

June 1994

Insurer Prejudice Analysis of an Expanding Doctrine in Insurance Coverage Law

Richard L. Suter

Follow this and additional works at: <https://digitalcommons.mainerlaw.maine.edu/mlr>



Part of the [Consumer Protection Law Commons](#), [Contracts Commons](#), and the [Insurance Law Commons](#)

Recommended Citation

Richard L. Suter, *Insurer Prejudice Analysis of an Expanding Doctrine in Insurance Coverage Law*, 46 Me. L. Rev. 221 (1994).

Available at: <https://digitalcommons.mainerlaw.maine.edu/mlr/vol46/iss2/4>

This Article is brought to you for free and open access by the Journals at University of Maine School of Law Digital Commons. It has been accepted for inclusion in Maine Law Review by an authorized editor of University of Maine School of Law Digital Commons. For more information, please contact mdecrow@maine.edu.

INSURER PREJUDICE: ANALYSIS OF AN EXPANDING DOCTRINE IN INSURANCE COVERAGE LAW

Richard L. Suter*

I. INTRODUCTION

All contracts of insurance place certain requirements on the insured both before and after a covered loss has occurred.¹ For example, all insurance policies require that an insured notify the insurer of a covered loss and cooperate with the insurer in the investigation of the loss and in the pursuit or defense of any claims arising out of the loss. Traditionally, if an insured failed to comply with such notification or cooperation requirements, the insurer could flatly deny coverage of the claim.² Recently, however, an increasing number of courts are requiring that the insurer show that it has been prejudiced in some way before it can deny coverage for the insured's failure to comply with such requirements.³ This requirement of showing prejudice will be referred to in this article as the insurer prejudice rule.

In Maine, the insurer prejudice rule was first recognized in a limited context in 1985.⁴ The application of the insurer prejudice rule in Maine remained limited until the Maine Supreme Judicial Court, sitting as the Law Court, suggested in *Marquis v. Farm Family Insurance Company*⁵ that the rule must be applied in all situations where an insurer has denied coverage based on the insured's failure to comply with any procedural requirement placed on the insured by the insurance policy.⁶ Although placing great limitations upon insurers, the broad application of the insurer prejudice rule, established in *Marquis*, is justified both by public policy considerations

* Associate, Litigation Practice Group, Preti, Flaherty, Beliveau & Pachios, Portland, Maine; B.S., United States Military Academy, 1984; J.D., Temple Law School, 1992.

1. See *infra* notes 55-78 and accompanying text for a discussion of the various policy provisions which place procedural requirements on an insured.

2. See *infra* notes 27-32 and accompanying text for a discussion of the traditional rule concerning denial of coverage for an insured's breach of such policy provisions.

3. See *infra* note 53 and accompanying text.

4. See *infra* notes 28-43 and accompanying text for a discussion of the initial recognition of the insurer prejudice rule in Maine. In Maine, the insurer prejudice rule originated in and remains part of the common law. It should be noted that some jurisdictions recognizing the insurer prejudice rule have codified the rule. See, e.g., MD. CODE ANN. INS. § 482 (1993); 1977 MASS. ACTS ch. 437; WIS. STAT. § 631.81 (1980).

5. 628 A.2d 644 (Me. 1993).

6. See *infra* notes 44-54 and accompanying text for a discussion of the expansion of the insurer prejudice rule in Maine.

and the principles of contract law concerning partial or immaterial breach.⁷ These same principles which support placing the burdens and limitations of the insurer prejudice rule on insurers, however, also support certain contractual remedies which are not generally recognized by the courts or pursued by insurers.⁸ Thus, in order for the insurer prejudice rule to be equitable to insureds and insurers alike, insurers must be permitted to take advantage of these remedies.

Since the scope of the insurer prejudice rule appears to be expanding in Maine and elsewhere, it is increasingly more important for both insurers and insureds to understand the various aspects and implications of the rule. This Article will provide an analysis of the insurer prejudice rule, beginning in Section II with a discussion of the definition of prejudice used when interpreting or applying the rule. In Section III, the Article will examine the inception and development of the rule in the State of Maine. Section IV will discuss the various policy provisions to which the rule theoretically applies in Maine and address certain issues of proof which have been associated with the rule. Three recognized exceptions to the insurer prejudice rule will be discussed in Section V. The analysis will conclude in Section VI with a discussion of the rationales supporting the rule and the potential insurer remedies which logically arise from it.⁹

II. WHAT IS PREJUDICE?

In order to understand and apply the insurer prejudice rule, it is essential to define the concept of "prejudice." An examination of case law indicates that courts have failed to develop a broadly recognized, comprehensive definition of the term. Many courts apply the insurance prejudice rule without supplying any definition whatsoever for the concept.¹⁰ Most courts, however, have developed a limited definition of prejudice which is based on and applied to the spe-

7. See *infra* notes 102-107 and accompanying text for a discussion of the rationales supporting the insurer prejudice rule.

8. See *infra* notes 108-121 and accompanying text for a discussion of insurer remedies which should accompany the rule.

9. This Article will discuss the insurer prejudice rule only as it applies to post-contract procedural requirements in insurance policies. The Article will not discuss pre-contract procedural requirements to which a similar insurer prejudice rule is also applied (*i.e.*, most courts require that an insurer prove prejudice before it denies coverage for the insured's misrepresentations or omissions on the application for insurance). See *Mutual Benefit Life Ins. Co. v. JMR Elecs. Corp.*, 848 F.2d 30, 32-33 (2d Cir. 1988); *Dukes v. South Carolina Ins. Co.*, 770 F.2d 545, 549 (5th Cir. 1985); *In re Epic Mortgage Ins. Litig.*, 701 F. Supp. 1192, 1242 (E.D. Va. 1988); *American Home Assurance Co. v. Ingeneri*, 479 A.2d 897, 899-901 (Me. 1984); *Powell v. Time Ins. Co.*, 382 S.E.2d 342, 350 (W. Va. 1989).

10. See, *e.g.*, *Johnson Controls, Inc. v. Bowes*, 409 N.E.2d 185, 187 (Mass. 1980); *Pickwick Park Ltd. v. Terra Nova Ins. Co.*, 602 A.2d 515, 518 (R.I. 1992).

cific facts presented in the case before the court.¹¹ A general comprehensive definition of prejudice can be developed, however, if the various cases applying the insurer prejudice rule are considered as a whole.

