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# Contracting out of unfavorable insurance law: The enforceability of insurance policy choice-of-law provisions

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**NOVEMBER 1, 2019**

Most insurance policies sold in the United States are standard form policies the language of which varies little, if at all, from state to state. However, the manner in which state jurisdictions interpret insurance policies can vary, with some states viewed as pro-insurer and others viewed as pro-policyholder in their approaches to policy interpretation.

This is particularly true with respect to the interpretation of policy provisions that result in a forfeiture of coverage unless the policyholder provides the insurer timely notice or obtains the insurer's consent before incurring costs.

An issue that has received little attention in the reported case law is whether an insurer may avail itself of a favorable jurisdiction's law by incorporating choice-of-law provisions into its insurance contracts.

New York, for example, strictly enforces notice conditions. Most other jurisdictions, including California, do not; instead, they require the insurer to prove it suffered prejudice as a result of the policyholder's failure to provide timely notice.

An issue that has received little attention in the reported case law is whether an insurer may avail itself of a favorable jurisdiction's law by incorporating choice-of-law provisions into its insurance contracts.

Recently, the California Supreme Court addressed this question in *Pitzer College v. Indian Harbor Insurance Co.,* 8 Cal. 5th 93 (Cal. 2019).

## FACTUAL BACKGROUND

Pitzer College is one of the Claremont Colleges, a collection of private colleges in Southern California.

The Claremont Colleges purchased pollution remediation insurance for all its members, including Pitzer, from Indian Harbor Insurance Co. The policy contained a broad choice-of-law provision requiring application of New York law to "all matters arising" under the policy, including "questions related to [its] validity[,] interpretation, performance and enforcement."

The provision expressly called for application of New York law regardless of whether New York's conflicts-of-laws rules would have resulted in application of the law of another state.

In January 2011, Pitzer began construction on a new dormitory. During site excavation, workers discovered discolored soil. Environmental consultants quickly determined that the soil was contaminated with lead and that remediation would be required.

After considering a range of options, Pitzer and its environmental consultants concluded that use of a transportable treatment unit to clean up the soil was the best option in light of the college's goal of completing the dormitory in time for the 2012-2013 academic year.

The treatment units normally have to be reserved well in advance, but one of the only two units in Southern California happened to be immediately available. Without notifying Harbor Insurance, Pitzer retained the available unit and immediately began remediating the soil at the dormitory site. The remediation effort was successful, and Pitzer completed the dormitory a few days before the students' move-in date.

About three months after it completed the remediation effort and six months after discovering the darkened soils, Pitzer informed Indian Harbor of the remediation effort and sought coverage for the $2 million expended on the effort.

The insurer denied coverage based on the college's failure to provide timely notice and its failure to obtain the insurer's consent before starting remediation, as required by the policy.

## FEDERAL LITIGATION

Pitzer sued Indian Harbor for breach of contract in the Los Angeles County Superior Court. After removing the case to the U.S. District Court for the Central District of California, Indian Harbor moved for summary judgment, arguing that under New York law it need not

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show it suffered prejudice as a result of Pitzer's failure to provide timely notice.

Finding that Pitzer failed to establish that the California notice-prejudice rule was a fundamental public policy that overrode the policy's choice-of-law provision, the District Court applied New York law.

The District Court determined that summary judgment was warranted under New York law because Pitzer failed to notify Indian Harbor. It also concluded that summary judgment was separately warranted because Pitzer failed to comply with the policy's consent provision. *Pitzer Coll. v. Indian Harbor Ins. Co.*, No. 13-cv-5863, 2014 WL 12558276 (C.D. Cal. May 22, 2014).

## CERTIFIED QUESTIONS

On appeal, the 9th U.S. Circuit Court of Appeals found no California authority on whether the parties to an insurance policy may contract around California's notice-prejudice rule by agreeing that the contract shall be governed by the law of another state. *Pitzer Coll. v. Indian Harbor Ins. Co.*, 845 F.3d 993 (9th Cir. 2017).

> California jurisprudence has long recognized the importance of the notice-prejudice rule in ensuring that the policyholder receives the full benefit of the bargain embodied in the insurance policy.

Accordingly, the appeals court certified two questions to the California Supreme Court, which restated the questions as follows:

(1) Is California's common law notice-prejudice rule a fundamental public policy for the purpose of choice-of-law analysis?

(2) If so, does the notice-prejudice rule apply to the consent provision of the insurance policy in this case?

