (Fla. Dist. Ct. App. 1990); *Hasbrouck v. St. Paul Fire & Marine Ins. Co.*, 511 N.W.2d 364 (Iowa 1993); *Regions Bank v. Kountz*, 931 So. 2d 506 (La. Ct. App. 2006); *Westport Ins. Corp. v. Albert*, No. 05-1726, 2006 WL 3522500 (4th Cir. Dec. 6, 2006); *Tenovsky v. Alliance Syndicate, Inc.*, 424 Mass. 678 (1997); *Schubiner v. New England Ins. Co.*, 207 Mich. App. 330 (1994); *Phillips v. Transamerica Ins. Co.*, 433 N.Y.S.2d 555 (1980); *Ace American Ins. Co. v. Underwriters at Lloyds & Cos.*, 2005 WL 2100150 (Pa. Com. Pl. Aug. 26, 2005), *aff'd*, 888 A.2d 1 (Pa. Super. Ct. 2005); *Pope v. Leuty & Heath, PLLC*, 87 S.W.3d 89 (Tenn. Ct. App. 2002); *Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653 (5th Cir. 1999); *Hardwick Recycling & Salvage, Inc. v. Acadia Ins. Co.*, 177 Vt. 421 (2004).

erroneously, that until such time as the self-insured threshold is surpassed by the expenditure of defense fees, there is no notice obligation under the "claims made" policy, assuming that it is still in force.

Lurking behind this presumption is the belief that a significant corporation need not advise its liability insurers of claims that may never reach a sufficient liability threshold to exceed its self-insured retention. Absent carefully drafted policy language, however, which limits the notice to the insurer to the date that its self-insured retention is exhausted by the payment of attorneys' fees in defense of the lawsuit or some percentage of the self-insured retention, this result may not naturally attend.

III. CAREFUL DRAFTING OF ENDORSEMENTS CAN LIMIT LATE NOTICE PROBLEMS

A. "Claims Made and Reported" Policies Are Typically Enforceable Even Though They May Severely Restrict Coverage Due to Late Notice

A number of forums have held that the prejudice standard cannot aid policyholders under claims-made policies where notice must be provided not only before the policy's expiration but also "as soon as reasonably practicable." A Ninth Circuit case recently addressed this issue:

> It is reasonable to conclude that a claims-made-and-reported policy differs from a general claims-made policy containing no requirement that the claim be reported within the policy period. We hold that this is a reasonable interpretation of California law. The reporting requirement serves two different purposes in the two policies. The notice provision in a general claims made policy, as in an occurrence policy, often requires notice "as soon as practicable." This serves to "facilitate the timely investigation of claims by bringing an event to the attention of the insurer and allows an inquiry 'before the scent of factual investigation grows cold.' " In contrast, in a claims-made-and-reported policy, notice is the event that actually triggers coverage. Because PTF's policy did not contain a reporting requirement, the notice prejudice rule applies. Under this rule, a factfinder on remand should determine (1) whether PTF's notice was late; and (2) if so, whether Federal was prejudiced by the delay in notice. *See Joyce v. United Ins. Co. of Am.*, 202 Cal.App.2d 654, 662, 21 Cal.Rptr. 361 (1962) ("Where a policy of insurance provides for the giving of notice of a claim "as soon as practicable," ... failure to give, or delay in giving, the required notice is not fatal to recovery under the policy, unless the insurer has been prejudiced by such failure or delay.").[2]

Some policies contain no reporting requirement, but only an "as soon as practicable" clause. The notice trigger is changed to require notice only where the risk manager or director of insurance is notified of a claim. Courts, however, have shown mixed results in the construction of the language where a lawsuit is filed against a company that potentially raises coverage.[3]

Nor does the presence of a significant "self-insured retention" or the use of "duty to reimburse" policy language change this result. The simple fact is there is an inherent tension created by an "as soon as practicable" condition where a policy is "claims made and reported."

The logic of the *Pension Trust Fund* case suggests that so long as the reporting requirement is contractually satisfied, the "as soon as practicable" condition should not further limit the insurer's obligation. Under Michigan law,

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[2] *Pension Trust Fund v. Federal Ins. Co.,* 307 F.3d 944, 956-57 (9th Cir. (Cal.) 2002) (citation omitted).

[3] *Elf Atochem N. Am., Inc. v. Pacific Employers Ins. Co.*, No. 92-1155, 1992 WL 332239 (E.D. Pa. Nov. 5, 1992); *OMI Holdings, Inc. v. Chubb Ins. Co. of Canada*, No. 95-2519-KHV, 1997 WL 30861 (D. Kan. Jan. 7, 1997).

prejudice must be shown under the current "claims made" policy.[4] Other California case law suggested, however, that "claims made" and "claims made and reported" policies are driven by distinct rationales.

