RIVKIN RADLER
ATTORNEYS AT LAW

July 2023 | Insurance Update | WWW.RIVKINRADLER.COM

Kentucky Supreme Court Holds That Notice-Prejudice Rule Does Not Apply to Claims-Made-And-Reported Policies

In a case of first impression for the Kentucky Supreme Court, the court ruled, like most courts that have considered the issue, that an insurer need not show that it was prejudiced by the insured's untimely notice to support a late notice defense under a claims-made-and-reported policy.

Two Kentucky State University (KSU) professors filed Equal Employment Opportunity Commission charges against the university and later sued in state court. KSU had claims-made-and-reported policies with Allied World. Under the policies, claims made against KSU had to be reported to the insurer during the policy period or within the 90-day extended reporting period.

Three days after the extended reporting period expired, KSU notified Allied World of the suit. Allied World denied coverage and KSU brought a declaratory judgment action. The trial court sided with KSU, finding that the policy did not unambiguously provide for a forfeiture of coverage for failure to promptly notify Allied World of a claim. The trial court applied the notice-prejudice rule and found that Allied World could not have been harmed by KSU's three-day delay. On appeal, the intermediate appellate court reversed and the Kentucky Supreme Court affirmed the intermediate appellate court's decision.

The Kentucky Supreme Court rejected KSU's argument that the policy had no specific forfeiture language. The policy stated that giving notice as soon as practicable was a condition precedent to coverage and in no event should notice be given any later than 90 days after the policy period ends. As KSU did not purchase Discovery Period coverage, the reporting period did not extend beyond the 90 days. The policy defined when notice was due and the consequences of not complying.

The court then explained how a claims-made-and-reported policy differs from an occurrence policy and why the notice-prejudice rule doesn't apply.

A claims-made-and-reported policy provides coverage only for claims made against the insured and reported to the insurer during the life of the policy regardless of when the underlying incident occurred. Timely notice of a claim is the event that not only *triggers* coverage, but also *defines* its scope. An occurrence-based policy, by contrast, provides coverage for incidents which occur during the life of the policy without regard to when a claim is brought. While prompt notice allows the insurer to investigate and defend the claim, it has no effect as to the scope of coverage.

The court emphasized that parties are bound by the clear and unambiguous terms of their contracts and the court may not rewrite those contracts. Thus, Allied World had no coverage obligations because KSU failed to comply with the policy's reporting requirements, which were integral to coverage.

The case is *Kentucky State Univ. v. Darwin Nat'l Ins. Co.,* No. 2021-SC-0130-DG (Ky. June 15, 2023).

Wisconsin Supreme Court Rules that Damage Caused by Defectively Installed Pool Could Be Covered

The Wisconsin Supreme Court took a closer look at whether faulty workmanship could lead to a covered occurrence under a commercial general liability policy, causing it to overrule earlier precedent.

A pool cracked and caused vast amounts of water to leak into the surrounding soil. The property owner had to demolish the entire pool structure and construct a new one. It then sued the general contractor and the concrete supplier.

Both the general contractor and supplier sought coverage under their CGL policies.

The insurers denied coverage because there was no "property damage" caused by an "occurrence" – the pool defects were caused by faulty workmanship.

The case made its way to the Wisconsin Supreme Court.

The court ruled for the policyholders, finding that a trier of fact could conclude that the property damage extended beyond the pool itself.

In reaching this conclusion, the court overruled its *Pharmacal* decision. In that case, the Wisconsin Supreme Court stated that "property damage" under a CGL policy requires damage to other property and used an integrated systems analysis to assess whether other property was damaged. The integrated systems analysis asks whether the product is part of an integrated whole such that any damage can be ascribed only to the product itself, rather than to other property.

But in hindsight, the court said that *Pharmacal* wrongly imported tort principles into insurance policy interpretation. The court should have focused on the language of the contract's insuring agreement.

