The Emergence of Prejudice As a Necessary Element of an Insurer’s Late Notice Defense

An Analysis of NY Law

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For years, insurers have invoked the so-called “late notice” defense under New York law, with relatively frequent success, to deny insurance coverage to insureds in circumstances in which the insured provides notice that is not timely under New York’s traditional “no prejudice” rule. Under this “no prejudice” rule, an insurer generally need not show any prejudice suffered by the insurer as a result of an insured’s untimely notice of an occurrence or claim giving rise to liability. Insurers have been able to cite certain New York case law stating that, with a few exceptions, an insurer may avoid coverage if the insured’s notice was untimely on the theory that notice is a condition precedent to coverage under the policy. See, e.g., Security Mut. Ins. Co. v. Acker-Fitzgerald Corp., 293 N.E.2d 76, 78 (N.Y. 1972); American Home Assurance Co. v. International Ins. Co., 684 N.E.2d 14, 16 (N.Y. 1997). This insured-unfavorable rule of law, however, appears to be in the process of changing. Recent New York case law indicates a shift away from a “no prejudice” rule, and an even more recent proposed state statute would permit an insurer to deny insurance coverage only in circumstances in which the insurer could “demonstrate that it has suffered material prejudice as a result of the delayed notice.” For these reasons, New York clearly appears to be moving toward the large majority of other states, which require an insurer to demonstrate material prejudice as a predicate to avoiding coverage in the context of the late notice defense.

Many policyholders have their principal place of business in New York. Some policies have choice-of-law clauses specifying New York law, and even in the absence of such clauses insurers often argue for application of New York law. For these reasons, developments in New York insurance law can have great impact on insureds.

This article presents an overview of some of the recent favorable case law and legislation.

Overview of the ‘Late Notice’ Defense and Prejudice Issue

Most insurance policies, including standard-form “occurrence”-based commercial general liability (“CGL”) policies and “claims-made” policies, include a provision that, in some form, requires the insured to provide the insurer with notice of a claim brought against the insured, or notice of an occurrence that may result in a claim. The notice provision of an insurance policy specifies when the policyholder must inform its insurer of an occurrence, claim, or suit. The terms of a notice provision can be, and often are, different from policy to policy. A CGL policy, for example, may require notice “as soon as practicable.” Other policies may provide that the insured must give notice of an occurrence or accident “promptly,” “immediately,” or “as soon as possible.” Courts generally interpret these phrases to require that notice be given within a reasonable time, based on the particular facts and circumstances of the case. Thus, such notice of occurrence provisions generally are treated the same whether they call for notice “immediately” or “as soon as practicable.”

The consequences of an insured’s unexcused failure to comply with a notice requirement may vary widely depending on the applicable law and can be severe: specifically, forfeiture of an otherwise meritorious claim for insurance coverage.

A very substantial majority of states now clearly follows the modern “prejudice” rule, however, which provides that a policyholder’s untimely notice of an occurrence or claim does not result in a forfeiture of coverage absent a showing that the insurer has suffered material prejudice by the untimely notice. See, e.g., Brakeman v. Potomac Ins. Co., 371 A.2d 193, 198 (Pa. 1977).

In addition, several states have enacted statutory provisions to that effect. For example, Md. Ins. Code Ann., Ins. §19-110(2000), provides:

An insurer may disclaim coverage on a liability insurance policy on the ground that the insured or a person claiming the benefits of the policy through the insured has breached the policy by failing to cooperate with the insurer or by not giving the insurer required notice only if the insurer establishes by a preponderance of the evidence that the lack of cooperation or notice has resulted in actual prejudice to the insurer.
Similar statutes in other states include Cal. Ins. Code §11580.23 (West 1996) (prejudice requirement imposed in context of uninsured motorist benefits); Mass. Gen. L. ch. 175, §112 (1987) (applies only to accidents and occurrences happening after the effective date of the statute, i.e., Oct. 16, 1977); Okla. Stat. tit. 36, §1250.57(7) (1999) (definition of unfair claims practice includes prejudice requirement for insurer to invoke late notice “except where there is a time limit specified in the policy”); Utah Code Ann. §31A-21-312(2) (1995) (“Failure to give notice within time specified ... does not bar recovery under the policy if the insurer fails to show it was prejudiced by the failure”); Va. Code Ann. §38.2-2201(8) (Michie 1996) (prejudice requirement imposed in context of automobile liability coverage); Wis. Stat. Ann. §631.81(1) (West 1995) (part of chapter titled “Insurance Contracts Generally,” requires the insurer to prove prejudice if notice, though late, was given within one year after the time it was required by the policy) and §632.26(2) (part of chapter titled “Liability Insurance in General,” states that failure to give timely notice “does not bar liability under the policy if the insurer was not prejudiced”).

