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The Impact of Conflict of Law on Insurance Claims

Risk Management Magazine

August 1, 2023

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When determining whether insurance coverage exists for a claim, a crucial consideration is whether the claim involves an event or occurrence that took place in a state other than where the relevant policy was delivered. This is often the case for large companies with national operations or markets. When this happens, it may be unclear whether the law that governs the coverage issue will be the law of the state where the claim arose or the state where the policy was delivered. This can be a recipe for trouble as the laws of the two states may be the exact opposite for a given coverage issue.

When such coverage issues surface, the claims landscape changes. Insurers may sue and ask a court to declare the parties' rights under the given policy. Insurers may also take the opportunity to choose a forum where the law substantially favors the insurer's position, even if a more appropriate or alternative forum is available. This decision can be costly for policyholders.

In the federal system, each U.S. state has the power to establish its own law governing the interpretation and enforcement of insurance policies. Inevitably, judges and justices in different states could have opposing views on what a given policy provision means, often leading to a conflict of laws among states. For example, a claim that is covered in New Jersey may not be covered just across the border in New York.

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Generally speaking, courts will apply the law of the state in which they sit. A state or federal court can apply the law of another state, but it will do so only if a complex and fact-intensive choice of law analysis establishes that applying foreign law is warranted. The difficulty (and expense) of convincing a court to apply the law of another jurisdiction should not be underestimated. It follows, then, that where a lawsuit is filed will most likely determine the outcome of the case. Hence, sophisticated litigants—especially some insurance companies—can be expected to shop for the forum most likely to advance their interests.

For example, consider a specific and limited batch of a nationally distributed product that was sold in a single state and that turns out to be contaminated or defective, causing multiple injuries and lawsuits in that state. If the liability policy was delivered to corporate headquarters in a different state, which state's law will govern the interpretation of the policy and whether there is coverage? If the insurer files a declaratory judgment action in one of those states, will it make a difference that the insurer sued first and selected the forum to adjudicate the insurance claim? These critical questions should be considered at the outset of a claim.

Conflict of Laws

Given the potential significance a conflict of law and an insurer's choice of forum can have on an insurance claim, it is useful to consider some specific examples where insurance law varies among states. Although not a comprehensive list, risk managers should watch for the following issues in the context of any given claim:

Extrinsic Evidence. Plaintiffs often do not draft their complaints to ensure that a defendant's liability insurance will be triggered. Known as the "four corners" or "eight corners" rule, several states will only look to the allegations in a complaint and compare them to the terms of the policy to determine whether a duty to defend exists. Thus, even if information is known to the insurer that would trigger the duty to defend, the insurer need not consider it when denying the claim. By the same token, if extrinsic (unpled) facts are known that would eliminate the coverage, the four corners rule would prevent an insurer from denying coverage based on those extrinsic facts, until such facts were established at trial.

The Pollution Exclusion. In all of its iterations, the pollution exclusion may have engendered more major coverage litigation than any other exclusion over the past 50 years. Focusing on the typical modern "absolute" or "total" pollution exclusion, some states have held that such exclusions only apply to traditional environmental liability, such as remediating a contaminated Superfund site or landfill. Other states have applied them to any claim involving an "irritant." For example, in some states, the total pollution exclusion will bar a claim for injury arising out of exposure to toxic fumes, such as ammonia fumes or carbon monoxide in a building, toxic fumes emitted from a floor coating/sealant operation, or even diesel fumes from a company vehicle fleet.

Late Notice. In a typical occurrence-based commercial liability policy (as opposed to claims-made), terms usually require that the policyholder give notice of a claim "as soon as practicable." States have different interpretations about what that means. Many states will only relieve an insurer of its coverage obligation if the notice is both late and caused "appreciable prejudice" to the insurer, which is a difficult standard to meet. Other states do not require prejudice to the insurer, meaning coverage can be forfeited if notice was not given "as soon as practicable."

The late notice issue can be especially dangerous when a claim reaches the umbrella or excess layers of coverage but those insurers were never notified, if there is a large deductible or retention that leads a policyholder to sit on a claim, or when the claim involves long-tail liabilities (such as environmental cleanup liability or asbestos litigation) and it takes time to find policies. For example, a policyholder may be a small party in a large Superfund site for years and then, for any number of reasons, find that its share of cleanup liability has ballooned, putting policies into play that it never believed it would need.

Government Subpoenas. Receiving and responding to a subpoena from a government agency can be a major undertaking, especially when the subpoena is the precursor to a civil enforcement action. It is not unheard of for the costs associated with a subpoena to reach the level and cost of full-blown discovery in a large litigation. Several states have taken opposite views on whether such a subpoena constitutes a claim that would trigger a D&O policy. For example, courts in New York and Illinois have held that such a subpoena does constitute a claim, whereas courts applying Virginia law have concluded that it does not.

Maximizing Coverage

Failing to give due attention to conflict of law issues early in the claims process can have major consequences for insurance coverage. When confronting a loss or liability, a risk manager should consider the following questions:

- What is the nature of the underlying claim or loss?
- Where did the underlying claim or loss arise?
- If it is a liability claim, where was the underlying lawsuit filed?
- Is there potential insurance coverage?
- Where was the relevant policy delivered and where is the policyholder domiciled? Is it in a different state than where the underlying claim arose or was filed?
- If different states are involved, could there be a conflict of law issue?
- If there is a potential conflict of law issue, is there a risk that the insurer will choose a forum more likely to support a denial of coverage?

By asking these questions, risk managers can identify choice of law issues and reduce the risk of being outmaneuvered by their insurer and potentially losing coverage. For example, in some instances, it may be better to seek a declaratory judgment very early in the claims process to preserve your ability to choose where an anticipated coverage issue will be litigated. This can be especially important when the stakes are high.

It is worth noting that many choice of law and choice of forum questions fall squarely into the territory of coverage lawyers and are typically outside of the purview of risk managers or broker claims advocates. Therefore, it is important for anyone responsible for claims to assess whether coverage counsel should be retained to help navigate these issues and establish where your claim should be litigated and what law applies. Under certain circumstances, it could mean the difference in whether or not a major loss is covered.

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