It explained that the reason an insured's defective work or product is not covered under a CGL policy is because of the business risk exclusions in the policy, not because there isn't an "occurrence." Business risk exclusions are considered only if the coverage grant is satisfied. Yet *Pharmacal* incorporated the concept of damage to property other than the insured's product or work – a concept relevant to the business exclusions – into the determination of whether an "occurrence" caused "property damage." It should not have considered concepts relating to exclusions when considering the initial grant of coverage.

Nor should it have considered the integrated systems analysis, which is used to determine whether damage to a defective component of an integrated system constitutes damage to other property. That test seeks to determine whether a party may pursue tort remedies, or whether the economic loss rule bars them, leaving the party to pursue only contract remedies.

These concepts, the court held, had no place in basic contract interpretation. The economic loss rule should not be used to determine whether a CGL policy provides coverage. Thus, the court overruled *Pharmacal's* holding incorporating the integrated systems analysis into insurance policy disputes, and its incorporation of an "other property" analysis when considering if an occurrence has caused "property damage" under an insurance policy.

Turning back to the pool claim, the court considered if the property damage was caused by an occurrence. "Property damage" meant "[p]hysical injury to tangible property, including all resulting loss of use of that property." "Occurrence" meant "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

The court observed that while faulty workmanship is not an occurrence, faulty workmanship can lead to an occurrence that causes property damage. The court acknowledged that the improper installation of shotcrete and the poor placement of steel reinforcing bars were not enough on their own to constitute an occurrence (its faulty workmanship). But the court found that the record supported a conclusion that this faulty workmanship caused the pool to crack and leak, and those cracks became worse as the pool leaked and destabilized the surrounding soil. The cracks, leakage, and soil damage could constitute accidents—unexpected and unforeseen events—caused by improper installation. And these cracks and the damage to the surrounding soil also could constitute physical injuries to the homeowner's tangible property.

In conclusion, the Wisconsin Supreme Court said the main takeaway is this: “When analyzing if there is ‘property damage’ under a CGL policy in the initial grant of coverage stage, we do not employ the integrated systems analysis nor do we limit our review of property damage to damage to ‘other property.’ We apply the terms of the policy.”

Because a factfinder could conclude there was “property damage” caused by an “occurrence,” the insurers were not entitled to summary judgment.

The case is *5 Walworth, LLC v. Engerman Contr., Inc*., 2019AP1085 & 2019AP1086 (Wis. June 20, 2023).

Ninth Circuit Holds That Insured’s Late Notice Prejudiced Insurer’s Ability to Investigate

California law, like most states, follows the notice prejudice rule. Except for claims-made-and-reported policies, an insurer won’t prevail on a late notice defense unless it can show actual prejudice from the delay. That’s often a factual issue, but here’s an example in which the issue can be decided as a matter of law.

Stockton Mariposa LLC, the insured, owned property that Kmart had occupied. Kmart vacated the building in March 2019, but a successor to Kmart remained the lessee and continued to pay rent. About a month after Kmart left, the City of Stockton issued a Notice of Violation directing the insured to remove graffiti from the property and to secure the property from intrusion by unauthorized persons.

When the insured's principal visited the vacant store in April, he learned that it had been vandalized and that copper pipes and wires had been taken. In July, more than three months later, the insured submitted a claim to West American Insurance Company for theft and vandalism. But the notice suggested that the vandalism had just taken place in July. West American wanted to inspect the property, but the insured claimed he could not provide access at that time. West American sent the insured a reservation of rights letter, noting its inability to access the property and raising late notice.

For months, West American sought to investigate. The insured claimed that he reached out to the current lessee but received no response. West American eventually managed to inspect the property in November and found the property to be heavily vandalized. The policy had a Vacancy Exclusion that bars coverage for certain losses arising from a consecutive vacancy for the prior 60 days. Applying this provision, only damage that occurred between March and May were covered.

