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Breach Of Cooperation Clause Of Liability Policy - Fidelity and Casualty Co. of N. Y. v. McConnaughy

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Breach Of Cooperation Clause Of Liability Policy

Fidelity and Casualty Co. of N. Y. v. McConnaughy[1]

Plaintiff sued James Butler in 1954 for injuries which she sustained in an accident with Butler's car. Fidelity and Casualty Co. undertook the defense of the case under an automobile liability policy it had issued to Butler. This suit resulted in a summary judgment recovery for the amount of $10,000 for the plaintiff. After an unsuccessful attempt to execute on the judgment, plaintiff brought suit against Fidelity, alleging that under the policy it had issued to Butler it was legally obligated to pay the judgment against him. The insurance company argued in defense that Butler had procured two witnesses whom he had induced to make false statements and that this action was a breach of the policy provision to cooperate. It also argued that these same false statements prejudiced the insurance company in that it had not accepted a $3,500 settlement which had been offered and then later withdrawn by the injured party. The trial court held the insurance company liable for the full amount of $10,000 with interest. On appeal, there was no dispute as to the fact that Butler, the insured, had acted fraudulently by procuring witnesses to testify falsely, and that this conduct resulted in a breach of the cooperation clause of his policy.[2] In reversing, the Court of Appeals, Judge Hammond, reduced the amount of recovery allowable against the insurer to $3,500, reasoning that the insurer had been prejudiced by testimony, but only to the extent of the difference between what it could have settled for ($3,500) before it became aware of the falsity of the insured's statements and what it was adjudicated to pay under the policy ($10,000).

The factual situation presented by the principal case falls into the general category of cases in which false statements favorable to the defense are either made or persisted in by the insured and this action subsequently results in a claim that there has been a breach of the cooperation clause. Within this general class of cases there are four principal issues discussed by the courts: (1) The extent of the insured's duty to cooperate;[3] (2) The conduct which consti-

[1] 228 Md. 1, 179 A. 2d 117 (1962).

[2] *Ibid.* The fact that the breach by Butler was in effect an attempt to over-cooperate is immaterial. See also, Hunt v. Dollar, 224 Wis. 48, 271 N.W. 405 (1937).

[3] This merely means that there must be a full, frank and fair disclosure of all the information reasonably needed by the insurer in the defense of the action against the insured. Farm Bureau Mutual Automo-

tutes a breach of the cooperation clause;[4] (3) The legal effect of the insured's failure to comply with the provisions of the cooperation clause;[5] (4) The requirement that the departure or breach result in substantial injury to the insurer. The first three of these problems[6] have now been resolved for the most part, and it is only over the fourth

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bile Ins. Co. v. Garlitz, 180 Md. 615, 26 A. 2d 388 (1942). See 72 A.L.R. 1457 (1931), supp. in 98 A.L.R. 1470 (1935), 139 A.L.R. 784 (1942).

[4] This is usually a question of fact for the jury or trier of fact. See Hardware Mut. Cas. Co. v. Mitnick, 180 Md. 604, 26 A. 2d 393 (1942). Also 72 A.L.R. 1453, 1455 (1931), supp. in 98 A.L.R. 1468 (1935), 139 A.L.R. 777 (1942).

> "[T]here may be some difference between the two standards [see infra ns. 8 and 11] as to when the question of breach will be decided by the judge and when by the jury. Even when the facts are not in dispute, breach of the notice or cooperation clause, like negligence, is a jury issue when it is a question upon which reasonable men could disagree [Standard Acc. Ins. Co. v. Winget, 197 F. 2d 97 (9th Cir. 1952)]. There is some indication that the material breach courts are somewhat more prone to take the question from the jury and find breach as a matter of law when substantial non-compliance is shown than are the prejudice standard courts."

See Comment, *Insurer's Duty to Defend*, 68 Harv. L. Rev. 1436, 1439 (1955). *Cf.*, State Automobile Mut. Ins. Co. v. York, 104 F. 2d 730 (4th Cir. 1939) (prejudice standard), with Parrish v. Phillips, 229 Wis. 439, 282 N.W. 551 (1938) (Wisconsin statute casting burden on assured apparently creating standard similar to material breach); Hagstrom v. American Fidelity Co., 137 Minn. 391, 163 N.W. 670 (1917) (material breach standard).

[5] This constitutes a defense to liability on the policy, if the insurer so elects, or the insurer may terminate its contractual obligation. See Indemnity Ins. Co. of N.A. v. Smith, 197 Md. 160, 78 A. 2d 461 (1951); 72 A.L.R. 1448 (1931), supp. 98 A.L.R. 1467 (1935); 139 A.L.R. 773 (1942).

