Insurance Companies Must Show "Substantial Prejudice" to Deny Claims for a Failure to Comply With the Proof of Loss Requirement

Following the August 2009 Station Fire, the lawsuits of over 1,440 policyholders filed against Fire Insurance Exchange ("FIE") and related insurers were consolidated into one case – *Henderson v. Farmers Group, Inc.*, __ Cal.App.4th __, 2012 Cal. App. LEXIS 1108 (October 24, 2012). In this case, the California Court of Appeal, Second Appellate District, issued an interesting opinion addressing several important issues.

In the consolidated lawsuit, the policyholders alleged that FIE improperly denied their claims by asserting either that: (1) the policyholders did not submit sworn proof of loss as required by the fire insurance policies, or (2) that the policyholders submitted delayed notice of loss. The policyholders asserted causes of action for breach of contract, breach of the implied covenant of good faith and fair dealing (bad faith) and unfair business practices under section 17200. Given the large number of policyholders, five plaintiffs were selected as representative of the other policyholders and had their claims litigated, while the lawsuits of the other policyholders were stayed.

FIE moved for summary adjudication against the five representative plaintiffs, asserting, among other things, that submission of proof of loss is a condition precedent to coverage under the policy, and the failure to submit proof of loss in a timely manner meant the policyholders did not meet their own contractual obligations. While the trial court granted summary adjudication to FIE, the California Court of Appeal reversed.

For the policyholders whose claims were denied based on a failure to meet the policies' proof of loss deadline – usually within 60 days of a request by FIE – the Court of Appeal ruled that California's notice-prejudice rule applied. Under the rule, an insurer cannot avoid liability for an untimely claim, unless the insurer shows it suffered "substantial prejudice" from the claimant's failure to provide timely notice and proof loss. The Court explained:

> There is ample reason to apply the "notice-prejudice" rule here. California has a strong public policy against "technical forfeitures." (*Bollinger v. National Fire Ins. Co.* (1944) 25 Cal.2d 399, 405.) Since forfeitures are not favored, "'conditions in a contract, will if possible be construed to avoid forfeiture. [Citations.] This is particularly true of insurance contracts. [Citation.] [¶] And where . . . the condition is express and cannot be avoided by construction, the court may, in a proper case, excuse compliance with it or give equitable relief against its enforcement.'" (*Root v. American Equity Specialty Ins. Co.* (2005) 130 Cal.App.4th 926, 942, quoting *O'Morrow v. Borad* (1946) 27 Cal.2d 794, 800.) FIE's employees testified that they waited for the insured to submit a proof of loss only where FIE's hygienist recommended cleaning, i.e., when its investigation determined the insured had sustained a specific measure of damage and cleanup costs would be greater than the deductible. A reasonable trier of fact might infer that the insureds' failure to provide a sworn proof of loss in such cases was a technical forfeiture that FIE used to avoid paying for cleanup costs when its hygienists recommended that course of action after testing samples from the property.

The Court further explained that "the notice-prejudice rule avoids an absurd result that would follow were courts to require absolute compliance with the proof of loss condition." Reviewing the available facts, the Court of Appeal found that FIE failed to establish "substantial prejudice," and indeed noted that even FIE's

person most knowledgeable testified that FIE relied upon the conclusions of expert hygienists hired to determine the level of char each house suffered, not the proof of loss, in preparing the damage estimates.

For the policyholders whose claims were denied because of delayed notice, the Court determined that FIE did show that it was prejudiced by the delayed notice because the condition of the property at the time the claim was made was substantially different from its condition when the loss occurred. However, summary adjudication was still reversed because FIE failed to raise the delayed notice until the lawsuit. In the letter denying the claim of the representative plaintiff that provided delayed notice, FIE's denial was based on the grounds that "there were insufficient levels of smoke, ash, and/or soot present in the home," and that it was reserving any available defenses. While FIE argued that the reservation language in the letter meant that it could raise the delayed notice defense to justify its denial decision, the Court of Appeal disagreed. Specifically, the Court held that under Insurance Code section 554, a failure to "promptly and specifically object to a delay in the presentation of notice" means that further objections based on delay are waived. The Court further noted that:

> "The law is established that where an insurance company denies liability under a policy which it has issued, it waives any claim that the notice provisions of the policy have not been complied with." (*Comunale v. Traders & General Ins. Co.* (1953) 116 Cal.App.2d 198, 202-203.) The rationale for this rule is "that an insurer cannot deny all liability, and at the same time be permitted to stand on a provision inserted in the policy for its benefit. . . . [W]here the insurer denie[d] all liability under the policy, the insured is misled into believing it would be futile to perform any affirmative obligation under the policy. In other words, the insurer is deemed to have waived the insured's failure to perform because the nonperformance is attributable to the insurer's conduct. [Citation.] Thus, the cases in which a notice or proof of loss provision has been deemed waived by the insurer usually involve an insured lulled by the insurer's silence into believing it had complied with the policy notice and/or proof of loss provisions. Consistent with this rule, section 554 operates to deem an insurer's belated objection to an untimely notice of claim or proof of loss waived if not promptly called to the attention of the insured. . . . [S]ection 554 prevents an insurer from lulling the insured into believing that notice and proof of loss are unnecessary." (*Insua v. Scottsdale Ins. Co.* (2002) 104 Cal.App.4th 737, 742–743, fns. omitted.)

Finally, the California Court of Appeal affirmed the trial court's summary adjudication ruling in favor of the insurer regarding alter ego and other vicarious liability theories, but reversed the trial court's summary adjudication ruling on the causes of action for breach of contract, breach of the implied covenant of good faith and fair dealing, and unfair competition under Business & Professions Code section 17200 et seq. With regard to the latter claim, the Court found that *Moradi-Shalal v. Fireman's Fund Insurance Companies*, 46 Cal. 3d 287 (1988), did not bar a UCL cause of action based on an insurer's bad faith, even if the same conduct might also constitute a violation of the Unfair Insurance Practices Act (which can only be enforced by the California Insurance Commissioner). With this, the lawsuit will be remanded back to the trial court, although we expect that the California Supreme Court's upcoming opinion in *Zhang v. Superior Court*, 178 Cal. App. 4th 1801 (2009) could result in a rehearing of the section 17200 cause of action.