The insured claimed $9 million in losses and sued West American for breach of contract and bad faith. West American denied coverage because its investigation was impeded. The district court ruled for the insurer and the case made its way up to the Ninth Circuit.

Affirming the district court's ruling, the Ninth Circuit held that West American had shown it suffered actual prejudice because of the insured's delay. The court found that West American's ability to investigate was not only impaired, but rendered impossible.

Because of the insured's late notice, West American lost the ability to pin down the nature and extent of the damage that occurred within the 60-day window. As there was now no way to determine what damage occurred between March and May, the court agreed that there was no factual dispute – West American suffered substantial prejudice because of the insured's late notice.

The case is *Stockton Mariposa, LLC v. W. Am. Ins. Co.*, No. 22-55343 (9th Cir. June 14, 2023).

Illinois Appeals Court: Contaminated Drinking Water from Poorly Maintained City Pipes Is Not Traditional Environmental Pollution

Courts differ as to the reach of pollution exclusions. Some find they apply only to what we traditionally think of as environmental pollution. Here, the court considers if contaminants within a municipality's drinking water system was pollution in the traditional sense.

Jennifer Campbell and Jeremy Pennington, residents of the City of Sycamore, filed a putative class action against the city for alleged failure to maintain water mains. The complaint alleged that the city provided its residents with unsafe drinking water and damaged the equipment that used water in their homes. Plaintiffs alleged that the water problem – excessive levels of lead, iron, and bacteria – was caused by the city's failure to replace century-old water mains.

Sycamore tendered the claim to its insurers, LM Insurance Corporation and Liberty Insurance Corporation ("Liberty"). Liberty denied coverage and filed a declaratory judgment action in Illinois state court. Applying the policies' pollution and lead exclusions, the trial court granted Liberty judgment on the pleadings. Sycamore appealed.

The appellate court reversed, finding the pollution and lead exclusions inapplicable. Under Illinois law, the court reasoned, total pollution exclusions were limited to "traditional environmental pollution." This means a release, discharge, or escape of a pollutant *into the environment*, including the land, atmosphere, or any watercourse or body of water.

But according to the court, no such thing occurred. Unlike the "traditional environmental pollution" cases, there was no release of pollutants into the ground that caused the groundwater to become contaminated. Instead, the complaint alleged that the contaminants resulted from the degrading water mains. Thus, the water did not become contaminated until it was already in Sycamore's water pipes. The court acknowledged that plaintiffs claimed to be harmed by pollutants in the water, but the court viewed this as being different from asserting harm by "traditional environmental pollution." The court said the primary factor to consider in determining whether there is traditional environmental pollution is whether the hazardous material is confined within the insured's premises, or if it escapes into the environment. Here, the contaminants did not escape from the pipes into the environment. They leached from the degraded pipes into the water. The court believed this distinction took the claim outside the pollution exclusion.

The court also held that the lead exclusion did not apply because the underlying plaintiffs complained of iron, lead, and bacteria pollution, not just lead pollution.

And the court rejected Liberty's argument that injuries caused by Sycamore's deferred maintenance of its water mains could not be an occurrence. Liberty argued that the natural and ordinary consequences of Sycamore's decision to defer maintenance on its water mains for decades is that those mains would deteriorate and cause problems for residents. But the court found the city's inaction could not invoke the "natural and ordinary consequences" principle because it wasn't an act clearly intended to injure. Plus, the court noted that other Illinois courts have found an occurrence under more egregious facts, such as when an insured knowingly distributed previously contaminated water.

For these reasons, the appellate court reversed and remanded to the trial court.

The case is *LM Ins. Corp. v. City of Sycamore*, No. 2-22-0234 (Ill. App. Ct. June 8, 2023).

Minnesota Court of Appeals Finds That Golf Carts Are Included in Recreational Use Exception

This case involved a dispute between two insurers over who owed primary coverage for a golf cart accident.