Generally speaking, an insurer is prejudiced by an insured's breach of a policy requirement when the purposes of the breached policy requirement are defeated.¹² Thus, to apply this comprehensive definition of insurer prejudice, one must first understand the purposes underlying the breached policy requirement. Since essentially all procedural requirements placed on an insured in any given insurance policy can be described as requiring some aspect of cooperation from the insured, the purposes of the various provisions significantly overlap.¹³ As most reported case law deals with the notice requirements in property and liability insurance contracts, these cases are a good reference for understanding the general purposes underlying procedural requirements which prescribe various aspects of cooperation from the insured.

Courts have identified many purposes for notice provisions in insurance policies. Prompt notice allows the insurer to properly investigate¹⁴ and evaluate claims. Timely notification is essential because of the evanescent nature of evidence. Locating witnesses, acquiring physical evidence, and obtaining accurate testimony all become more difficult with the passage of time.¹⁵ An insurer also requires prompt notice in order to weed out fraudulent claims.¹⁶ As time passes, fraud becomes more difficult to discover and prove. Timely notification also allows the insurer to properly evaluate its position

11. See, e.g., *Select Ins. Co. v. The Superior Court of San Diego County*, 276 Cal. Rptr. 598, 601 (Cal. Ct. App. 1990) (concerning breach of notice requirement—prejudice occurs if the insurer would have acted differently had it received timely notice); *Commercial Union Assurance Cos. v. Monadnock Regional Sch. Dist.*, 428 A.2d 894, 896 (N.H. 1981) (concerning breach of notice requirement—insurer's lost opportunity to contact witnesses and obtain fresh, uninfluenced statements constituted prejudice); *Pennsylvania Gen. Ins. Co. v. Becton*, 475 A.2d 1032, 1035 (R.I. 1984) (concerning breach of notice requirements—insurer's inability to have the claimant examined by a physician of his choice and to investigate the claim fully amounted to prejudice); *State Farm Mut. Auto. Ins. Co. v. Davies*, 310 S.E.2d 167, 168 (Va. 1983) (concerning breach of cooperation clause—insured's failure to assist in the preparation for trial and failure to attend the trial constituted prejudice).

12. See BARRY R. OSTRAGER AND THOMAS R. NEWMAN HANDBOOK ON INSURANCE COVERAGE DISPUTES, at 98 (5th ed. 1992); *Great American Ins. Co. v. C. G. Tate Constr. Co.*, 265 S.E.2d 467, 473 (N.C. Ct. App. 1980).

13. *Indiana Ins. Co. v. Williams*, 448 N.E.2d 1233, 1236 (Ind. Ct. App. 1983) (“[c]ooperation clause provisions and notice provisions have the same purpose and effect.”).

14. See *Aetna Casualty and Surety Co. v. Murphy*, 538 A.2d 219, 223 (Conn. 1988).

15. See *Kolbeck v. Rural Mut. Ins. Co.*, 235 N.W.2d 466, 469 (Wis. 1975).

16. See, e.g., *Steinbach v. Aetna Casualty and Surety Co.*, 440 N.Y.S.2d 637, 642 (1981).

and determine its rights and liabilities.¹⁷ The insurer requires early control over a claim to explore the option of settlement¹⁸ and, if necessary, to prepare an adequate defense. Prompt notice also allows the insurer to maintain adequate reserves and establish more accurate renewal premiums.¹⁹ Finally, a fully informed insurer can take steps to eliminate or reduce losses from similar risks in the future.²⁰ This ability to control future losses would apply not only to the insured who suffered the original loss, but to all other insureds with similar loss exposures as well.

Insurer prejudice has been found to exist when one or more of the purposes of the breached policy provision has been frustrated. For example, prejudice has been found where:

1. The insurer was unable to properly investigate the claim;²¹
2. The insurer's ability to settle the claim was hampered;²²
3. The insurer was unable to prepare an adequate defense;²³ and
4. The insurer was unable to participate in decisions to adopt corrective actions.²⁴

As with cases dealing with notice requirements, courts have generally found insurer prejudice in cooperation clause cases in situations where one or more of the purposes of the cooperation requirement has been defeated.²⁵ A cooperation clause generally requires the insured to cooperate with the insurer in the defense of a claim or in pursuing subrogation. It has been said that the purposes of a cooper-

17. *D.C.G. Trucking Corp. v. Zurich Ins. Co.*, 440 N.Y.S.2d 74, 75-76 (1981).

18. *Steinbach v. Aetna Casualty and Surety Co.*, 440 N.Y.S.2d at 642.

19. *E.g.*, *Commercial Union Ins. Co. v. International Flavors & Fragrances, Inc.*, 822 F.2d 267, 271 (2d Cir. 1987); *Utica Mut. Ins. Co. v. Fireman's Fund Ins. Cos.*, 748 F.2d 118, 121 (2d Cir. 1984).

20. *Commercial Union Ins. Co. v. International Flavors & Fragrances, Inc.*, 822 F.2d at 271.

21. *Kermans v. Pendleton*, 233 N.W.2d 658, 661 (Mich. Ct. App. 1975) (where homeowner's insurer not notified of shooting until three years after incident, court found insurer had no opportunity to physically examine victim or determine if there were any viable affirmative defenses).

22. *Commercial Union Assurance Cos. v. Monadnock Reg. Sch.*, 428 A.2d 894, 896 (N.H. 1981) (liability insurer's inability to establish cooperative relationship with claimant due to delay in notice recognized as factor in court's finding of prejudice).

23. *See Ratcliff v. National County Mut. Fire Ins. Co.*, 735 S.W.2d 955, 958-59 (Tex. Ct. App. 1987) (auto liability insurer first notified of suit after default judgment already entered).

24. *Steelcase, Inc. v. American Motorists Ins. Co.*, U.S. Dist. LEXIS 17028 (W.D. Mich. 1989), *aff'd*, 907 F.2d 151 (6th Cir. 1990) (when insurer not notified of chemical spill until two years later, court found insurer had right to approve and participate in clean-up efforts and failure to comply with notice provisions materially prejudiced insurers and released them from liability under the policies).

