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New York Reverses Long-Standing “No Prejudice” Late Notice Rule and Permits Direct Actions by Third-Party Claimants Against Insurers

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On July 23, 2008, Governor David A. Patterson signed into law new legislation that reverses New York’s longstanding “no-prejudice” rule regarding the late notification of liability claims, and permits third-party claimants to sue liability insurers directly with regard to insurance coverage disputes. Both aspects of this new law are significant developments in New York, which has always been regarded as a relatively “insurer friendly” jurisdiction.

The two areas addressed in this new insurance legislation (the imposition of a “prejudice requirement” in order to establish a late notification defense and the introduction of a “direct action” provision in terms of third-party claims against insurers) will likely impact the manner in which liability underwriters, insurance agents and brokers and claims professionals carry out insurance business in New York.

Late Notice- Actual Prejudice Required

Under New York common law, insurers are currently permitted to disclaim coverage on late notice grounds without having to prove that they have been prejudiced by the delay. See Donovan v. Empire Insurance Group, 2008 N.Y. Slip Op 2100 (App. Div. 2d Dep’t Mar. 11, 2008). This common law “no prejudice” rule in New York is unique (most states require the insurer to demonstrate actual prejudice in order to disclaim coverage to an insured on late notice grounds) and has been a source of considerable coverage litigation. While the ramifications are potentially draconian to the insured parties (and the source of considerable litigation against agents and brokers for liability in late claims notifications), the “no prejudice” rule afforded predictability for insurers, many of whom would designate New York as the choice of law in liability insurance policies for that reason.

The new law changes all that and amends New York Insurance Law Section 3420 to permit an insurer to disclaim coverage on late notice grounds only where the insured’s untimely notice has prejudiced the insurer. The burden of proof to establish “prejudice” is on the insurer if the delayed notification to the liability insurer is made within two years after the time period required under the policy. However, if the notification is delayed beyond two years, the burden then shifts to the insured (or injured third-party claimant in a direct action) to prove that the insurer was not prejudiced by the delay.

The law also establishes an irrefutable “presumption” of prejudice where the notification to the insurer is made after the insured’s liability is determined by a trial court or arbitration panel, or after the

insured has settled the claim. The “prejudice” requirement is defined in the new legislation as the “material impairment of the insurer’s ability to investigate or defend the claim.” The term “material” is not defined in the law. In other insurance–related contexts, however, the term “material” requires proof that, had the facts been known at the time, the insurer’s actions would have been different. See Nat’l Specialty Ins. Co. v. Lafayette St. Corp. LLC, 2008 WL 629994 (SDNY 2008). As such, this “materiality” requirement will mean that insurers will essentially have to prove that they were actually prejudiced by the late notification, which in many circumstances is difficult to prove in the absence of a settlement or other tangible circumstance that impairs the insurer’s ability to investigate and/or defend the third-party liability claim.

Late Notice- Claims Made Policies Exempted?

There is language in the new legislation that appears to expressly exempt claims-made policies from the “prejudice” requirement. At Section (a)(5), the law states that “[w]ith respect to a claims-made policy, however, the policy may provide that the claim shall be made during the policy period, any renewal thereof, or any extended reporting period....” The use of the “however” language will suggest to those on the “pro-insurer” side that claims-made policies are exempted from the prejudice requirement under the new law. On the contrary, those on the “pro-policyholder” side will likely argue that the failure to spell out whether late notifications made during a claims-made policy period are indeed exempt from the “prejudice” requirement means that insurers must still prove prejudice on late notifications that are otherwise made during a claims made policy period. As a result, litigation is likely over the issue of whether an insurer can deny coverage on late notice grounds in connection with a claims-made policy without proving prejudice if the late notification is made within the policy period. There is also the potential for an increase in “laundry list” notifications at the tail-end of a claims-made policy, especially if the insured is obtaining coverage from a different carrier.

Direct Action

As to the declaratory judgment provision, the new legislation amends Insurance Law Section 3420(a) and permits a third-party claimant in an action arising out of personal injury or wrongful death to file suit directly against the insurer for declaratory relief where the insurer’s denial is premised upon late notice. Previously, New York law allowed a tort claimant to file a direct action against an insurer only where a judgment against an insured remained unsatisfied for thirty days. In the new law, the “sole question” in a third-party claimant’s declaratory action is limited to the insurer’s denial on late notice grounds. However, it appears that third-party claimants do not have the right to file suit directly against the insurer if the insured or insurer brings a declaratory judgment action against the other (insured or insurer) within sixty days of the denial, and the third-party claimant is named as a party in that declaratory judgment action.

The intent of the direct action provision of the new legislation appears to be an effort to limit the third-party claimant’s right to sue only on the issue of late notice. Unfortunately, the language in the law is arguably imprecise, and policy-holders/third-party claimants may claim that the direct action provision provides standing to third-party claimants to sue insurers directly not only in circumstances where an insurer disclaims coverage for untimely notice, but on other grounds as well.

Confirmation of Coverage

The new legislation also requires a response by the liability insurer (within sixty days) to a request by a third-party claimant in a personal injury or wrongful death action as to whether the insured maintained a liability insurance policy in effect at the time of the occurrence and to set forth the limits of coverage provided under such policy. The impact of this requirement may also lead to litigation, as there is a question as to whether this requirement potentially raises “waiver” arguments unless any and all coverage defenses (in addition to late notice defenses) are addressed and expressly reserved in the response confirming coverage.

Effective Dates- Retroactive Application

The new legislation, signed into law by Governor Patterson on July 23, 2008, will not apply retroactively to policies already issued by insurers. Section 8 of the new legislation states that it shall become effective six months (180 days) after it is signed into law (January 19, 2009), and only applies to policies issued after that six month period. Thus, liability policies issued prior to 2009 will be governed by traditional common law principles regarding late notice, prejudice and direct action claims. Those issued after January 19, 2009 will be subject to the new rules.

In sum, this new insurance legislation, recently signed into law by Governor Patterson, changes the landscape for liability insurers in New York. The well-developed substantive insurance case law in New York and the quality of the appellate courts continue to make New York a smart choice for insurers and policyholders in connection with the law to be applied to the interpretation of liability policies. This new law, however, perhaps designed to lend more predictability and eliminate confusion over late notification issues, may very well lead to more coverage litigation, not less.