Matthew Fee, Luke Buck, and John Gillen played golf at Tanners Brook Golf Course. During the game, Fee was allegedly injured when he was thrown from a golf cart operated by Gillen that struck a golf cart operated by Buck. The golf carts were owned by Tanners Brook. At the time, Wadena Insurance Company provided businessowners' insurance to Tanners Brook and Nationwide Insurance Company provided homeowners' insurance to Buck.

Buck's homeowners policy with Nationwide excluded coverage for "motor vehicle liability" for any motor vehicle being used for any business purpose "except for a motorized golf cart while on a golfing facility." But a separate provision said that for the "motor vehicle liability" coverage to attach, the "motor vehicle" must be "designed for recreational use off public roads" and must not be owned by an insured. Another exception dealt specifically with motorized golf carts owned by the insured.

After Fee sued Buck, Nationwide filed a declaratory judgment action against Wadena. Nationwide argued that only one exception to the motor vehicle liability exclusion specifically addressed golf carts, and because Buck didn't own the golf cart, the exception did not apply. Wadena conceded that the "motorized golf cart" exception did not apply, but contended that other exceptions to the "motor vehicle liability" coverage in Nationwide's policy applied and that Wadena's policy was excess to Nationwide's.

The trial court found that Nationwide's motor vehicle liability exclusion did not apply to: (1) vehicles designed for recreational use off public roads that are not owned by Buck; and (2) golf carts owned by Buck and used in a certain manner. In ruling for Wadena, the trial court found that the golf cart was a vehicle designed for recreational use off public roads and was not owned by Buck.

The Court of Appeals of Minnesota affirmed. The court noted that golf carts are primarily used for transportation while playing golf and thus were designed for recreational use off public roads. It did not matter, the court held, that the other exception to the exclusion specifically relating to golf carts was inapplicable. The court found that nothing in the golf-cart exception stated that it was the only exception applicable to occurrences involving golf carts. The exception to the exclusion was separated by the disjunctive "or," which ordinarily refers to different things as alternatives.

Nationwide thus owed primary coverage.

The case is *Nationwide Ins. Co. v. Wadena Ins. Co.*, A23-0085 (Minn. Ct. App. June 20, 2023). (Note that this decision is unpublished).

Business Exclusion Bars Coverage for Dog Bite Claim, Alabama Federal Judge Rules

Does a business exclusion apply when an insured provides a service for free?

The insured had a federal firearms license that allowed him to sell and broker firearms. He worked out of his home. He typically charged $20 dollars for his brokerage services, but often didn't charge friends or regular customers.

The insured's friend bought a gun from an out-of-state dealer and had it shipped to the insured. The insured didn't charge his friend for this brokerage service. When the friend went to pick up the gun, the insured's not-so-friendly dog bit him. The friend sued the insured for injuries he sustained from the dog bite.

The insured submitted a claim to Nationwide, his homeowners and personal umbrella insurer. Those policies excluded coverage for personal liability and medical payments if connected to a business run out of the insured location. Nationwide filed a declaratory judgment action seeking a ruling that it had no duty to defend or indemnify. The insured defaulted but the friend intervened.

The dispute centered on whether the friend's visit to the insured's house "arose out of" or was "connected with" the insured's firearm business. The friend argued it wasn't because he didn't pay for the service.

The court disagreed, finding that the friend would not have been at the insured's house if not for the need to pick up a gun that the insured helped broker. The court noted that the insured's brokerage service was a business service that he paid taxes on. Even though the friend did not pay for this particular brokerage service, the friend had paid for firearms in the past and was a repeat customer. It was the insured's business practice to waive brokerage fees for repeat customers. Thus, because the dog bite incident was connected to the insured's business, it was excluded.

The case is *Nationwide Gen. Ins. Co. v. Hope,* No. 4:21-cv-930-CLM (N.D. Ala. June 12, 2023).

RIVKIN RADLER LLP
ATTORNEYS AT LAW

Rivkin Radler LLP
926 RXR Plaza, Uniondale NY 11556
www.rivkinradler.com