> The notice-prejudice rule holds that "[u]nless an insurer can demonstrate actual prejudice from late notice, the insured's failure to provide timely notice will not defeat coverage." . . .
> . . . .
> . . . [*Northwestern Title Security Co. v. Flack* (1970) 6 Cal.App.3d 134, 85 Cal.Rptr. 693 (*Flack*)] applied the notice-prejudice rule to affirm a judgment in favor of the insured (a title company) as against its malpractice insurers (a Lloyd's underwriter) who had issued a claims made policy. . . .
> While *Flack* wasn't quite so conclusory as *Pacific Employers* might lead one to believe, we do not rely on it in this decision. For one thing, it involved a "claims made" as distinct from a "claims made and reported" policy.[5]

The same result has been held to apply to "claims made" policies issued by excess carriers. *Zurich Ins. Co. v. Walsh Construction Co. of Illinois*, 352 Ill. App. 3d 504, 511, 816 N.E. 2d 801, 807-08 (1st Dist. 2004). Therein, the court recognized the lesser need for rapid notice to an excess insurer that, like Zurich, has no duty to defend. The same principle would apply to a duty to reimburse policy or a policy issued over a self-insured retention that had not yet been exhausted. Thus, the *Walsh* court noted, "[C]ourts recognize that it is more important for a primary carrier to receive prompt notice because it must be able to adequately investigate the facts of the occurrence and defend the suit." *Id.*, 352 Ill. App. 3d at 509, 816 N.E.2d at 806.

B. A "Claims Made and Reported" Policy Should Specify That Expenditures for Defense Fees and Settlement Should Exhaust the Policy's Self-Insured Retention ("SIR")

One policy form to expressly address this issue is from National Union, A165 Form 80517 (10/04) AH0877. § IV Limits of Liability provides:

> **M.** We will not make any payment under this policy unless and until:
> . . . .
> 2. The total applicable Self-Insured Retention has been satisfied by the Payment of **Loss** to which this policy applies.
>
> . . . .
> **P.** **Loss** means those sums actually paid as judgments or settlements.

This form, however, does not include monies paid as attorneys' fees. The only sure pathway to insurance is to either suffer an adverse adjudication or enter into a settlement that exceeds the SIR threshold which then offers the promise of defense fee reimbursement otherwise unavailable. An endorsement that clarifies that the policyholder's payment of defense fees exhausts the SIR would be helpful to resolve this issue where a new policy form actually restricts the policyholder's ability to access coverage due to notice requirements. The additional language may not be enforceable where, without making it clear to the policyholder, it actually restricts coverage.[6]

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[4] *Sherlock v. Perry*, 605 F. Supp. 1001 (E.D. Mich. 1985).

[5] *Root v. American Equity Specialty Ins. Co.*, 130 Cal. App. 4th 926, 929, 936-37 (2005) (footnote omitted).

[6] Many states find that an insurer's failure to advise specifically, in writing, in its renewal that the new policy form it adopts reduces coverage, as this one clearly does, bars it from enforcing any lesser coverage provided therein. *See Guillen v. Potomac Ins. Co. of Illinois*, 203 Ill. 2d 141, 153-54 (2003) (specific statute); *Janes v. New York Central Mut. Ins. Co.*, 722 N.Y.S.2d 669, 678 (App. Div. 2001) (common law).

C. There Is a Distinction Between Policyholder's Right to Reimbursement of Defense Fees Where They Exceed the SIR But There Is No Settlement or Adverse Adjudication and Where the Policyholder Prevails in the Underlying Action

Item 8 of a subsequent National Union policy form states:

Corridor Self-Insured Retention: $1 million per occurrence shall not be eroded by defense expenses.

Endorsement 9 to this policy (while noting that the SIR is not reduced by **defense expenses**), provides that the SIR can be eliminated by payment of one or more claims that would be insured by the National Union policy. Defense expenses expressly include settlement once the SIR is eliminated. Arguably, defense fees incurred in that amount, once the underlying action is resolved, would constitute a loss suffered by the insured. That loss is a defense expense. All defense expenses are subject to reimbursement. This is consistent with a portion of Endorsement 9 which states:

> The . . . duty to defend any claim or suit seeking damages covered by the terms and conditions of the policy when . . . $1 million per occurrence has been exhausted by payment of claims to which this policy applies is defined as payments allocated to settlement or defense of claims or suit including . . . attorneys' fees.

In such a case the claims asserted **would be** covered as the policy requires. "Would be" is a progressive tense, "would" conveying condition. It does not connote any distinctions regarding "actual" versus "potential" coverage. Those distinctions depend on the circumstances in which the reimbursement duty arises. If defense fees are subject to reimbursement when they exceed the $1 million SIR and were incurred in a lawsuit seeking damages that would be covered if a judgment were rendered under any theory or cause of action that could be based on the facts involved, the "would be" language is satisfied.[7]

Addressing such a policy form, a leading treatise writer observed:

> Most liability policies that do not contain a duty to defend provision contain a provision obligating the insurer to indemnify the insured for the costs incurred in providing his or her own defense. . . .
>
> . . . [A]ssuming that the case ends in a judgment in favor of the insured, is the insured nevertheless entitled to reimbursement for costs of defense? Absent express policy language to the contrary, the answer is yes if **any of the claims** against the insured **would have been covered** by the policy if they had been proved.[8]