25. *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Davies*, 310 S.E.2d 167, 168 (Va. 1983). *But see United States Fidelity & Guaranty Co. v. Perez*, 384 So. 2d 904, 905 (Fla. Dist. Ct. App. 1980) (even though purpose of cooperation clause was frustrated by insured's failure to testify, court found no prejudice due to the fact that insured's testimony could not possibly have been beneficial to the insurer).

ation clause are, inter alia, to prevent any collusion between the insured and a third-party claimant, to discover fraudulent claims, and to avoid over-payment in cases of warranted claims.²⁶ Although extensive case law does not exist concerning many other procedural requirements found in insurance policies, the existence of prejudice can likewise be determined by establishing the purpose for the specific policy provision and analyzing whether this purpose has been frustrated by the insured's breach of the provision.

III. DEVELOPMENT OF THE INSURER PREJUDICE RULE IN MAINE

Traditionally, in Maine, an insurer was able to flatly deny coverage of a loss if an insured failed to comply with a procedural requirement contained in the insurance contract.²⁷ In 1985, the Maine Supreme Judicial Court, sitting as the Law Court, issued its opinion in *Ouellette v. Maine Bonding & Casualty Co.*²⁸ In this case, the insureds notified their uninsured motorist insurance carrier about an automobile accident and their resulting injuries approximately four years after the accident occurred.²⁹ The insurer denied coverage for the claim based on a provision in the insurance policy which required that the insureds notify the insurer "promptly of how, when and where the accident or loss happened."³⁰ In reviewing the propriety of this denial of coverage, the Law Court recognized that pursuant to the traditional rule, an insurer was not required to show that it was prejudiced by an insured's unreasonable or unexplained delay in giving notice.³¹ The *Ouellette* court commented that "[t]he theory behind the traditional rule is that an insurance policy is a contract and the delay in giving notice constitutes a breach of contract, making the presence or absence of prejudice to the insurer immaterial."³² The court noted, however, that other jurisdictions had aban-

26. *Watson v. Jones*, 610 P.2d 619, 624 (Kan. 1980); ROWLAND H. LONG, 2 THE LAW OF LIABILITY INSURANCE, § 14.01, at 14-3 (1993).

27. See, e.g., *Whalen v. Equitable Accident Co.*, 99 Me. 231, 234-35 (1904) (failure to comply with notice requirement); *Heywood v. Maine Mut. Accident Ass'n*, 85 Me. 289, 293 (1893) (failure to comply with notice requirement); *Gates Formed Fiber Products, Inc. v. Imperial Casualty & Indem. Co.*, 702 F. Supp. 343, 348 (D. Me. 1988) (breach of cooperation clause); *Wheeler v. Lumbermen's Mut. Casualty Co.*, 5 F. Supp. 193, 197 (D. Me. 1933) (breach of cooperation clause). But see *Camire v. Commercial Ins. Co.*, 160 Me. 112, 122 (1964) (suggesting that some damage must result for insurer to deny coverage for lack of cooperation); *Medico v. Employers Liab. Assurance Corp.*, 132 Me. 422, 427 (1934) (requiring substantial prejudice before insurer can use the defense of non-cooperation of the insured against injured parties).

28. 495 A.2d 1232 (Me. 1985).

29. *Id.* at 1233. Essentially, uninsured motorist coverage provides an insured a source of recovery should the insured become involved in an accident tortiously caused by an uninsured driver.

30. *Id.*

31. *Id.* at 1234.

32. *Id.*

done this traditional rule and were considering whether the insurer had been prejudiced by the delay.³³ The *Ouellette* court recognized that the rationale for abandoning the traditional rule was that an insurance contract was typically not a "negotiated agreement" but rather a "contract of adhesion," with terms dictated by the insurance company.³⁴ The court recognized that the traditional rule would often result in "an undeserved windfall to the insurer."³⁵ Based on its analysis, the *Ouellette* court adopted the rule that a liability insurer must not only show that a notice provision was in fact breached but also that the insurer was prejudiced by such breach, placing the burden of proof on the insurer to establish prejudice.³⁶ The court also noted that the issue of prejudice was generally a question of fact.³⁷

Two years later, in *Lanzo v. State Farm Mutual Automobile Insurance Co.*,³⁸ the Maine Law Court, applying *Ouellette*, ruled that an insurer who failed to present any evidence of prejudice could not deny coverage for its insured's breach of the notice requirements.³⁹ This ruling reinforced the court's previous holding in *Ouellette* that the burden of showing prejudice rests with the insurer. The Law Court next addressed the issue of insurer prejudice in *Maine Mutual Fire Insurance Co. v. Watson*.⁴⁰ In this case, a property insurer had denied coverage for a loss because the insured had not complied with a policy provision that required that the insurer be provided with a proof of loss within sixty days after the loss.⁴¹ The insurer argued that this proof of loss provision was a condition precedent to recovery for any loss under the policy.⁴² On review, however, the Law Court held that coverage was appropriate in this instance, because, inter alia, the insurer "failed to show that it was in any way prejudiced by the late filing of the proof of loss claim."⁴³

Following *Ouellette*, *Lanzo*, and *Watson*, the insurer prejudice rule appeared to be limited to notice and proof of loss requirements only.⁴⁴ The Maine Law Court, however, greatly expanded the scope

33. *Id.* at 1235.

34. *Id.* A "contract of adhesion" may be defined as a standard-form, printed contract submitted on a "take it or leave it" basis. See, e.g., *Dairy Farm Leasing Co. v. Hartley*, 395 A.2d 1135, 1139 n.3 (Me. 1978).

35. *Ouellette v. Maine Bonding & Casualty Co.*, 495 A.2d at 1235.

36. *Id.*

37. *Id.*

38. 524 A.2d 47 (Me. 1987).

39. *Id.* at 50.

40. 532 A.2d 686 (Me. 1987).

41. *Id.* at 687.

42. *Id.* at 688.

43. *Id.* (citing *Ouellette v. Maine Bonding & Casualty Co.*, 495 A.2d 1232 (Me. 1985)).

