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Pennsylvania Supreme Court set to decide whether to extend Brakeman's "notice prejudice" rule to claims-made liability policies.

The Pennsylvania Supreme Court will soon decide an issue of great importance to policy holders and insurers alike. An interesting facet of the case is that an insurer, ACE American Insurance Company, will be advocating the policy holder's position, and, if successful, will have advanced the Pennsylvania law in favor of policy holders and against insurers.

In the case of *ACE American Insurance Co. v. Underwriters at Lloyds and Columbia Casualty Company*, the high court will decide whether to extend the holding in *Brakeman v. Potomac Insurance Co.*, 371 A.2d 193 (Pa. 1977), that the insurance company is required to prove that the insured breached the notice provision resulting in prejudice to the insurer, known as the "notice-prejudice" rule. In *Brakeman*, the Supreme Court reversed previous law that said a party claiming rights under a liability policy had the burden of proving compliance with the terms and conditions of the policy. In addition, it departed from prior law that said the determination whether to relieve the insurer of its obligations under the policy because of late notice was dependent only upon the length of delay and the reasons to excuse the delay. *Id. at 195*. Following trends in other jurisdictions, our Supreme Court held that "the preferable rule is that which requires the insurance company to prove not only that the notice provision was breached, but also that it suffered prejudice as a consequence." *Id. at 196*.

Because the insurance policy at issue in *Brakeman* was an "occurrence based" policy, the state and Federal courts in subsequent cases have consistently held that the *Brakeman* holding does not extend to "claims-made" policies. See, eg., *Employers Reinsurance Corp. v. Sarris*, 746 F.Supp. 560 (E.D.Pa. 1990); *Lexington Ins. Co. v. W. Pa. Hosp.*, 318 F.Supp.2d 270 (W.D.Pa.2004); *Pizzini v. American International Specialty Lines Insurance Co.*, 210 F.Supp. 658 (E.D.Pa. 2002). In the present case the Pennsylvania Supreme Court will decide whether to depart from that history.

The Court will need to consider whether there is any discernible difference between an "occurrence-based" policy and a "claims-made" policy that would justify continued disparate treatment. The federal courts in the Eastern District and the Middle District of Pennsylvania have found the distinctions important enough to rationalize the refusal to extend the "notice prejudice" rule to claims-made policies. The Eastern District Court applying Pennsylvania law in *Pizzini*, *supra*, reasoned that the distinction is appropriate because "a 'claims made' insurance policy represents a distinct bargained-for exchange between insurer and insured. An insurer obtains the benefit of a clear and certain cut-off date for coverage. In return, the insured typically pays a lower premium." *Id. at 669*. In *City of Harrisburg v. International Surplus Lines Insurance Co.*, 596 F.Supp. 954 (M.D.Pa.1984), the Middle District cited with approval to a Florida Supreme Court case, *Gulf Insurance Co. v. Dolan, Fertig and Curtis*, 433 So.2d 512 (Fla. 1983), which held that a finding for the insured in a late notice case involving a claims-made policy would in essence re-write the contract between the insurer and the insured and ignore the benefits sought by each of the parties when a claims-made policy was purchased rather than an occurrence policy.

The Florida Supreme Court and the Middle District Court relied on a law review comment, *Comment, The "Claims Made" Dilemma In Professional Liability Insurance*, 22 U.C.L.A. Rev. 925 (1975), in determining the benefits of a claims made policy and the rationale for making the distinction between the occurrence policy and claims made policy for purposes of the "notice prejudice" rule. The rationale assumes that the insured has a choice of an occurrence policy when purchasing coverage typically offered in a claims-made policy. It assumes that the insured, in purchasing the claims-made policy has appreciable bargaining power. It also assumes that the insurer has established premium rates for both a claims-made policy and occurrence policy that would cover the same type of risk. In the absence of any bargaining power or ability to negotiate for expanded coverage, the insured is placed in the same position vis-à-vis the claims-made policy as it would be with an occurrence policy.

The purposes of the notice requirements in liability policies as identified by the *Brakeman* court are to give the insurer an opportunity to investigate the claim and protect against fraudulent claims. *Brakeman, supra at 197*. In other words, the notice requirements serve to protect the insurance company's interests from being prejudiced. *Id.* The purpose is **not** to "provide a technical escape-hatch" or to "deny the insured the very thing paid for." *Id.* The *Brakeman* court considered the use of the late notice defense, absent a showing of prejudice, to be a "condition of forfeiture", which it found to be "arbitrary", "too restrictive", "severe and inequitable", outside the reasonable expectations of the insured, and against the public interest. *Brakeman, supra at 198*. It therefore held that "where an insurance company seeks to be relieved of its obligations under a liability insurance policy on the ground of late notice, the insurance company will be required to prove that the notice provision was in fact breached and that the breach resulted in prejudice to its position." *Id. 198*.

The Supreme Court, in the *ACE American* case, will likely analyze the same considerations. It must determine whether an insured with a claims-made policy has any bargaining power when purchasing that policy, and, if so, whether there are any bargained-for benefits to the insured in purchasing a claims-made rather than an occurrence policy. It will need to consider whether the notice requirement in a claims-made policy serves purposes different from the purposes identified and relied upon by the *Brakeman* court, or whether the late notice argument is simply a condition of forfeiture, which, in the absence of actual prejudice, is arbitrary, restrictive, severe, inequitable, outside the reasonable expectations of the insured and against the public interest.

Interestingly, the insured in this case is itself an insurance company. *ACE American* is the victim of the late notice defense asserted successfully in the lower courts by its errors and omissions carriers. *ACE American's* legal argument is adverse to insurance carriers, at least to those that write professional liability and other claims-made policies. The case is expected to be briefed by the end of the year, and insurance practitioners on both sides will await the Pennsylvania Supreme Court's ruling with great interest.

Please contact Nicolson Associates LLC for further information or with questions or comments about this Update.

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