

Retaining Insurance Coverage in the Face of Late Notice and Misconduct Exclusions

by Sergio F. Oehninger

A Texas federal court recently ordered an insurer to reimburse an oil and gas company for costs and expenses incurred while defending against environmental claims. The court found that a duty to defend existed even though the insured failed to immediately notify the insurer of the occurrence, giving rise to the claim as required by the insurance policy, and despite alleged willful misconduct that was excluded from coverage under the policy. The opinion presents important lessons for corporate policyholders concerning choice of law, the notice-prejudice rule and the duty to defend.

EXAMINING THE CASE

The United States sued ATP Oil and Gas Corporation for allegedly discharging pollutants from an offshore platform located in the Gulf of Mexico. Water Quality Insurance Syndicate (WQIS) insured ATP under a maritime pollution insurance policy. ATP notified WQIS of the government's claim seven months after the suit was filed and 18 months after the ATP learned of the allegations.

WQIS denied coverage because ATP failed to give "immediate notice" of an "occurrence or incident which may give rise to a claim" as required by the policy. After conducting a choice of law analysis, the court applied Texas law to hold that an insurer must prove prejudice before it may enforce a notice provision in its insurance policy. Because WQIS failed to prove prejudice, the court ordered the insurer to reimburse costs and expenses incurred by ATP in its defense of the underlying litigation.

WQIS also declined coverage arguing that the claims were excluded under the policy's "willful misconduct" exclusion. The underlying lawsuit primarily alleged willful misconduct—the government claimed that ATP willfully hid its use of an unpermitted chemical dispersant that masked oil in wastewater discharged from the platform. However, the government also alleged that ATP negligently operated the platform, resulting in the unlawful discharge of oil. The policy covered negligent acts.

Because the duty to defend arises if at least one of the claims in the complaint is potentially or facially within the policy's coverage, the court held that WQIS was obligated to defend the entire underlying lawsuit, notwithstanding the "willful misconduct" exclusion.

INSURANCE COVERAGE LESSONS FROM THE ATP DECISION

ATP offers several important lessons for corporate policyholders:

Choice of Law. The ATP decision illustrates that choice of law rules, which may vary from state to state, can have a significant effect on notice issues. And, choice of law provisions in insurance policies may not always be enforced.

ATP's policy provided that federal maritime law applied to the policy and the rights and obligations of the parties under the policy. In the absence of applicable federal maritime law, the policy specified that New York law would apply.

After concluding that no applicable federal maritime rule addressed notice, the court conducted a choice of law analysis to determine whether to apply the law of New York (as required by the policy) or Texas (ATP's state of residence). As discussed below, Texas requires that an insurer prove prejudice from the insured's late notice before it can enforce a notice provision in its insurance policy—this is commonly known as the "notice-prejudice" rule. New York also follows the notice-prejudice rule for most insurance policies, but it does not require proof of prejudice from late notice under maritime policies unless the policy expressly says so. ATP's maritime policy did not contain any such provision. Accordingly, a conflict existed between New York law and Texas.

The court found that the choice of law provision in ATP's policy was ambiguous. A Texas statute mandates that insurance contracts payable to its citizens are governed by Texas law. Because ATP is a Texas resident, the policy incorporated Texas law. In Texas, policy provisions are invalid if they are inconsistent with statute. Thus, the court found an ambiguity as to whether to apply statutorily-required Texas law or contract-

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mandated New York law. Because ambiguities within insurance policies are resolved in favor of the insured, the court refused to enforce the choice of law provision in the policy and ruled that Texas law, which was more favorable to ATP, applied. Because WQIS failed to prove prejudice as required under Texas law, the court ruled that WQIS could not enforce the notice provision in the policy.

Importantly, had the court applied New York law to ATP's policy, WQIS's denial of coverage likely would have been upheld. Thus, the ATP decision shows that choice of law issues may be outcome-determinative. Understanding which state's choice of law rules and late-notice laws are applicable to a company's insurance policies can mean the difference between the existence or denial of coverage.

Notice-Prejudice. Whether an insured is required to prove prejudice before it can rely on a notice provision to deny coverage may turn on relevant policy language.