Invoking "California's strong preference to avoid technical forfeitures of insurance policy coverage," the Supreme Court answered that (1) the notice-prejudice rule is a fundamental public policy of California in the context of insurance policy interpretation, and (2) the rule generally applies to consent provisions in the context of first-party liability policy coverage and not to consent provisions in third-party liability policies.

## CHOICE-OF-LAW ANALYSIS

The outcome of the coverage dispute turned largely on whether California courts will enforce the choice-of-law provision in Indian Harbor's policy. In *Nedlloyd Lines BV v. Superior Court*, 3 Cal. 4th 459 (Cal. 1992), the California Supreme Court summarized the rules that California courts must follow concerning contractual choice-of-law clauses.

Adopting the rules set forth in Section 187 of the Restatement (Second) Conflict of Laws, the court ruled that the law of the state chosen by the parties to a contract will govern "unless either (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties choice, or (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue."

Elaborating, the court explained that the proper approach to deciding whether to enforce a contractual choice-of-law provision "is for the court first to determine either: (1) whether the chosen state has a substantial relationship to the parties or their transaction, or (2) whether there is any other reasonable basis for the parties' choice of law. If neither of these tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice of law. If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a *fundamental* policy of California" (emphasis in original). If it is, the contractual choice of law shall not be enforced if California has a materially greater interest than the chosen state in having its law enforced.

Pitzer College and Indian Harbor agreed that there was a reasonable basis for selecting New York law and therefore the choice-of-law provision survived the first step of the *Nedlloyd Lines* choice-of-law analysis. Accordingly, the court began with *Nedlloyd Lines'* second step, examining whether California's notice-prejudice rule embodied a fundamental public policy.

## CALIFORNIA'S NOTICE-PREJUDICE RULE

California's notice-prejudice rule requires an insurer to prove that the insured's late notice of a claim substantially prejudiced its ability to investigate and negotiate payment of the insured's claim.

California jurisprudence has long recognized (and Indian Harbor did not dispute) the importance of the notice-prejudice rule in ensuring that the policyholder receives the full benefit of the bargain embodied in the insurance policy.

Indian Harbor argued that any determination of what constitutes a fundamental policy of California must be made in light of the California Supreme Court's recognition in *Nedlloyd Lines* of a "strong" public policy favoring enforcement of contractual choice-of-law provisions.

Quoting language from the California Supreme Court's decision *Gantt v. Sentry Insurance*, 1 Cal. 4th 1083 (Cal. 1992), Indian Harbor argued that no judicially established common law public policy, regardless of its importance and strength, is sufficiently fundamental to override the freedom to contract.


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Instead, fundamental public policies must be expressed in either the constitution or statutes, Indian Harbor contended. Under this approach, only in those very rare circumstances where the parties' choice of law deprives the state of its sovereign power to legislate for the benefit and protection of its citizenry will California courts interfere with contracting parties' freedom to choose the law under which their dispute is to be resolved.

Disagreeing, the Supreme Court backed away from the focus solely on statutes and constitutional provisions in identifying the fundamental public policy of California. The court acknowledged that the narrow focus of *Gantt* cannot be reconciled with the court's adoption of the Restatement's approach to deciding the enforceability of a choice-of-law provision.

Comment (g) to Conflict Restatement Section 187 provides several important guidelines for determining when a particular public policy is "fundamental" and thus precludes enforcement of a contractual agreement to apply the law of another state. Significantly, Comment (g) says a fundamental public policy may, *but need not be*, embodied in a statute.

Under California Insurance Code Section 16, "the word 'shall' is mandatory and the word 'may' is permissive." Thus, the use of the phrase "may be embodied in a statute," as used in Comment (g), indicates that statutory edicts are one of a number of ways in which a fundamental public policy may be expressed.

The court explained that while the focus exclusively on statutes and constitutional provisions may have been justified in *Gantt*, it is not appropriate in the context of a dispute over whether an insurer must prove prejudice in order to defeat coverage based on its insured's untimely notice.

In *Gantt*, the plaintiff sued his former employer, alleging he had been constructively discharged in retaliation for testifying truthfully about a co-worker's sexual harassment claim.

Stating that a fundamental public policy must be "delineated in constitutional or statutory provisions" or a rule of unconscionability, the Supreme Court held that the employer violated a fundamental public policy embodied in Government Code Section 12975, which prohibits obstruction of a Department of Fair Employment and Housing investigation. *Gantt,* 1 Cal. 4th at 1095-1097.

In *Pitzer*, the Supreme Court distinguished *Gantt*, finding implicit in the *Gantt* court's focus on constitutional and statutory provisions "is the recognition that it would be unreasonable to expect employers to anticipate what fundamental public policies that courts might identify, on pain of liability in tort."