44. See *Gates Formed Fibre Products, Inc. v. Imperial Casualty & Indem. Co.*, 702 F. Supp. 343, 348 (D. Me. 1988) (finding that Maine law did not require a showing of

of the insurer prejudice rule in Maine through its 1993 decision in *Marquis v. Farm Family Insurance Company*.⁴⁵ In *Marquis*, the insured had made a claim to his property insurer for damages arising out of a fire.⁴⁶ As a result of its initial investigation, the insurer requested that the insured submit to an examination under oath and produce documents relating to the claimed losses.⁴⁷ Shortly thereafter, the insured was indicted on two counts of arson by a grand jury.⁴⁸ The insured notified the insurer that he would not submit to an examination under oath until the completion of the criminal proceedings.⁴⁹ The insurer then rejected the insured's claim in its entirety due to his failure to submit to the examination under oath as required by the policy.⁵⁰

In reviewing this denial of coverage, the *Marquis* court held that the insurer was required to demonstrate prejudice as a result of the insured's postponement of this examination under oath.⁵¹ In addition to this specific holding on the facts of the case before it, however, the *Marquis* court also suggested that insurer prejudice must be demonstrated before the insurer is relieved from its obligation to cover a loss based on the insured's failure to comply with any procedural requirement in the insurance policy.⁵² Therefore, following *Marquis*, the insurer prejudice rule in Maine arguably applies not only to notice requirements, proof of loss requirements, and examination under oath requirements, but also to any and all insurance policy provisions that require the insured's cooperation in any way or that are procedural in nature.⁵³ It should be noted that the grad-

prejudice before an insurer could deny coverage based on breach of a cooperation clause in a comprehensive general liability policy).

45. 628 A.2d 644 (Me. 1993).

46. *Id.* at 646.

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* at 649.

52. *Id.* at 650 (citing *Pickwick Park, Ltd. v. Terra Nova Ins. Co.*, 602 A.2d 515, 520 (R.I. 1992) and *Bowyer by Bowyer v. Thomas*, 423 S.E.2d 906, 910-11 n.9 (W. Va. 1992)).

53. A discussion of Maine case law on the insurer prejudice rule would not be complete without mention of a recent federal case on the topic. In *State Farm Mut. Automobile Ins. Co. v. Lucca*, CIV. No. 93-0082-B (Nov. 30, 1993), the United States District Court for the District of Maine ruled that State Farm had no duty to defend or indemnify its insured because twenty-two months had elapsed before the insured provided State Farm with notice of an automobile accident. *Id.* at 3. To overcome the insurer's burden of showing prejudice from the delay in notice, a State Farm investigator testified that the delay made it impossible for State Farm to investigate either of the vehicles involved in the collision, to interview witnesses while their memories were fresh, or to do a prompt, independent medical examination of the claimant. *Id.* Due to the fact that the insured offered no contradictory evidence on the issue of prejudice, the court held that the issue could be decided in State Farm's favor as a

ual expansion of the scope of the insurer prejudice rule in the State of Maine reflects a national trend in this area of insurance coverage law.⁵⁴

IV. SCOPE AND DETAILS OF THE INSURER PREJUDICE RULE

A. *Various Policy Provisions to Which the Insurer Prejudice Rule Applies*

The insurer prejudice rule in Maine now appears to apply whenever an insurer attempts to deny coverage based on the insurer's breach of *any* procedural requirement or, in other words, *any* policy provision that requires the insurer's cooperation in *any* way. It is surprising to note just how many standard insurance policy provisions fall within this description. Although there are procedural and cooperation requirements placed on the insured in every type of insurance policy, for purposes of brevity, this Article will examine three types of standard insurance policies: (1) a comprehensive general liability insurance policy, (2) property coverage in a businessowner's policy, and (3) a personal automobile insurance policy.⁵⁵

The standard comprehensive general liability insurance policy contains numerous procedural requirements which are primarily found under the "Conditions" section of the policy. Under this section the insured is required to allow the insurer to inspect its property and operations at any time.⁵⁶ The insured must also allow the insurer to examine and audit its books and records at any time during the policy period.⁵⁷ In the event of an occurrence, the insured must provide written notice to the insurer "as soon as practicable" providing the name and address of the injured party and of all available witnesses.⁵⁸ If a suit is ultimately filed, the insured must "immediately" forward the suit papers to the insurer.⁵⁹ The insured is required to cooperate with the insurer and, upon request, assist in making settlements, conducting litigation, and enforcing any right of

matter of law. *Id.* at 4.

54. See BARRY R. OSTRAGER AND THOMAS R. NEWMAN, *HANDBOOK ON INSURANCE COVERAGE DISPUTES* 63, 97 (5th ed. 1992); Charles C. Marvel, *Modern Status of Rules Requiring Liability Insurer to Show Prejudice to Escape Liability because of Insured's Failure or Delay in Giving Notice of Accident or Claim, or in Forwarding Suit Papers*, 32 A.L.R. 4th 141, 145 (1984); ROLAND H. LONG, 2 *THE LAW OF LIABILITY INSURANCE* 14-23 to 14-24 (1993).

55. All citations to standard insurance policy language are taken from SUSAN J. MILLER AND PHILIP LEFEBVRE, *MILLER'S STANDARD INSURANCE POLICIES ANNOTATED* (1988). It should be noted that this treatise provides annotations and commentary to the Insurance Service Office, Inc.'s standard property and casualty insurance policies which are widely utilized in the American insurance industry. *Id.* at 1.

56. *Id.* at 409.

57. *Id.* at 410.

58. *Id.*

59. *Id.*

contribution or indemnity. Specifically, the insured must attend hearings and trials and assist in securing witnesses. The insured may not voluntarily make any payment, assume any obligation, or incur any expense other than first-aid at the time of the accident.⁶⁰ In the event that the insurer makes a payment under the policy, the insured is required to cooperate if a subrogation action is pursued. The insured may do nothing after the loss to prejudice the insurer's subrogation rights.⁶¹ Finally, an insured may not assign its interest under the policy without the consent of the insurer.⁶²

Concerning property coverage in a standard businessowner's policy, procedural requirements can be found in the "Common Policy Conditions" section and also in the "Property Loss Conditions" section of the "Property Coverage Form." Under these sections an insured may not intentionally conceal or misrepresent any material facts concerning the policy, covered property, the insured's interest in the covered property, or any claims under the policy.⁶³ The insured must also allow the insurer to examine and audit its books and records at any time during the policy period and up to three years thereafter.⁶⁴ The insured must allow the insurer to make inspections and surveys, accept reports on the conditions found, and accept recommended changes.⁶⁵ In the event that the insurer decides to pursue subrogation, the insured must cooperate.⁶⁶ Rights and duties of the insured under the policy may not be transferred without the insurer's consent.⁶⁷ An insured may not abandon property to the insurer.⁶⁸ If a loss occurs to covered property, the insured must comply with the following requirements:

- a. Notify the police if a law may have been broken.
- b. Give the insurer "prompt" notice of the loss, including a description of the damaged property.
- c. Provide the insurer "as soon as possible" a description of how, when, and where the loss occurred.
- d. Take all reasonable steps to protect the covered property from further damage.
- e. At the insurer's request, provide a complete inventory of covered property.
- f. Allow the insurer to inspect the property and to take samples

60. *Id.*

61. *Id.* Once an insurer makes payment to an insured under a policy, the insurer is typically permitted to bring suit in the insured's name against any liable parties to recover such payment. This is generally referred to as a right of subrogation. See ME. R. Civ. P. 17.

