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California Supreme Court Recognizes "Substantial Prejudice" Requirement as Fundamental California Public Policy

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Insurance Recovery

Can an insurance company covering a risk in California use a New York choice of law clause to circumvent California's pro-policyholder "notice of claim" rules?

On August 29, 2019, the California Supreme Court answered this long-simmering question with resounding "no," finding that California's notice-prejudice rule—which protects policyholders from forfeiture of coverage for technical breaches of their policy's notice conditions—is a "fundamental policy" of California that may override the state law designated in a choice of law provision. See *Pitzer College v. Indian Harbor Ins. Co.*, No. S23950 (Cal. Aug. 29, 2019). The ruling applies to breaches of all notice provisions, and to consent provisions in first party liability policies. As a result of the ruling, California courts must now apply the more lenient notice-prejudice rule to such breaches where California has a materially greater interest in the determination of the issue, even when the insurance policy designates another state's law as governing.

The California Supreme Court has made it significantly more difficult for insurance companies operating in California or issuing policies to California policyholders to receive a windfall merely by designating the less-favorable law of another state. *Pitzer* thus will help California policyholders (or policyholders with a connection to California) obtain coverage despite notice or consent disputes.

Background

Pitzer College was insured by Indian Harbor Insurance Company for legal and remediation expenses resulting from pollution conditions. In the process of constructing a new dormitory on campus, Pitzer discovered darkened soils that required environmental remediation. In order to complete the dormitory for the 2012-2013 academic year, Pitzer quickly arranged for lead removal on-site, which cost $2 million. Pitzer did not receive consent from Indian Harbor for the lead removal. Instead, Pitzer notified Indian Harbor of the remediation approximately three months after it was completed and six months after Pitzer had discovered the darkened soil.

Indian Harbor then denied coverage on the grounds that Pitzer did not: (1) give notice as soon as practicable as required by the policy's "notice of claim" provision; or (2) obtain its consent before commencing the remediation process as required by the policy's consent provision. Indian Harbor moved for summary judgment, claiming that it had no obligation to indemnify

Pitzer because Pitzer had violated the policy's notice and consent provisions and New York law—which was designated as governing the policy in its choice of law provision—did not require an insurer to demonstrate prejudice from such violations in order to deny coverage.

The district court agreed and granted the summary judgment motion. The district court also noted, however, that Indian Harbor could not have prevailed on this ground at summary judgment had it been required to show prejudice. The district court further noted that New York law applied only because Pitzer had failed to establish that California's notice-prejudice rule was a "fundamental policy" of the state. Pitzer appealed the summary judgment ruling to the Ninth Circuit, which then certified two issues to the California Supreme Court: (1) Is California's common law notice-prejudice rule a fundamental public policy for the purpose of choice of law analysis; and (2) if so, does the notice-prejudice rule also apply to breaches of an insurance policy's consent provision.

The California Supreme Court's Decision

The California Supreme Court reversed the district court and recognized for the first time that the notice-prejudice rule constitutes a "fundamental policy" of the state. Accordingly, under California's choice of law analysis, California courts will not enforce contractual choice of law provisions in an insurance policy designating the law of a state that does not apply the notice-prejudice rule with respect to the policy's notice provision where California's interest in the issue is materially greater than that of the chosen state. In that instance, the insurer may only avoid coverage based on a breach of the "notice of claim" provision when, "with timely notice, and notwithstanding a denial of coverage or reservation of rights, [the insurer] would have settled the claim for less or taken steps that would have reduced or eliminated the insured's liability."

The Court applied the same reasoning to consent provisions and held that it was a fundamental policy of California to apply a prejudice requirement to the denial of coverage for the breach of a consent provision in first party liability policies. The Court reasoned that the purposes of such provisions in first party policies "are much the same as those pertaining to notice" and so justify the application of the same rule. The Court reached a different conclusion, however, with respect to consent provisions in third party policies that include a duty to defend the insured like those providing commercial general liability and certain director and officers policies. In contrast to first party policies, third party policies with a duty to defend allow the insurer to control settlement negotiations and generally require the insurer to defend, settle, and pay damages claimed by a third party against the insured. The Court reasoned that the purposes of consent provisions in these types of policies are substantially different from those in first party policies, as third party consent provisions are "designed to ensure that responsible insurers that promptly accept a defense tendered by their insureds thereby gain control over the defense and settlement of the claim." Because the control of defense and settlement of claims is "paramount in the third party context," the Court held that the prejudice rule did not apply to the breach of a consent provision in that context. The Court did not specifically address whether the same reasoning would apply to a third party policy with no defense duty, but *dictum* later in the opinion suggests that it would not apply.

Implications for Policyholders

Whether and when California would recognize the notice-prejudice rule as a fundamental state policy has been a topic of discussion within the insurance bar for decades. Until *Pitzer*,

California decisions had stressed the importance of the rule, and in some cases characterized it as "strong" or "abiding" policy of the state, but had never recognized the doctrine as a fundamental policy for purposes of the choice of law analysis. *See, e.g.*, *Steadfast Ins. Co.*, 216 Fed. Appx. 662, 664 (9th Cir. 2007) (noting the "strong public policy behind [California's] notice-prejudice rule"). The California Supreme Court's acknowledgment of the "essentially semantic" difference between the "strong" and "fundamental" labels is a long-awaited clarification of California law.

The decision also represents a tangible benefit for California policyholders or policyholders with a strong connection to the state. Insurance companies have long sought to shield themselves from California law by insisting on choice of law provisions that designate the law of another state to govern, especially that of New York, which enforces "notice of claim" provisions literally, with no "prejudice" exception, in insurance policies issued to businesses and individuals who are not New York residents. In light of *Pitzer*, policyholders denied coverage based on the alleged breach of notice or consent provisions should carefully consider whether California has the greater interest in their coverage dispute—often the case for a California policyholder—and insist on the application of the notice-prejudice rule regardless of the state law designated in their policy.

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