The rationale for requiring the insurer to prove that it was prejudiced by the insured’s untimely notice acknowledges the fact that “what is involved is a forfeiture, for the carrier seeks, on account of a breach of that [notice] provision, to deny the insured the very thing paid for.” Brakeman, 371 A.2d at 197.

Significantly, in most jurisdictions applying the “notice-prejudice” rule, the insurer has the burden of demonstrating prejudice as a result of an unreasonable delay in receiving notice. This has proven a very difficult hurdle for insurers to meet.

A minority of states apply the older rule that notice is a “condition precedent” to coverage requiring strict compliance. In these states, an excused delay in notice relieves the insurer of its duties to defend and indemnify, regardless of whether the delay prejudiced the insurer. The jurisdiction most commonly associated with this rule is New York.

Insurers have argued successfully in a number of (though by no means all) New York cases that coverage is completely forfeited in the event the policyholder provides notification of a claim that is “late” under a provision in the policy, without any need for the insurer to show that the allegedly “late” notice actually prejudiced or harmed the insurers’ legitimate interests in any way. Policyholders have as a result failed to obtain coverage for perfectly valid claims for which coverage would otherwise be available.

As discussed below, however, the recent New York case law indicates a shift away from a “no prejudice” rule. If current proposed legislation is signed, moreover, New York will be squarely in accord with its sister states in the very near term.

**A TREND TOWARD A PREJUDICE REQUIREMENT**

A number of New York cases indicate a trend toward requiring that an insurer demonstrate prejudice before avoiding coverage based on untimely notice.

In a relatively recent decision, for example, In re Brandon, 769 N.E.2d 810 (N.Y. 2002), the New York Court of Appeals, New York’s highest court, ruled that prejudice was a necessary element of an insurer’s late notice defense in circumstances in which the insured had notified its automobile insurer of an automobile accident but had delayed in giving notice of his own claim against the underinsured driver. Notably, in so ruling, the Court of Appeal signaled a potential willingness to consider the continued applicability of the “no prejudice” rule outside the context of exceptions for reinsurers and uninsured motorists as was at issue in Brandon. In particular, the Court of Appeals took note of the fact that New York stands alone in adhering strictly to the “no prejudice” rule and suggested that its holding could signal a broader shift to a prejudice requirement:

New York is one of a minority of States that still maintains a no-prejudice exception. Formerly a majority of states took this approach, but, as the Supreme Court of Tennessee noted when it recently adopted a prejudice requirement in a case involving a late notice of claim for uninsured motorist coverage, ‘the number of jurisdictions that still follow the traditional view has dwindled dramatically.’ Indeed, that court noted that in the preceding twenty years, only two States — New York and Colorado — had ‘considered the issue’ and ‘continued to strictly adhere to the traditional approach.’ Since then, Colorado adopted the majority rule, requiring insurers to demonstrate prejudice. Brandon, 769 N.E.2d at 813 n.3.

Following Brandon, the U.S. Court of Appeals for the Second Circuit found New York law to be uncertain as to whether the insurer must demonstrate prejudice from the insured’s untimely notice in the context of a claims-made malpractice policy in Varrichio v. Chicago Ins. Co., 312 F.3d 544 (2nd Cir. 2002). The Second Circuit in Varrichio deemed New York law “open” on the notice-prejudice question, stating that if it were to decide the case it would determine that the New York Court of Appeals would not apply the no-prejudice rule:

Were we to decide the case ourselves, we likely would conclude that the general principles that the New York Court of Appeals adopted in Brandon suggest that
that court would not apply the no-prejudice rule in the case before us. The Court of Appeals identified the traditional rationales for the no-prejudice rule as ‘the insurer’s need to protect itself from fraud by investigating claims soon after the underlying events; to set reserves; and to take an active, early role in settlement discussions.’ *Varrichio*, 312 F.3d at 549 (citing *Brandon*, 769 N.E.2d at 810).