62. MILLER'S STANDARD INSURANCE POLICIES ANNOTATED, *supra* note 56, at 410.

63. *Id.* at 484.

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.* at 507.04.

- of damaged property for inspection, testing and analysis.
- g. Submit to an examination under oath if requested by the insurer.
 - h. Provide the insurer with a signed, sworn statement of loss within sixty days after request.
 - i. Cooperate with the insurer in the investigation or settlement of the claim.
 - j. Resume all or part of the insured's "operations" as quickly as possible.⁶⁹

Procedural requirements in the standard personal automobile insurance policy may be found in "Part E—Duties After An Accident Or Loss" and "Part F—General Provisions." In these sections, an insured is required to notify the insurer "promptly" of how, when, and where an accident or loss happened. Names and addresses of injured persons and witnesses must also be provided.⁷⁰ The insured must cooperate with the insurer's efforts in investigating, settling or defending any claim or suit. Furthermore, the insured must "promptly" send the insurer suit papers and submit as often as reasonably required to physical examinations and examinations under oath. Also, the insured must authorize the insurer to obtain medical reports and other pertinent records and must submit a proof of loss statement when required by the insurer.⁷¹ The insured may not voluntarily make any payment or assume any obligation, or incur any expense other than first-aid at the time of the accident.⁷² If the insured is making an uninsured motorist claim, the insured must promptly notify the police if a hit-and-run driver is involved and send the insurer copies of legal papers if the insured brings suit.⁷³ If seeking coverage for property damage to an automobile, the insured must take reasonable steps after a loss to protect the vehicle from further damage. The police must be notified if the vehicle is stolen. The insured must permit the insurer to inspect and appraise any damage to a covered vehicle prior to its repair or disposal.⁷⁴ No coverage is provided to insureds who make fraudulent statements or engage in fraudulent conduct.⁷⁵ Finally, insureds may not assign their rights and duties under the policy without the insurer's written consent.⁷⁶

As this brief outline of these three standard policies reveals, insurance contracts place numerous and detailed procedural requirements on the insured. Based on the Maine Law Court's decision in

69. *Id.* at 507.04-507.05.

70. *Id.* at 10.1.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.* at 10.2.

Marquis, a Maine insurer could not deny coverage for the insured's breach of any of the above-described or similar policy provisions unless the insurer could show that it was somehow prejudiced by the breach. A mere showing that the insurer was forced to incur significant additional costs as a result of the breach may not be sufficient to meet this burden of showing that the purpose of the policy provision has been defeated by the insured's actions.

Although it is beyond the scope of this Article to discuss the issue in great detail, it should be noted that the insurer prejudice rule has also been held applicable to procedural and cooperation requirements in excess insurance policies and reinsurance contracts.⁷⁷

B. Standards and Manner of Proof

Maine law dictates that the insurer has the burden of proving not only that the insured breached the procedural requirement in the policy, but also that the insurer was prejudiced by such breach.⁷⁸ A placement of the burden of proof on the insurer in such instances reflects the law of the majority of American jurisdictions.⁷⁹ The rationale for placing the burden of proof on the insurer is two-fold. First, the insurer is encouraged to make a prompt preliminary investigation once it is given a delayed notification of a claim.⁸⁰ Second, because the insurer is an expert in investigating accidents, it is in a much better position to determine whether it has been prejudiced by any delay.⁸¹

In Maine, and elsewhere, the issue of insurer prejudice is typically a question of fact.⁸² Some courts have held that under certain cir-

77. See, e.g., *State Farm Mut. Auto. Ins. Co. v. Stanley*, 966 F.2d 628, 630 (11th Cir. 1992) (notice requirement in excess insurance policy); *Insurance Co. of Pennsylvania v. Associated Int'l Ins. Co.*, 922 F.2d 516, 524 (9th Cir. 1990) (notice requirement in reinsurance contract); *Security Mut. Casualty Co. v. Century Casualty Co.*, 531 F.2d 974, 978 (10th Cir. 1976) (notice requirement in reinsurance contract); *Olin Corp. v. Insurance Co. of North America*, 771 F. Supp. 76, 79 (S.D. N.Y. 1991) (notice requirement in excess insurance policy).

78. *Marquis v. Farm Family Mut. Ins. Co.*, 628 A.2d 644, 649-50 (Me. 1993); *Maine Mut. Fire Ins. Co. v. Watson*, 532 A.2d 686, 688 (Me. 1987); *Ouellette v. Maine Bonding & Casualty Co.*, 495 A.2d 1232, 1235 (Me. 1985).

79. See BARRY R. OSTRAGER AND THOMAS R. NEWMAN, *HANDBOOK ON INSURANCE COVERAGE DISPUTES* at 99-100 (5th ed. 1992). It should be noted that a minority of jurisdictions hold that a breach of a procedural requirement in an insurance policy gives rise to a presumption of prejudice which the insured then bears the burden of rebutting. *Id.* at 100; see, e.g., *Olin Corp. v. Insurance Co. of North America*, 771 F. Supp. at 79.

80. See *Great American Ins. Co. v. C. G. Tate Constr. Co.*, 279 S.E.2d 769, 775 (N.C. 1981).

81. *Id.* at 776 ("An insured would be in a far less enviable position if he had the burden of showing an absence of prejudice. Indeed, the insured would be forced to prove a negative.").