An exception to this rule has found recognition in decisions under compulsory liability insurance statutes (*e.g.*, Royal Indemnity Co. v. Olmstead, 193 F. 2d 451 (9th Cir. 1951)); financial responsibility acts (*e.g.*, Farm Bureau Auto. Ins. Co. v. Martin, 97 N.H. 196, 84 A. 2d 823 (1951)) and in a few cases under direct action statutes (*e.g.*, Churchman v. Ingram, 56 So. 2d 297 (La. 1951)). In these cases insurers were required to compensate injured parties of auto accidents who had received judgments against a policyholder, regardless of whether or not the assured had breached the notice or cooperation clause.

[6] Concerning these issues, it is apparent that, for the most part, the fact that particular false statements are favorable to the insured's defense and are *consistently* maintained, creates no exception to these rules. "Further than that it has been especially emphasized that, with reference to the fact that the false statement is favorable, the insurer may thereby have been misled into a failure to settle the case or prepare a defense consistent with the truth, and that, with reference to the fact that the false statement is consistently maintained by the insured even in the trial of the action against him, truth rather than consistency is the test. See especially Ciaccio v. Norfolk and Dedham Mut. Fire Ins. Co. (1960) R.I. 158 A. 2d 277, on rearg. 165 A. 2d 718 (R.I. 1960).

> "A possible indication, however, that consistency in a false statement favorable to the defense may be afforded some weight in determining whether the interests of the company were adversely affected in a substantive and material way is to be found in [Rochon v. Preferred Accident Ins. Co., 118 Conn. 190, 171 A. 429 (1934)]."

See 79 A.L.R. 2d 1041, 1042 (1961).

that there is still considerable controversy. This note is concerned with an examination of this fourth issue; i.e., whether a breach of the cooperation clause must be substantial and material, or whether the insurer must be prejudiced thereby.[7]

The courts in interpreting cooperation clauses in liability insurance policies speak in terms of three different standards for determining whether there has been a sufficient lack of cooperation to constitute a breach of this clause:

(1) *The prejudice standard* — under this approach the courts have adopted the rule that the insured's violation of a cooperation clause constitutes a defense to the insurer's liability only where the insurer can show that it was substantially prejudiced by such violation.[8] This view subscribes to the theory that the insurer has the burden of proof to establish that there was a breach of the policy provisions of notice and lack of cooperation. Courts have reasoned that liability contracts are at least in part third party beneficiary contracts and that consequently there is a public interest in seeing that those persons who are injured and themselves free from fault should recover — except in instances where their recovery would cause an inequitable result.[9]

(2) *The non-compliance standard* — Under this view the burden of proving compliance with the requirements that the insured cooperate and give prompt notice rests with the insured, and the question of actual harm or the probable effect of a breach is immaterial.[10] The harshness of this view is, however, mitigated by the fact that many of these courts speak in terms of "*material* non-compliance."[11]

(3) *The presumption of prejudice standard* — This approach has been advanced by the California courts. They have held that where the insured breaches the cooperation clause; i.e., where there is significant non-compliance, prejudice to the insurer

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[7] See 72 A.L.R. 1455 (1931), supp. in 98 A.L.R. 1469 (1935), 139 A.L.R. 780 (1942).

[8] See cases listed 8 APPLEMAN, INSURANCE (1962) § 4773, p. 107, n. 22. This view will be referred to throughout the note as the "prejudice standard."

[9] *Supra*, n. 1. Also 8 APPLEMAN, INSURANCE (1962) § 4773.

[10] Imperiali v. Pica, 338 Mass. 494, 156 N.E. 2d 44 (1960); Pearl Assur. Co. Ltd. v. Watts, 58 N.J. Super. 483, 156 A. 2d 725 (1960).

[11] This view will be referred to as the "material standard" throughout the note.

will be presumed.[12] In forcing the plaintiff to rebut the presumption and show that in fact his non-compliance did not result in prejudice to the insurer, an important procedural difference between the standards is achieved.

A procedural difference in borderline situations, i.e., the area in which the degree of non-compliance is critical, may have important substantive significance, and result in the additional factor which causes courts using different standards to reach conflicting conclusions under similar fact situations. The material and prejudice standard courts require the plaintiff (who is either the insured or the injured third party) to go forward with specific proof of non-prejudice or immateriality once a non-compliance of significant proportions is shown by the insurer.[13] There is a marked difference, depending on what standard is applied, as to what the phrase "non-compliance of significant proportions" means; i.e., the degree of non-compliance which will place the burden of going forward on the plaintiff. The prejudice standard requires the insurer, defendant, to show a considerably higher degree of non-compliance than does the material standard before the burden shifts to the plaintiff.[14] The material standard, in turn, places a more stringent burden on the insurer than the California presumption of prejudice rule. This latter approach, by placing the burden of proof on the plaintiff at the outset and requiring him to show that his non-compliance did not prejudice the insurer, has resulted in the following: (1) When there has only been slight non-compliance the presumption is easily rebutted by the plaintiff where the lack of cooperation is not of decisive or significant importance. (2) In the borderline area, i.e., the area in which the degree of non-compliance may be decisive, the onus of going forward is placed on the insured rather than the insurer.[15]

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[12] Valladao v. Fireman's Fund Indemnity Co., 13 Cal. 2d 322, 89 P. 2d 643 (1939).