Those same concerns do not apply in the context of an insurance coverage dispute, the court reasoned, where the issue is not whether tort liability should be imposed but whether the insurer should be afforded a "technical escape-hatch" from its contractual obligations based on the insured's failure to comply with a policy provision designed to protect insurers from prejudice.

Having freed itself from the constraints of constitutional and statutory law in determining fundamental public policy in the context of an insurance coverage dispute, the court looked to other courts for guidance on how to determine whether a policy is fundamental in the absence of a legislative or constitutional mandate.

From the justifications courts have used for finding fundamental public policy in common law rules, the court distilled three criteria to employ in determining whether the notice-prejudice rule embodies a fundamental public policy of California:

(1) Is the rule mandatory and thus not subject to being waived contractually?

(2) Does the rule protect against otherwise inequitable results?

(3) Does the rule promote the public interest?

The court concluded that the notice-prejudice rule meets all three criteria. First, "[w]hen it applies, it prevents enforcement of a contractual term. It overrides the parties' express intentions for a defined notice term, preventing a technical forfeiture of insurance benefits unless the insurer can show it was prejudiced by the insured's late notice."

Second, "the notice-prejudice rule protects insureds against inequitable results that are generated by insurers' superior bargaining power." Third, "[t]he notice-prejudice rule promotes objectives that are in the general public's interest because it protects the public from bearing the costs of harm that an insurance policy purports to cover."

## CONSENT PROVISION AND THE NOTICE-PREJUDICE RULE

Having determined that the notice-prejudice rule is a fundamental part of California public policy, the court turned to the second question certified from the 9th Circuit: namely, does the notice-prejudice rule also apply to insurance policy provisions requiring the insurer's consent before the insured incurs costs?

Although acknowledging that the consent provision performs a role beyond that of a notice provision in that it allows the insurer to control costs and protect its subrogation rights, the court concluded that "at core" the purpose of consent provisions and notice provisions are "much the same" in that they both "facilitate the insurer's primary duties under the contract and speak to minimizing prejudice in performing

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those duties." Accordingly, the court concluded that the insurer must prove prejudice resulting from the insured's breach of a consent provision in a first-party insurance policy.

Though the court extended the notice-prejudice rule to consent provisions in first-party insurance policies, it was not willing to do the same for consent provisions in third-party liability policies. It specifically endorsed the result and reasoning in *Jamestown Builders Inc. v. General Star Indemnity Co.*,77 Cal. App. 4th 341 (Cal. Ct. App., 4th Dist. 1999), where the California Court of Appeal held that a liability insurer's contractual right to control the defense and settlement of claims makes the insured's failure to obtain consent inherently prejudicial.

The Supreme Court reasoned that because insurers do not exercise a similar degree of control over potential losses under first-party policies, there is no logical reason to presume prejudice from the insured's breach of a consent provision. Thus, to avoid coverage based on the insured's violation of a consent provision, the insurer must prove it suffered prejudice.

## COMMENT

In *Tri-Union Seafoods LLC v. Starr Surplus Lines Insurance Co.*, 88 F. Supp. 3d 1156 (S.D. Cal. 2015). the court held that, under Conflict Restatement Section 187, the failure of New York law to recognize a tort remedy for an insurer's breach of the implied covenant of good faith and fair dealing was contrary to the fundamental public policy in California.

In reaching its decision, the *Tri-Union* court relied on the "special relationship" between the policyholder and insurer and that, "[u]nlike most other contracts, ... *an insurance policy is characterized by elements of adhesion, public interest* and fiduciary responsibility" (emphasis added). The fundamental public policy at issue in *Tri-Union* was not statutorily created.

While *Tri-Union* presaged the California Supreme Court's willingness to back away from a black-line rule limiting fundamental public policy to statutes and constitutional provisions, its treatment of the covenant of good faith and fair dealing as a fundamental public policy will not survive the *Pitzer College* decision.

*Pitzer* recognizes that general rules of contract law designed to encourage (rather than compel) or discourage (rather than prohibit) are not "fundamental" and thus do not justify refusal to enforce a contractual choice-of-law provision.

*This article first appeared in the November 1, 2019, edition of* Westlaw Journal Insurance coverage.

**In *Pitzer College v. Indian Harbor Insurance Co.*, the California Supreme Court held that:**

(1) The notice-prejudice rule is a fundamental public policy of California in the context of insurance policy interpretation.

(2) The rule generally applies to consent provisions in the context of first-party liability policy coverage and not to consent provisions in third-party liability policies.

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