82. *Ouellette v. Maine Bonding & Casualty Co.*, 495 A.2d at 1235; *Weaver Bros., Inc. v. Chappel*, 684 P.2d 123, 126 (Alaska 1984); *Watson v. Jones*, 610 P.2d 619, 626

cumstances, the breach of the procedural requirement and ensuing prejudice to the insurer can be presumed as a matter of law.⁸³ In addition, it should be noted that some jurisdictions require the insurer to prove, in addition to prejudice, that the insured "willfully and intentionally" violated the particular clause in the insurance policy and that the insurer exercised "reasonable diligence" in obtaining the insured's cooperation.⁸⁴ These additional items of proof only appear applicable, however, in cases where the insured has breached a liability policy provision requiring it to cooperate in the defense of a claim.⁸⁵

V. EXCEPTIONS TO THE INSURER PREJUDICE RULE

As with every good legal rule, the insurer prejudice rule has certain recognized exceptions. In fact, certain courts have recognized three specific exceptions to the general rule: 1) the bad faith exception, 2) the entry of judgment exception, and 3) the claims made exception.

In *Great American Insurance Co. v. C. G. Tate Construction*,⁸⁶ the Supreme Court of North Carolina addressed a situation where a liability insurer denied coverage based on the insured's breach of the notice requirement in the policy.⁸⁷ The court adopted the insurer prejudice rule requiring that the insurer show prejudice to support its denial of coverage. After adopting the insurer prejudice rule, however, the court also immediately carved out an exception thereto.

Lest this decision be perceived as encouraging dilatory tactics in the notification of the insurer and, thus, as being unfair to insurers, we also now impose the requirement that any period of delay beyond the limits of timeliness be shown by *the insured* to have been in good faith. Anyone who knows that he may be at fault or that others have claimed he is at fault and who purposefully and knowingly fails to notify ought not to recover even if no prejudice results. Equity dictates that a bad faith delay in notifying an insurer, even though no material prejudice results, should bar the insured

(Kan. 1980); *P. G. Bell Co. v. United States Fidelity & Guar. Co.*, 853 S.W.2d 187, 191 (Tex. Ct. App. 1993).

83. See, e.g., *West Bay Exploration v. AIG Specialty Agencies*, 915 F.2d 1030, 1037 (6th Cir. 1990) ("where the facts are so clear that one conclusion only is reasonably possible") (citation in parenthetical omitted); *Montgomery v. Professional Mut. Ins. Co.*, 611 F.2d 818, 820 (10th Cir. 1980); see also, *infra* notes 91-95 and accompanying text for a discussion of the entry of judgment exception to the insurer prejudice rule.

84. *Bowyer v. Thomas*, 423 S.E.2d 906, 910-11 (W. Va. 1992).

85. See, e.g., *id.*; *Watson v. Jones*, 610 P.2d 619, 623 (Kan. 1980); *Stumpf v. Continental Casualty Co.*, 794 P.2d 1228, 1233 (Or. Ct. App. 1990); *State Farm Mut. Auto. Ins. Co. v. Davies*, 310 S.E.2d 167, 168-69 (Va. 1983).

86. 279 S.E.2d 769 (N.C. 1981).

87. *Id.* at 770.

from enforcing the policy.⁸⁸

The court justified this exception on the general principle of contract law "that implicit in every contract is the obligation of each party to act in good faith."⁸⁹ Since the concept of good faith is applicable to all provisions in insurance policies, it can be reasonably assumed that the bad faith exception to the insurer prejudice rule would be applicable not only to breaches of a notice requirement, but also to breaches of any other procedural requirement in an insurance policy.

The entry of judgment exception to the insurer prejudice rule has been recognized by several courts.⁹⁰ The entry of judgment exception is a limited exception to the insurer prejudice rule, as it applies only to breaches of the notice requirement in liability policies. Essentially, this exception dictates that insurer prejudice will be presumed in cases where an insured fails to notify the insurer of a pending lawsuit against him until after a default judgment has been entered.⁹¹ It should be noted that prejudice is assumed to be present "even though the option to file a motion for a new trial is still available to the insurer."⁹² The entry of judgment exception cannot be relied upon, however, in cases where the insurer was on notice of the pending suit through information supplied by other parties, even though the insured failed to satisfy the notice requirements.⁹³ Although there do not appear to be any cases on the point, a logical extension of this exception should be made to situations where default has been entered prior to the insured's compliance with the notice provisions in the policy, and the insurer is unable to obtain an order from the court lifting the entry of default due to the insured's lack of good excuse for failing to timely respond to the complaint.⁹⁴

The third exception to the insurer prejudice rule is the claims made exception. In *Slater v. Lawyers' Mutual Insurance Co.*,⁹⁵ the California Court of Appeals ruled that the insurer prejudice rule should not be applied to "claims made" policies.⁹⁶ The *Slater* court

88. *Id.* at 776.

89. *Id.* (citing 17 AM. JUR. 2D *Contracts* § 256 (1964)).

90. *See, e.g.,* *Campbell v. Continental Casualty Co. of Chicago*, 170 F.2d 669, 673 (8th Cir. 1948); *Members Ins. Co. v. Branscum*, 803 S.W.2d 462, 466 (Tex. Ct. App. 1991).

91. *Members Ins. Co. v. Branscum*, 803 S.W.2d at 466.

92. *Id.*

93. *See P. G. Bell Co. v. United States Fidelity and Guar. Co.*, 853 S.W.2d 187, 192 (Tex. Ct. App. 1993).

94. *See Porges v. Reid*, 423 A.2d 542, 544 (Me. 1980) (requiring that (1) good excuse for the default, and (2) likelihood of success on the merits both exist for an entry of default to be set aside).

95. 278 Cal. Rptr. 479 (Cal. App. 2 Dist. 1991).

96. *Id.* at 483.

recognized the inherent differences between "claims made" insurance policies and "occurrence" policies.⁹⁷

All professional liability policies were at one time occurrence policies. Underwriters soon realized, however, that occurrence policies were unrealistic in the context of professional malpractice because the injury and the negligence that caused it were often not discoverable until years after the delictual act or omission. In an effort to reduce their exposure to an unpredictable and lengthy tail of lawsuits filed years after the occurrence they agreed to protect against, underwriters shifted to the claims made policy This type of policy differed materially from an occurrence policy in several aspects. Most notably, it was transmittal of notice of the claim to the insurer which was the event that invoked coverage.⁹⁸

Thus, under a "claims made" policy, coverage is triggered when notification of a claim is made, as opposed to when the underlying accident or loss actually occurs, as is the case under an "occurrence" policy. The court noted that applying the insurer prejudice rule in situations of late notice involving a "claims made" policy would essentially convert the "claims made" policy into an "occurrence" policy.⁹⁹ Of course, the claims made exception only applies to situations of delayed notice and would not have any application to an insured's breach of other requirements of cooperation listed in the "claims made" policy.