D. Another Way to Insure a Policyholder's Control Over Its Retained Counsel Is to Obtain a Reimbursement Policy Over the SIR Where the Defense Fees Incurred May Exhaust the SIR

Should National Union have wished to avoid reimbursing the policyholder in the event there was no adjudication against it for liability or settlement in excess of $1 million, it could have achieved that end by plainly so stating. While National Union may argue that its statement in Endorsement 9 that the SIR is not reduced by defense fees accomplishes that end, there are ambiguities as to how the policy would respond in the circumstance noted that may cause at least one construction, albeit not the only one, of that language to favor the policyholder and permit it to recover post-SIR

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[7] *See* CROSKEY, ET AL., CALIFORNIA PRACTICE GUIDE: INSURANCE LITIGATION § 7:520 (Rev. #1) (2002).

[8] ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES, REPRESENTATION OF INSURANCE COMPANIES AND INSUREDS § 6:20 (4th ed. 2001) (emphasis added).

attorneys' fees if incurred.[9] Having attorneys' fees expressly exhaust the SIR is the preferred option.

IV. WHERE PRE-TENDER FEES ARE NOT RECOVERABLE UNDER APPLICABLE LAW, PROMPT NOTICE TO THE INSURER IS ADVISABLE

Unless a policyholder is persuaded that there are no circumstances where its resolution of the underlying action could exceed the SIR – whether or not attorneys' fees may be applied to exhaust that sum – prompt notice to the insurer is essential. Otherwise, the insurer could argue that no pre-tender fees are recoverable if the only pathway to recover defense fees expended is where a settlement/judgment in the underlying action exceeds the SIR.

Indeed, "voluntary payments" provisions have routinely been enforced against policyholders to avoid the obligation to pay pre-tender fees.[10] Thus, where a settlement for policy limits is ultimately made and no notice was provided to National Union, it might argue that all fees incurred prior to the date of notice were not reimbursable, even though the SIR threshold was ultimately satisfied by the amount of a settlement. The same pertinent conditions apply under both policy forms.

V. CONFLICT OF LAW ANALYSIS CAN SUPPORT APPLICATION OF LAW FROM FORUMS WITH PREFERABLE RULES ON LATE NOTICE

Although addressing an "occurrence," not "claims made" policy, the Ninth Circuit in an unpublished order recently clarified why an apparent conflict between the law of New York and California regarding late notice can be resolved in favor of applying California law without finding any conflict rewarding the policyholder for initiating suit in California and obtaining application of its choice of law rules.[11] Therein, the court applied California's governmental interest analysis as part of its choice of law rule to assess whether a true conflict arose between New York and California law. It reasoned:

> New York . . . "can be said to have an interest if the policies underlying its [law] would be advanced when the law is applied to this transaction." *Rosenthal v. Fonda,* 862 F.2d 1398, 1402 (9th Cir.1988). One of the primary rationales for New York's no-prejudice rule is protecting insurers from fraud and collusion, but here there has been no collusion allegation, so this rationale cannot give rise to a true interest. *See Brandon v. Nationwide Mut. Ins. Co.*, 769 N.E.2d 810, 813-14 (N.Y.2002). A second rationale behind New York's rule is facilitating settlements, *id.* at 813, but the record reflects that Western offered Gulf opportunities to participate in settlement discussions and Gulf declined.

The court thus concluded that New York did not have an interest significant enough to justify the application of foreign law. So the third step of the governmental interest test was not reached. A policyholder's astute selection of a California forum led to procurement of favorable California notice law.

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[9] *Fireman's Fund Ins. Cos. v. Atlantic Richfield Co.*, 94 Cal. App. 4th 842, 852 (2001) ("[A]n insurance company's failure to use available language to exclude certain types of liability gives rise to the inference that the parties intended not to so limit coverage.");

Cruz v. County of Dupage, No. 96 C 7170, 1998 WL 832642, at *5-6 (N.D. Ill. Nov. 23, 1998) ("The language at issue states: 'ULTIMATE NET LOSS – . . . *which are paid as a consequence of any occurrence covered hereunder*.' . . . **The policy clearly separates out damages**, which Lloyd's is required to pay only after litigation on the merits or settlement, **from defense costs, which includes no such time limitations.**" (bold emphasis added)).

[10] *Towne Realty, Inc. v. Zurich Ins. Co.*, 201 Wis. 2d 260, 271 (Wis. 1996) ("The court of appeals held that Zurich is liable for all pre-tender expenses. We disagree. Zurich can only be liable for damages which 'naturally flow' from its breach of a contractual *duty.* **Zurich had no duty to defend until it had been put on notice that there was a claim against the Insureds.**" (bold emphasis added; citations omitted)).

[11] *Western Int'l Syndication Corp. v. Gulf Ins. Co.*, No. 05-55092, 2007 WL 625264, at *3 (9th Cir. Feb. 26, 2007).

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