

Late Notice, Claims-First-Made and Misrepresentation Defenses Preclude Coverage for Lawsuit Not Reported During Policy Period of Filing

July 2012

The United States District Court for the Northern District of Alabama has found no coverage under either of two successive claims-made miscellaneous errors and omissions policies on the basis that the claim was not timely reported under the first policy and was not first made within the policy period of the second policy. *Sharp Realty and Mgmt., LLC v. Capitol Spec. Ins. Corp.*, 2012 WL 2049817 (N.D. Ala. May 31, 2012). In a "lengthy . . . and multi-faced opinion," the court also discussed a host of other issues, including "loss," cooperation, estoppel, and misrepresentation by the insured.

The underlying lawsuit was brought against the insured real estate management company for alleged mismanagement of an investment property. The owner of the insured entity also indirectly owned 25% of the entity that brought the underlying lawsuit and owned the investment property at issue. The lawsuit was filed in July 2009, during the claims-made policy period of the first of two errors and omissions policies at issue. The principal of the insured did not read the complaint when he received it and merely forwarded it to his attorney. No one provided notice of the claim to the first E&O insurer until after the termination of the policy, and the insured stated in its application for a second E&O policy for the following policy period that it was not aware of any fact, circumstance, error, or omission which could reasonably be expected to result in a claim, suit or proceeding during the preceding year.

In March 2010, the insured's insurance agent notified both E&O insurers of the underlying lawsuit, more than eight months after it was filed. The first E&O insurer denied coverage on the basis that notice of the claim was not provided "promptly" as required under the policy and under policy exclusions for liability arising from breach of contract and liability for claims made by an entity over which the insured has an ownership interest. Following objections from the insured, the first insurer agreed to defend under a reservation of rights. The second insurer denied coverage because the underlying lawsuit was not a claim first made during its claims-made policy period and because coverage was barred by an exclusion for claims made by an entity in which the insured has an ownership interest.

The insured filed coverage litigation against both insurers. While the coverage litigation was pending, the underlying lawsuit was settled by the insured without the insurers' consent and with no payment by the insured, except to the extent insurance coverage was determined to be available. The insured's principal explicitly retained a 25% interest in any insurance proceeds recovered.

In the coverage litigation, the court concluded that the insured failed to comply with the first policy's notice provision, which required that the insured "promptly . . . [n]otify the Company in writing" of any claim. Under Alabama law, compliance with notice provisions is a condition precedent to coverage, and prejudice to the insurer by late notice is presumed. When determining whether notice has been provided "promptly," the court held it may only consider: (1) the length of the delay, and (2) the existence or non-existence of an objectively reasonable excuse for the delay. Here the eight month delay was held to be unreasonable as a matter of law, and the failure of the insured and his attorney to read the underlying lawsuit was not a reasonable excuse.

The court also found that the first insurer could not be bound by the insured's settlement of the underlying action because it was entered without the insurer's consent and with the agreement that the insured never be "legally obligated to pay" any amounts itself. The court determined that, when an insured reaches a settlement in which the insured will never pay anything, the insurer is simultaneously relieved. The court also stated that the insured is not free to settle in violation a policy provision precluding settlement without the insurer's written consent where, as here, the insurer has not declined to defend.

With respect to the second policy, the court found that the underlying lawsuit was not first made during the policy's claims-made policy period because it was filed before the policy's inception. The insured argued that interrogatory responses in the underlying litigation that broadened the scope of the alleged mismanagement and increased the asserted damages constituted a new claim that was first made during the second policy period. The court disagreed, noting that the interrogatory answers and the audit letter on which they were based discussed erroneous acts "logically or causally connected by common facts, circumstances, transactions, events and/or decisions" to the erroneous acts alleged when the underlying lawsuit was filed. Under the policy, such erroneous acts were treated as one "erroneous act" and all claims arising from that same erroneous act were considered made at the time of the first such claim. Accordingly, the court concluded that the later audit letter and interrogatory answers were not a separate claim first made during the second policy period. In reaching this conclusion, the court rejected the insured's argument that the interrogatory answers addressed different tenants, different leases, and different negotiations from the original underlying lawsuit. The court reasoned that such facts "do not detract from the undisputed, more direct facts that the same claimant . . . asserted the same kind and character of wrongful conduct in its original complaint and its amended damages claim."

The court also found, in the alternative, that coverage under the second policy was voidable because the insured misrepresented its claims history. Under Alabama law, an insurer relying on such a misrepresentation defense must demonstrate that its underwriting guidelines dealing with similar misrepresentations are equally and evenly applied and that it would not have issued the policy had it known the actual circumstances. The

court here found that burden was met by an affidavit showing that the insurer was unlikely to issue a policy where an existing claim was disclosed in an application but had not been reported under the existing policy. The court rejected the insured's argument that the insurer had waived the right to rely on misrepresentation as a defense because it did not raise misrepresentation in its first letter. The court found no waiver because the insurer had not at any time denied coverage "based on one defense and no other" but had instead specifically asserted in its denial the right to raise additional defenses, including misrepresentation.