VI. RATIONALES AND IMPLICATIONS OF THE INSURER PREJUDICE RULE

A. Rationales for the Rule

There are essentially two basic rationales which have emerged in case law which support the recognition of the insurer prejudice rule. First, as was recognized by the *Ouellette* court, "[a]n insurance contract is not a negotiated agreement, but rather . . . a contract of adhesion, because the terms are dictated by the insurance company to the insured"¹⁰⁰ The *Ouellette* court further suggested that under the traditional rule, which did not require a proof of insurer prejudice, a forfeiture of coverage based on a breach of a procedural policy requirement often resulted in "an undeserved windfall for the

97. *Id.*

98. *Id.* (quoting *Pacific Employer's Ins. Co. v. Superior Court*, 221 Cal. App. 3d 1348, 1357-58 (Cal. App. 1990)).

99. *Id.*

100. *Ouellette v. Maine Bonding & Casualty Co.*, 495 A.2d 1232, 1235 (Me. 1985); see also *Johnson Controls, Inc. v. Bowes*, 409 N.E.2d 185, 187 (Mass. 1980) ("The only aspect of the contract over which the insured can 'bargain' is the monetary amount of coverage.") (quoting *Brakeman v. Potomac Ins. Co.*, 371 A.2d 193, 196 (Pa. 1977)).

insurer."¹⁰¹

The second recognized justification for the insurer prejudice rule is the fact that it encourages compensation of accident victims. One court has described the goal of liability insurance as extending "the maximum protection possible consonant with fairness to the insurer."¹⁰² Thus, by encouraging coverage, the insurer prejudice rule supports this goal.

Insurance contracts are not purely private matters between insurance companies and their insureds. Rather, there is a public interest in . . . liability insurance contracts and that is the protection of innocent victims of . . . accidents. This public interest would not be deserved by a rule that denied an accident victim recovery against the insurance company because it received late notice of the accident, even though it suffered no prejudice as a consequence thereof.¹⁰³

Therefore, by placing the burden of showing prejudice on the insurer, courts have reasoned that coverage to both the insured and the injured third parties will be maximized, and no undeserved windfalls will be reaped by the insurer.

Another argument in support of the insurer prejudice rule, although not generally recognized in case law, can be found in the principles of contract law concerning partial or immaterial breach. Procedural requirements in a contract were traditionally interpreted as conditions to the insurer's obligation of performance under the contract.¹⁰⁴ The Restatement (Second) of Contracts provides for continued performance of a contract, however, in cases when the non-occurrence of a condition would cause disproportionate forfeiture.

To the extent that the non-occurrence of a condition would cause disproportionate forfeiture, a court may excuse the non-occurrence of that condition unless its occurrence was a material part of the agreed exchange.¹⁰⁵

This section of the Restatement allows a court, in the appropriate circumstances, to excuse a party's failure to perform a condition in the contract if an inequitable forfeiture would occur. The court can only excuse such a non-occurrence in situations where the condition was not a material part of the contract. The insurer prejudice rule is

101. *Ouellette v. Maine Bonding & Casualty Co.*, 495 A.2d at 1235 (citing *Brakeman v. Potomac Ins. Co.*, 371 A.2d at 196-97).

102. *Oregon Automobile Ins. Co. v. Salzberg*, 535 P.2d 816, 819 (Wash. 1975).

103. *Brakeman v. Potomac Ins. Co.*, 371 A.2d at 198 n.8; *see also Fox v. National Savings Ins. Co.*, 424 P.2d 19, 23 (Okla. 1967); *Bowyer v. Thomas*, 423 S.E.2d 906, 911 (W. Va. 1992).

104. *See supra*, notes 27-31 and accompanying text for the discussion of the traditional rule.

105. RESTATEMENT (SECOND) OF CONTRACTS, § 229 (1979).

essentially an application of this principle. By excusing non-performance of procedural requirements in cases where an insurer has not been prejudiced, the court is essentially excusing the non-occurrence of an immaterial condition. If the insured's failure to perform the condition did not result in prejudice to the insurer, the rule assumes that the condition was not a material part of the insurance contract.

B. An Insurer's Cause of Action for Damages for Non-Material Breaches of the Insurance Contract

The insurer prejudice rule essentially dictates that a breach of a procedural requirement in an insurance policy by an insured is not a material breach unless it prejudices the insurer. An insurer, therefore, should be permitted to pursue any and all remedies which are normally available in situations when a contract is immaterially or partially breached. Comment 8 of Section 241 of the Restatement (Second) of Contracts states:

A determination that a failure is not material means only that it does not have the effect of the non-occurrence of a condition
Even if not material, the failure may be a breach and give rise to a claim for damages for partial breach¹⁰⁶

Therefore, even if an insured's breach of a procedural requirement is not material because the insurer has not been prejudiced thereby, the insurer should not be precluded from pursuing an action against the insured for damages for partial breach of the insurance contract.

There does appear to be some support for this proposition in case law. In *Insurance Co. of Pennsylvania v. Associated International Insurance Co.*,¹⁰⁷ the United States Court of Appeals for the Ninth Circuit examined a case where a reinsurer failed to cover a loss due to the primary insurer's breach of the notice requirements in the reinsurance contract.¹⁰⁸ The circuit court first applied the insurer prejudice rule requiring the reinsurer to show prejudice before it could deny coverage for the loss.¹⁰⁹ The reinsurer had claimed that it was prejudiced by the lack of notice in that it was unable to establish a reserve for the loss and thereby obtain a tax deduction.¹¹⁰ The court ruled, however, that such inability to claim a tax deduction did not constitute prejudice so as to relieve the reinsurer from its liability under the reinsurance contract.¹¹¹ The court noted, however, that the reinsurance company was not precluded from collect-

106. *Id.*

107. 922 F.2d 516 (9th Cir. 1991).

108. *Id.* at 518.

109. *Id.* at 524.