[13] See *e.g.* Curran v. Connecticut Indemnity Co., 127 Conn. 692, 20 A. 2d 87 (1941); Wehner v. Foster, 331 Mich. 113, 49 N.W. 2d 87 (1951).

[14] *Cf.* Bauman v. Western & Southern Indemnity Co., 230 Mo. App. 835, 77 S.W. 2d 496 (1934) and State Farm Mut. Automobile Ins. Co. v. Cassinelli, 67 Nev. 227, 216 P. 2d 606 (1950) (material breach standard) *with* Leach v. Farmer's Auto. Interinsurance Exch., 70 Idaho 156, 213 P. 2d 920 (1950) (prejudice standard); Kennedy v. Dashner, 319 Mich. 491, 30 N.W. 2d 46 (1947) (dictum).

[15] 8 APPLEMAN, INSURANCE (1962) § 4773, p. 110. Wisconsin by statute casts on the assured or injured claimant the burden of proving non-prejudice from failure to give prompt notice, Calhoun v. Western Casualty & Surety Co., 260 Wis. 34, 49 N.W. 2d 911 (1951). 25 WIS. STAT. ANNO. (1962) § 204.34.

In theory the three standards should produce quite dissimilar results; however, the case law shows that this is not in fact true. Due to certain basic policy considerations the approaches of the various courts, no matter which standard is applied, tend to produce similar results. For example, the fact that the insurance contract is a contract of adhesion is used by the material breach courts to temper the harshness of a stringent, technical, condition precedent view,[16] while at the same time this fact is used by the prejudice standard courts to justify their approach.[17] The most important single policy consideration converging the results of the cases, despite the use of different standards by the courts, is the belief on the part of the judges that when an injury has occurred which is clearly within the terms of the policy, it would be unjust to deny a recovery against the insurer because of an irresponsible insured. With this idea in mind a prejudice standard court may go to great lengths to find an absence of prejudice,[18] as will a material standard court in finding the non-compliance immaterial.[19]

This same policy consideration which considers the public to be a third party beneficiary to the contract between the insured and insurer was also the underlying rationale for the development of the important doctrine of excuse where the lack of cooperation by the assured is not in bad faith.[20] In time, however, the element of bad faith, or culpability on the part of the insured, has come to be considered independent of the factor of whether the non-compliance was material or prejudicial.[21] Thus, for an insurance company to avoid liability on a policy, there must be bad faith on the part of the insured, and good faith on the part of the insurer as well as a finding that there was sufficient non-compliance to meet the "standard" or "test" required by the particular court involved.[22] The additional

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[16] Rochmiss v. New Jersey Manufacturer's Ass'n F. Ins. Co., 112 N.J.L. 136, 169 A. 663, 664 (1934).

[17] Kennedy v. Dashner, *supra*, n. 14, 47.

[18] State Farm Mut. Automobile Ins. Co. v. Koval, 146 F. 2d 118 (10th Cir. 1944); Pacific Indemnity Co. v. McDonald, 107 F. 2d 446 (9th Cir. 1939).

[19] General Acc. Fire & Life Assur. Corp. v. Rinnert, 170 F. 2d 440 (5th Cir. 1948); *supra*, n. 16.

[20] Spradlin v. Columbia Ins. Co. of New York, 34 Tenn. App. 17, 232 S.W. 2d 605 (1950); Lienhard v. Northwestern Mut. Fire Ass'n, 187 Wash. 47, 59 P. 2d 916 (1936).

[21] See *infra*, n. 23.

[22] The problem which this imposes on the insurer is accentuated by the fact that in the majority of cases, the assured's first account of the accident contains facts which would indicate due care and the second account states facts leading to a conclusion of negligence. It is possible

requirement of culpability at times makes it extremely difficult for an insurance carrier to assert a failure of cooperation.[23]

The question as to which of the three standards the Maryland Court of Appeals will apply is, despite its latest pronouncement on the subject, not completely clear. In the case being noted, the Court cites and quotes, apparently with approval, the Maryland case of *Indemnity Ins. Co. of N. A. v. Smith*,[24] an A.L.R. annotation,[25] and several State and Federal cases,[26] which assert the basic proposition that *if "the insurer fails to show prejudice, no breach has occurred."*[27] Prior to 1936, the Court of Appeals had held that no prejudice need be shown for the insurer to be absolved when the insured had failed: (1) to notify the insurer of an accident, (2) forward suit papers, and (3) fulfill a policy provision not to assume liability.[28]

