Capturing the Elusive Prejudice Standard: 4th Circuit Offers "Meaningful" Test

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When a policyholder breaches an insurance policy condition, that breach may not automatically result in a forfeiture of coverage. Depending on the law of the state, the policy type and the specific language at issue, an insurer may be required to show that its interests have been prejudiced by the breach in order to effectively deny coverage. The prejudice issue arises most often in the "late notice" context -- when a policyholder fails to report a claim to the insurance carrier within a specified time frame. Once a late notice breach has been established, in some instances, the insurer then has the burden of establishing prejudice.

The problem, however, is the difficulty in defining what "prejudice" actually means in this context. Is there a bright-line rule (*i.e.*, is a 3-month delay *per se* prejudicial)? Are there certain pre-notice events in the underlying litigation *(i.e.*, retention of defense counsel, the filing of a substantive motion, or the entry of a default judgment) that are indicia of prejudice? While courts addressing the prejudice issue have developed somewhat workable standards, the parties are often left guessing. For example, the Maryland Court of Appeals has recognized that "[i]t is very difficult to fashion a workable 'one size fits all standard" to define actual prejudice. *Allstate Insurance Company v. State Farm Mutual Automobile Insurance Company*, 767 A.2d 831, 841 (Md. 2001).

But a clearer standard may be emerging. On April 14, 2016, in *St. Paul Mercury Ins. Co. v. American Holdings, Inc*. (No. 15-1559), the United States Court of Appeals for the Fourth Circuit addressed the notice-prejudice issue, offering a standard rooted in a bedrock principle of insurance law: an insurance policy is a contract. In *American Holdings*, the policyholder American Bank Holdings, Inc. was served with a complaint on June 18, 2008, but did not tender notice to St. Paul Mercury Insurance Company until February 25, 2009, a roughly eight-month delay. Prior to noticing the claim to St. Paul, American Holdings spent $1.8 million in legal fees vacating a $98.5 million default judgment that had been entered against it.

The insurance policy provided that:

The Insureds shall, as a condition precedent to their rights under this Policy, give to the Insurer written notice of any Claim made against the Insureds as soon as practicable, but in no event later than: (a) sixty (60) days after expiration of the Policy Year in which the Claim was first made . . .

The policy also provided that St. Paul:

[S]hall have the right and shall be given the opportunity to effectively associate with, and shall be consulted in advance by, [American Bank] regarding: (a) the selection of appropriate defense counsel; (b) substantive defense strategies,

including decisions regarding the filing and content of substantive motions; and (c) settlement negotiations.

St. Paul denied coverage on late notice grounds, and filed a complaint for declaratory judgment that it had no duty to pay for American Bank's defense. American Bank filed a counterclaim for declaratory judgment, and the parties filed cross-motions for summary judgment. The United States District Court for the District of Maryland held that St. Paul correctly denied coverage because American Bank did not provide St. Paul with notice "as soon as practicable," as required by the insurance policy, and because the late notice prejudiced St. Paul (Maryland law requires that an insurer "establish by a preponderance of the evidence that the lack of . . . notice has resulted in actual prejudice to [it]." Md. Code Ann., Ins. §19-110). The court concluded that American Bank's late notice precluded St. Paul from exercising its contractual rights under the policy to participate in American Bank's defense and advance credible defense strategies.

On appeal, the Fourth Circuit agreed and affirmed the District Court's decision. The court held that St. Paul was "denied the opportunity to involve itself in considering the possibility of settlement negotiations . . . prior to the default judgment and prior to the expenditure of $1.8 million incurred by American Bank to vacate it." The court noted that American Bank's late notice "denied St. Paul Insurance the opportunity to participate in the selection of counsel, to speak with counsel, and to discuss credible defense strategies for dismissing [the lawsuit] before the default judgment." The court concluded: "when a late notice precludes an insurer from exercising meaningful contractual rights provided to it by the policy – in this case, all the contractual rights – we agree with the district court that the insurer has suffered actual prejudice."

American Bank's failure to provide notice to St. Paul until after a $98.5 million default judgment had been entered against it – even though the default was subsequently vacated after American Bank spent $1.8 million in legal fees – was certainly a significant factor in the court's decision. The Fourth Circuit's holding nevertheless offers a straightforward approach to measuring prejudice. While the court focused on St. Paul's inability to consider the possibility of settlement negotiations, insurance policies contain a host of "meaningful" contractual rights, including the selection of defense counsel and defense strategies. Under this standard, an insurer may suffer prejudice when, for example, a policyholder's late notice prevents the insurer from selecting defense counsel, or making decisions regarding defense strategies such as the filing of substantive motions. At the same time, however, the decision might also beg the question of what is a "meaningful" contractual right as opposed a "non-meaningful" contractual right. Notwithstanding, while it will always be difficult to fashion a "one size fits all" test for prejudice, the "meaningful contractual rights" standard might be a step in the right direction.

If you have questions or would like additional information on this topic, please contact Greg Steinberg (steinbergg@whiteandwilliams.com; 212.714.3066) or another member of the Insurance Coverage Group.