The Second Circuit therefore certified the following question to the New York Court of Appeals, which may have assisted policyholders seeking to avoid forfeitures of coverage based on the late notice defense:

Where an insured has already complied with a policy’s notice of claim requirement, does New York require the insurer to demonstrate prejudice in order to deny coverage based on the insured’s failure to comply with the policy’s notice of suit requirement? *Id.* at 550.

Notably, the New York Court of Appeals accepted the certified question, which would have allowed the Court of Appeals to re-examine the continued viability of New York’s draconian “no prejudice” rule, see *Varrichio v. Chicago Ins. Co.*, 783 N.E.2d 895 (N.Y. 2002), but the certified question was withdrawn and the appeal dismissed following a confidential settlement stipulation between the parties. See *Varrichio v. Chicago Ins. Co.*, 328 F.3d 50 (2d Cir. 2003); *Varrichio v. Chicago Ins. Co.*, 790 N.E.2d 1190 (N.Y. 2003).

In other relatively recent rulings, the New York Court of Appeals applied the “no-prejudice” rule to the threshold requirement of notice of accident, but required a showing of prejudice for coverage to be denied based on late notice of the claim arising from the accident. See, e.g., *Rekemeyer v. State Farm Mut. Auto. Ins. Co.*, 828 N.E.2d 970 (2005). The Court of Appeals in *Rekemeyer* noted that the “no prejudice” rule actually is an exception to general contract principles, and held that in the absence of prejudice, the insurer would not be permitted to deny coverage:

Although this [no-prejudice] rule has sometimes been characterized as the ‘traditional rule,’ it is actually a limited exception to two established contract principles: (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 [requiring strict compliance] ordinarily will not be construed as a condition precedent absent clear language showing that the parties intended to make it a condition. The idea behind strict compliance with the notice provision in an insurance contract was to protect the carrier against fraud or collusion.

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The facts of the current case, while different from *Brandon*, also warrant a showing of prejudice by the carrier … Under these circumstances, application of a rule that contravenes general contract principles is not justified. Absent a showing of prejudice, [the insurer] should not be entitled to a windfall. Additionally, [the insurer] should bear the burden of establishing prejudice ‘because it has the relevant information about its own claims-handling procedures and because the alternative approach would saddle the policyholder with the task of proving a negative.’ *Id.* at 973-74 (citations omitted) (quoting *Unigard Sec. Ins. Co. v. North Riv. Ins. Co.*, 594 N.E.2d 571 N.Y. 1992)).

Even more recently, a few months ago, the New York intermediate appellate court in *New York Central Mutual Fire Ins. Co. v. Ward*, 833 N.Y.S.2d 182 (N.Y. App. Div. 2007) held that an insurer was not entitled to deny coverage based on the insured’s failure to timely submit a proof of claim form (a condition in the policy similar to the timely notice of claim provision). The court held that the insurer had failed to demonstrate that it was prejudiced by the insured’s failure to submit the proffered proof of claim form, and, thus, the insurer was barred from disclaiming coverage on the basis of the insured’s failure to comply with his contractual duties.

The insured in *Ward* argued that the notice of claim exception to the no-prejudice rule set forth by the court in *Rekemeyer* should now be extended to apply to proof of claim. The intermediate appellate court agreed with the insured.

In reaching its decision, the court noted an apparent trend away from a strict “no prejudice” rule:

This court has held that where an insurance policy is conditioned upon the insured’s timely completion and return of proof of claim forms, the insured’s failure to do so, or to have a reasonable excuse for the failure, is a breach of a condition precedent that vitiates coverage.

For many years, New York has followed the rule that an insured’s failure to provide timely notice of an accident relieves the carrier of its obligation to perform, regardless of whether it can demonstrate prejudice. This has been known as the no-prejudice rule. Recently, there has been a shift away from the no-prejudice rule. Since the issuance of the order and judgment appealed from in *Brandon*, the Court of Appeals has reaffirmed this shift away from the no-prejudice rule.