Under the ATP policy, WQIS was required to indemnify and reimburse ATP "with respect to an Occurrence," defined as "any one accident or series of accidents" that "commences on or after the inception date and time and on or before the expiration date and time shown on the declarations page." The policy required ATP to give "immediate notice" of any such occurrence.

The ATP court ruled that "an insurer must demonstrate prejudice before it will be allowed to enforce a notice provision in its insurance policy." The court also held that under a claims-made policy, "when an insured notifies its insurer of a claim within the policy term or other reporting period . . . the insured's failure to provide notice 'as soon as practicable' will not defeat coverage in the absence of prejudice to the insurer." A showing of prejudice is required even if the policy language indicates that the notice provision is a condition precedent to coverage. Because WQIS failed to prove prejudice, the court ordered it to reimburse costs and expenses incurred by ATP in its defense of the government's claims.

The applicability of the notice-prejudice rule may depend on the specific language in an insurance policy, including whether a policy is occurrence-based, claims-made, or claims-made-and-reported.

Occurrence-based policies provide liability coverage for injury or damage occurring during the policy term, regardless of when the claim is made. These policies frequently require the policyholder to notify the insurer of an occurrence or claim "promptly," or "as soon as practicable." In most states, an insurer is required to prove prejudice before it may deny coverage for late notice under an occurrence-based policy.

Claims-made policies provide coverage for claims made during the policy period. The notice provisions in such policies typically require an insured to report a claim "as soon as practicable." Most states apply the notice-prejudice rule to claims-made policies.

Claims-made-and-reported policies condition coverage on the insured reporting the claim within the policy period or alternatively within a specific "extended reporting period," such as 60 or 90 days. Unless there is a statute to the contrary, most states do not extend the notice-prejudice rule to claims made after the date-certain reporting period under claims-made-and-reported policies. (However, the notice-prejudice rule typically applies to any "as soon as practicable" notice provision in such policies.) This is because the date-certain notice provisions in claims-made-and-reported policies serve a very different function than the prompt notice requirements in occurrence and general claims-made policies. As the Texas Supreme Court recently explained,

Whereas a prompt notice requirement serves to allow the insurer to investigate the claim and negotiate with the third party asserting the claim, the date-certain notice requirement defines the temporal boundaries of the policy's basic coverage terms. In other words, timely notice of a claim is the event that triggers coverage. For this reason, although excusing late notice and applying a prejudice requirement make sense in the context of a prompt notice requirement, extending such concepts to a date-certain notice requirement would defeat the fundamental concept on which coverage is premised.

ATP's policy was not a claims-made-and-reported policy and did not contain a date-certain reporting period. Had it contained such a provision and had ATP failed to comply with it, the court likely would not have required WQIS to prove prejudice, leading to a different result.

Insurance policy terms and conditions can significantly impact whether coverage is available under the policy. It is therefore important for policyholders to scrutinize the language in their policies as well as the applicable law when analyzing notice issues.

Duty to Defend. Finally, the ATP decision illustrates that allegations of conduct that may be excluded from coverage under an insurance policy do not preclude an insurer's duty to defend where there are any other covered allegations. In ATP, the policy excluded coverage arising out of ATP's "willful misconduct." The bulk of the government's allegations centered on ATP's willful misconduct. However, the court found that the complaint also contained some allegations of negligence, which were covered under the policy. For instance,

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the complaint alleged that ATP negligently failed to operate the wastewater system and a primary float system that would have limited oil in the wastewater.

As the court explained, where a complaint “alleges multiple claims or claims in the alternative, some of which are covered under the policy and some of which are not, the duty to defend arises if at least one of the claims in the complaint is facially within the policy’s coverage.” Once “coverage has been found for any portion of a suit, an insurer must defend the entire suit.”

Under the eight-corners rule, the court compared the policy (covering negligent acts) to the complaint (alleging negligent acts), holding that the negligent acts triggered WQIS’s duty to defend. WQIS’ duty to defend extended to entire lawsuit against ATP.

ATP illustrates that the duty to defend is broad. Allegations of intentional or knowing misconduct will not eliminate the duty when allegations of negligence are present. Thus, policyholders should consider the entire claim when evaluating an insurer’s duty to defend or responding to an insurer’s denial of coverage based on allegations of uncovered claims. ■

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