From 1936 to the present decision, there have been at least three Maryland Court of Appeals' decisions dealing with the situation in which an insured had given to an insurer a version of an accident which was falsified so as to appear favorable to his defense. In the 1942 case of *Farm Bureau Mutual Automobile Ins. Co. v. Garlitz*,[29] the Court held, without mentioning the question of whether or not the insurer had been prejudiced, that the insured was deprived of his coverage in that he had breached the cooperation clause of his policy. In 1950, in the case of *Indemnity Ins. Co. of N. A. v. Smith*,[30] the Court mentioned for the first time the prejudice standard. While it quoted a federal

in this situation for a jury in a tort action to reach a verdict in accord with the second account, and still have a suit on the policy result in a finding that the second account was in accord with the insured's honest belief, Galt v. Phoenix Indemnity Co., 120 F. 2d 723 (D.C. Cir. 1941); Hoffman v. Labutzke, 238 Wis. 164, 298 N.W. 583 (1941).

[23] This difficulty occurs most frequently in cases where inconsistent accounts of an accident are given by an assured. If the inconsistency is due to faulty memory or perception, rather than bad faith, the insurance company is in no worse a position to defend than the assured would be himself. Therefore, it is immaterial how difficult it makes the defense; the insurer will not be able to avoid liability on the grounds of non-cooperation. Ohio Farmers Indemnity Co. v. Charleston Laundry Co., 183 F. 2d 682 (4th Cir. 1950).

[24] 197 Md. 160, 78 A. 2d 461 (1951).

[25] ANNO. 34 A.L.R. 2d 264, 267, 269 *et. seq.* (1954).

[26] *E.g.*, Fidelity and Casualty Co. of N.Y. v. McConnaughy, 228 Md. 1, 14, 179 A. 2d 117 (1962); Pacific Indemnity Co. v. McDonald, 107 F. 2d 446 (9th Cir. 1939).

[27] *Ibid.* (Emphasis supplied).

[28] Employers' Liability Assur. Corp. v. Perkins, 169 Md. 269, 181 A. 436 (1935); American Automobile Ins. Co. v. Fidelity & Casualty Co., 159 Md. 631, 152 A. 523 (1930); Lewis v. Commercial Casualty Ins. Co., 142 Md. 472, 121 A. 259 (1923).

[29] 180 Md. 615, 26 A. 2d 388 (1942).

[30] 197 Md. 160, 78 A. 2d 461 (1951).

court decision to the effect that "discrepancies in statements made by the insured must be made in bad faith and must be material in nature and prejudicial in effect,"[31] its actual holding dealt only with the element of bad faith. This same federal court language was quoted in the case of *Union Assurance Soc. v. Garver*,[32] but, once again absence or presence of prejudice was not essential to the holding. Thus, although the Court applies the prejudice standard in the instant case, there is only weak precedent in prior Maryland decisions for such an approach, and the question of which of the three standards Maryland will adopt remains unsettled.[33]

The Court, in holding that the insurer could not disclaim liability because of the policyholder's breach of the cooperation clause, and in absolving the insurance company of liability only for that amount to which it had been prejudiced, used the doctrine of prejudice to serve a dual purpose. First, it was applied to the question of whether or not the insured had breached the cooperation clause of his contract. Then after finding that there had been a breach, and that the insurer had not waived this breach, it again applied the prejudice standard to determine the degree to which the insurer would be allowed to escape liability, citing no case in support. The customary approach in this area has been for courts to find either a waiver of an insured's breach, and thereby force the insurer to pay the entire recovery allowable under the policy, or to find that the insurer had not waived a breach and thus completely absolve it of liability.[34] Reasoning that "the insurer *itself* has established that it was prejudiced only as to the excess of the policy limit over $3,500,"[35] the amount for which it could have settled the claim originally, the Court had no difficulty in assigning an exact dollar amount to the prejudice which the insurer suffered and allowing recovery for the balance. While such a result constitutes an unusual application of the prejudice standard, it seems justified under the facts of the principal case.

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[31] *Id.*, 13-14, citing State Automobile Ins. Co. v. York, 104 F. 2d 730 (4th Cir. 1939).

[32] 223 Md. 412, 416, 164 A. 2d 879 (1960).

[33] See, e.g., Watson v. United States Fidelity and Guaranty Co., ... Md. ...., 189 A. 2d 625 (1963) the most recent Maryland decision on the subject. Here the court rejected the prejudice standard where insured breached his duty of notification.

[34] For the proposition that the insurer is completely absolved of liability once it has been determined that an insured has in fact breached the cooperation clause of a policy, See cases listed in 72 A.L.R. 1448 (1931), supp. in 98 A.L.R. 1467 (1935), 139 A.L.R. 774 (1942).

[35] 228 Md. 1, 14, 179 A. 2d 117 (1962).