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Here, the facts, as in *Rekemeyer*, warrant a showing of prejudice by the insurance carrier. The petitioner did not meet this burden of showing that the appellant’s failure to comply with his contractual duties was prejudicial to it. Therefore, the petitioner was bound by its contractual duty to provide coverage for the appellan[(...)] 783 N.Y.S.2d 183-84 (emphasis added, citations omitted).

PROPOSED LEGISLATION WOULD REQUIRE MATERIAL PREJUDICE TO AVOID COVERAGE

Recently, both the New York State Assembly and Senate passed a bill addressing the “late notice” issue.
The New York bill, which is numbered A08363 in the Assembly and S06506 in the Senate, if signed by Governor Eliot Spitzer, would establish a “material prejudice” rule with respect to notice under all liability insurance policies. The Senate passed this legislation on June 20, 2007, and the Assembly passed the same piece of legislation on June 21, 2007. This legislation only requires signature by New York Governor Eliot Spitzer to become law.

The bill’s amendments to the New York Insurance Law would add a new §3451 to Article 34 (“Insurance contracts — property/casualty”) to address the “late notice” issue. According to the bill’s legislative history in the Assembly, “it is inherently unfair for an insurance company to deny a claim based on late notice, where in fact ... such late notice has no negative effect on the insurer’s ability to respond to the claim. Such denials amount to a windfall to the insurer based upon a technicality.”

The new §3451 contains the following provisions:

- **Insurer Must Show “Material Prejudice” to Deny Late Claims.** Under proposed §3451, the insurer “shall not deny coverage for a claim based on the failure of an insured to give timely notice of a claim unless [the insurer] is able to demonstrate that it has suffered material prejudice as a result of the delayed notice.” (emphasis added);

- **Rebuttable Presumption of No Prejudice.** The statute provides that “[e]vidence that such insurer had knowledge of the accident, loss, injury or death that is the subject of the claim” from various specified sources, creates a “rebuttable presumption that such insurer has not been prejudiced by delayed notice.”

- **Notice to Insurer’s Agent Sufficient.** The statute also states expressly that “[n]otice given to any licensed agent of such insurer in this state with particulars sufficient to identify the insured shall be deemed notice to such insurer.”

- **No Definition of “Material Prejudice.”** Proposed §3451 does not define the term “material prejudice.” Although courts presumably will have to apply that term on a case-by-case basis, the term should be construed liberally in favor of the policyholder under the terms of the statute (see below);

- **Liberal Construction.** The statute states expressly that the “provisions of this section shall be liberally construed in order to effectuate the purpose hereof which is to mitigate against the potential for procedural denial of insurance coverage resulting in unreasonable loss of insurance protection for claimants.”

The bill also states that §3451 “shall apply to all insurance contracts executed, issued, reissued or renewed on or after” the date of the bill and would be “applicable to all insurance coverage in the state issued pursuant to this article and to every insurance contract executed, issued, reissued or renewed on or after the effective date of this section by an authorized insurer subject to the provisions of this article,” except as provided in Article 51 (“Comprehensive motor vehicle insurance reparations”). The scope of Article 34 is such that §3451 would encompass at least third-party liability and first-party property policies.

The bill also would permit a third-party claimant against the policyholder to seek declaratory relief in the New York state courts directly against the insurer prior to the time that the third party’s underlying action against the policyholder is concluded.

As of press time, the bill is awaiting action by New York Governor Eliot Spitzer.

**CONCLUSION**

Signature by Governor Spitzer of the proposed legislation would be of significant benefit to policyholders and would bring New York “notice” law clearly into line with the law of the large majority of other states, at least with respect to policies executed, issued, reissued, or renewed on or after the bill’s effective date. If the bill does become law, however, it remains to be seen what effect it will have on insurer “late notice” defenses under policies issued prior to the effective time of the bill, and on cases in which the insurer alleges failure by the policyholder to satisfy a condition other than notice, such as a condition requiring the policyholder to cooperate with the insurer. Even if Governor Spitzer does not sign the proposed legislation, the perceptible trend in the case law appears to be toward requiring that an insurer make a showing of prejudice in order to establish a “late notice” defense to coverage.