Case Alert

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The Notice-Prejudice Rule Lives on in California

The California Court of Appeals recently confirmed California's support for the notice-prejudice rule. The notice-prejudice rule requires insurers that deny coverage based on a failure to provide notice under the policy to show that they have been prejudiced by the untimely or insufficient notice. The Court held that a policyholder who failed to notify her life insurance carrier that she had become totally disabled, as required by a policy rider, did not forfeit her beneficiaries' right to receive life insurance benefits when she died.

The case is *Lat v. Farmers New World Life Insurance Co.*, Case No. B282008 (Cal Ct. App., Oct. 16, 2018). The insured purchased a life insurance policy from Farmers New World Life Insurance Company ("Farmers") and named her sons as beneficiaries. The policy established an "accumulation account," under which the insured's premium payments and associated interest were added. Monthly costs of insurance and other amounts were then deducted from that account. If that account reduced below the amount needed for the next month's deduction, a 61-day grace period would apply in which the insured could pay the premium needed for the next deduction or the policy would be cancelled. However, the policy contained a rider that would cause Farmers to waive the monthly deductions in the event of the insured's total disability, but only if Farmers received written notice of disability during the period of disability.

In August 2012, the insured was diagnosed with stage 4 colon cancer, rendering her totally disabled. The insured did not provide Farmers with notice of her disability and eventually stopped making payments on the policy. After a series of warning letters from Farmers, informing her that the premium payments were insufficient and that the policy would lapse and terminate coverage, Farmers terminated the policy.

The insured died in September 2013 and the beneficiaries contacted Farmers to claim the policy's death benefits. After Farmers advised them that they were not entitled to benefits because the policy had lapsed, the beneficiaries sued.

The trial court granted summary judgment in Farmers' favor, holding that it was undisputed that the insured did not make her premium payments within the 61-day grace period and that she did not make a disability claim until after the grace period elapsed.

On appeal, the California Court of Appeals considered whether the requirement that the insured give Farmers notice of her disability is excused by California's notice-prejudice rule, thereby waiving the preclusive result of her delinquent payments and effectuating coverage.

Under California's notice-prejudice rule, an insurer may not deny an insured's claim under an occurrence-based policy due to a lack of timely notice or proof of claim unless it can show actual and substantial prejudice from the delay. This rule is based on the notion that the notice requirement serves to protect insurers from prejudice, not to relieve them of their contractual obligations based on a technicality. The rule places the burden of proof on the insurer to demonstrate that delayed notice caused it to lose something that would have impacted the underlying claim.

Farmers contended that the insured's policy terminated when her accumulation account dropped below the level necessary for the premium deduction and she subsequently failed to make a payment within the 61-day grace period, causing Farmers to terminate the policy. According to Farmers, once the policy ended, the rider ended and could not subsequently be invoked by the beneficiaries. The court found these arguments circular and unavailing. The court noted,

> [Farmers'] premise that the policy lapsed because [the insured] failed to pay the deduction assumes Farmers' conclusion that [the insured] was not entitled to the deduction waiver benefit because the policy had lapsed. If, of course, [the insured] was entitled to that benefit, she was excused from paying the deductions while she was disabled and the policy would not have lapsed.

Ultimately, the court held that there was no dispute that the insured was totally disabled while the policy was in force and that she would have been entitled to the deduction waiver benefit under the rider if she had given Farmers timely notice of her disability. If Farmers had provided that benefit, the policy would have been in force at the time of her death. Indeed, the only reason Farmers terminated the policy was because it applied the deduction it had promised it would waive.

The court explained that,

> [t]he fact that Farmers was unaware of [the insured's] disability when it declared the policy had lapsed explains why it declared the policy lapsed – indeed, Farmers appears to have been entirely innocent in making that determination – but once it learned of [the] disability and, therefore, her entitlement to the deduction waiver, Farmers' continued refusal to honor its contractual obligations to [the insured] and her beneficiaries precludes summary judgment in its favor.

Reversing the trial court's ruling, the appellate court found that Farmers made no assertion that it was prejudiced by the delayed notice of the insured's disability. The insured was entitled to the benefit promised under the rider – to waive the deductions charged to her account.

This case exemplifies California's well-established stance that coverage rights will not be surrendered due to improper or late notice without proof of an actual and substantial prejudicial effect on the insurer. This case also demonstrates that the notice-prejudice rule extends beyond the context of notice of a claim itself, to other notices that may be required under an insurance policy.

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