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CLIENT ALERT

September 2019
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California Supreme Court holds that "Notice-Prejudice Rule" Is a "Fundamental Public Policy" of California for the Purpose of Choice of Law Determination

On August 29, 2019, the California Supreme Court issued a decision on an important issue to many insurance coverage disputes. In *Pitzer College v. Indian Harbor Insurance Co.*, the Court held that California's "notice-prejudice rule"—which requires an insurer to prove it was substantially prejudiced by an insured's untimely notice of a claim in order to deny coverage on that basis—is a "fundamental public policy" of California for the purpose of choice-of-law analysis. The Court also ruled that California's notice-prejudice rule applies to consent provisions contained in "first party" policies, which, among other things, cover an insured's costs arising from damage to its own property.

The Ninth Circuit certified two questions to the California Supreme Court in Pitzer's dispute with Indian Harbor: (1) Is California's common law notice-prejudice rule a fundamental public policy for the purpose of choice-of-law analysis? (2) If so, does the notice-prejudice rule apply to the consent provision of the insurance policy in the *Pitzer* case?

In *Pitzer*, the insurance policy contained a choice-of-law provision stating that New York law applied. The Court noted that under New York law, "policies issued and delivered outside New York [as is the case here] are subject to a strict no-prejudice rule under New York common law, which denies coverage where timely notice is not provided." Pitzer argued that this rule should not apply, but instead, a choice-of-law analysis should be invoked.

The Court analyzed applicable choice-of-law principles, which provide that when a choice-of-law provision is stated in an insurance policy, the parties' choice of law generally governs unless (1) it conflicts with a state's fundamental public policy, and (2) that state has a materially greater interest in the determination of the issue than the contractually chosen state.

The Court then agreed with Pitzer's argument that the notice-prejudice rule is a fundamental public policy for the purpose of choice-of-law analysis because, among other reasons, it protects the state's insureds from "technical forfeitures" of insurance coverage.

"The insurer establishes actual and substantial prejudice by proving more than delayed or late notice," Associate Justice Ming W. Chin wrote for the Court. "It must show 'a substantial likelihood that, with timely notice, and notwithstanding a denial of coverage or reservation of rights, it would have settled the claim for less or taken steps that would have reduced or eliminated the insured's liability.'" Justice Chin further noted,

"In the context of third party coverage, for example, the insurer must show that timely notice would have enabled it to achieve a better result in the underlying third party action."

Because the Court was limited to answering the Ninth's Circuit's certified question, it left it to that court to decide whether California has a materially greater interest than New York in determining the coverage issue, such that the policy's choice of law would be unenforceable because it is contrary to California's fundamental public policy. However, this decision has now eliminated an insurer's ability to simply designate another state's law in a policy issued to a California-based insured as a way to avoid California's notice-prejudice rule.

The Court then moved on to the second question—whether the notice-prejudice rule also applies to a "consent" provision in Pitzer's policy, which required the college to obtain Indian Harbor's permission before incurring any remediation expenses. In addition to its late notice defense, Indian Harbor also argued that Pitzer failed to obtain the insurer's consent before incurring such remediation expenses.

The Court held, as a matter of first impression, that the notice-prejudice rule is equally applicable to consent provisions in first-party policies. Justice Chin noted that "the notice-prejudice rule makes good sense for consent provisions in first party policies just as it does for notice provisions." Thus, a first-party insurer must prove it suffered prejudice in order to deny coverage due to an insured's breach of a consent provision.

However, the Court did not apply the notice-prejudice rule to consent clauses in third-party liability policies, which protect an insured against claims for property damage or bodily injury brought by a third party. It noted that third-party policies present somewhat different issues where the insurer's right to control the defense and settlement of claims is paramount.

Why this matters: *Pitzer* will have a huge impact on insurance cases, as insurers can no longer argue that choice-of-law provisions in their policies automatically preclude the applicability of California's notice-prejudice rule to California-based insureds. Moreover, insurers cannot continue to argue that the consent provisions in their first-party policies bar coverage unless they can prove that they were actually and substantially prejudiced by an insured's failure to obtain consent. Thus, this decision potentially can breathe new life into cases as California public policy is clear that forfeitures of coverage are to be avoided.

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