110. *Id.* at 524-25.

111. *Id.* at 515.

ing money damages to the extent that such damages were caused by the insured's late notice.¹¹²

The idea of an insurer's cause of action for damages for the insured's partial breach of the policy is also supported in *Colonial Gas Energy System v. Uniguard Mutual Insurance Co.*¹¹³ In that case, a property insurer denied coverage for damages to one of the insured's gas tanks, based on the insured's breach of the notice requirement in the policy.¹¹⁴ Prior to notifying the insurer, the insured had inspected, tested, and repaired the gas tank, and then refilled and restored it to operation.¹¹⁵ The court held that the insurer was prejudiced in that the insured had made inaccessible, if not nonexistent, the only source of evidence which could have established the insurer's sole defense on the merits of the claim.¹¹⁶ The court stated, however, that it would defer entry of judgment in the insurer's favor in order to give the insured an opportunity to submit to the insurer an unconditional written offer of access to the damaged tank at the insured's expense.¹¹⁷ It had been estimated by the parties that the cost of emptying the tank would be between one and two hundred thousand dollars.¹¹⁸ Thus, by allowing the insurer access to its tank, the insured was allowed to eliminate, after the fact, the prejudice which its breach of the insurance contract had caused to the insurer. The substantial cost of emptying the tank, however, was placed with the insured, as the cost was incurred as a proximate result of the insured's breach of the insurance contract. Therefore, had the insurer paid to empty the tank in order to conduct an inspection prior to covering the claim, arguably it would have had a claim for damages against the insured. Since the expense was necessitated by the insured's breach of the notice requirement, the insurer would seek to recover the costs incurred.

There will often be situations where the insurer, although unable to establish prejudice, will incur significant costs as a result of the insured's non-compliance with a procedural requirement in the policy. Theoretically, in cases where an insured breaches a procedural requirement in a first party property insurance policy, and the insurer has been damaged but cannot prove prejudice, it could set off the damages resulting from the insured's partial breach of the insurance contract from the proceeds that are payable under the contract. For example, if an insured failed to give notice of a loss to his

112. *Id.* (citing *Security Mutual Casualty Co. v. Century Casualty Co.*, 531 F.2d 974, 978 (10th Cir. 1976)).

113. 441 F. Supp. 765 (N.D. Cal. 1977).

114. *Id.* at 767.

115. *Id.*

116. *Id.* at 769-70.

117. *Id.* at 771.

118. *Id.*

property until after he had sold or otherwise disposed of the damaged property, and the insurer as a result is required to hire an investigator to ascertain the location of the property, the insurer should be able to offset the costs incurred in the search. This follows because those costs resulted from the insured's breach of the notice provision in the policy.

For liability insurers, a claim against the insured for a partial breach of the insurance contract may be somewhat more difficult to enforce, as a right of set-off may not be available.¹¹⁹ In such a situation an insurer would probably have to fulfill its obligations under the policy and pay any amount owed to the injured party. Subsequently, the insurer would bring a separate action for damages against the insured to recover the losses caused by the insured's partial breach of the contract. For example, if an insured's failure to cooperate with the insurer in defending a claim caused the insurer to incur additional attorney costs or court imposed sanctions (perhaps for the insured's repeated failure to attend a deposition or failure to respond to discovery requests), the insurer would have a claim for damages to recoup these resultant costs, based upon the insured's breach of the cooperation clause. As an alternative to a suit for damages against its insured, a liability insurer could consider the possibility of requiring the insured to pay a certain amount of money at the inception of the insurance relationship which would be maintained by the insurer in an interest-bearing account. Such a fund would function similarly to a security deposit held by a landlord. If the insurer incurred costs as a result of the insured's partial breach of a procedural requirement in the policy, the appropriate amount would be deducted from the account. Finally, another alternative would be to simply reflect costs incurred by the insurer due to the insured's partial breach in the premium charged during the next policy period.

119. Depending on the wording of the policy, an argument might be made that an insurer could set-off from the amount due the injured party any amount for damages which were approximately caused by the insured's immaterial breach of a policy provision. Section 309 of the Restatement (Second) of Contracts states:

Except as stated . . . in § 311 or as provided by the contract, the right of any beneficiary against the promisor is not subject to the promisor's claims or defenses against the promisee or to the promisee's claims or defenses against the beneficiary.

RESTATEMENT (SECOND) OF CONTRACTS § 309(3) (1979).

Sections 311(1-2) indicate that the promisor's duty to the beneficiary can be modified by the conduct of the promisee if the contract does not have a term prohibiting such modification. Thus, any amount owed to an insurance contract beneficiary could be modified by the breach of the insurance contract by the insured. Of course, allowing such a set-off against the policy proceeds payable to the injured party could be considered contrary to the above-discussed purposes of liability insurance, namely, to provide as much coverage as possible without being unfair to the insurer. *See supra* notes 99-100 and accompanying text.

A strong argument can be made that the recognition of such insurer remedies would be in the public's best interest. If such remedies are not recognized, the overall effect of the insurer prejudice rule may be to encourage loose compliance with or even general disregard for the many insurance policy provisions to which the rule applies. Such a result would not only be costly and inconvenient to insurers, but also cause general disruption and inefficiency in insurance relationships. Furthermore, if insurers are forced to bear the extra costs caused by insureds who breach procedural requirements, such costs will most likely be spread to all insureds in the form of higher premiums. This result would be unfair to those insureds who have strictly complied with their policies and have not caused their insurers added and unnecessary expenses. Recognition of the above-described remedies would also be fairer to non-breaching insureds, as insurers would recoup costs only from those insureds who breach their policies causing additional, unnecessary expenses.

VII. CONCLUSION

In Maine and elsewhere the insurer prejudice rule has rapidly become an important concept in insurance coverage law. As has apparently occurred in Maine, it is likely that other jurisdictions will ultimately apply this rule to all situations where an insured has breached *any* procedural requirement or cooperation clause in an insurance policy. Although the rule is clearly justified, both by public policy considerations and long-standing concepts in contract law, its overall effect is unfair to insurers. Insurers should be permitted to pursue remedies which are also justified by public policy and contract law. By allowing insurers to recover costs incurred due to an insured's non-prejudicial breach of a procedural requirement, the insurer prejudice rule would have a more logical and equitable effect on both insurers and insurance relationships.

