

Insured's Breach of Cooperation Clause Causes Actual Prejudice if the Willful Conduct Has, or May Reasonably Have, Precluded Insurer From Establishing a Legitimate Issue on Insured's Liability

In *Allstate Ins. Co. v. State Farm Mutual Automobile Ins. Co.*, 363 Md. 106 (2001), the Court of Appeals of Maryland considered the standard for determining “actual prejudice” required by §§ 19-110 of the Insurance Article to denying coverage based upon an insured's failure to cooperate. There, two suits against the insured, Latricia Kirby, arose out of an automobile accident. Ms. Kirby initially gave her insurer's investigator an exculpatory statement regarding the accident. Later, she refused to cooperate in her defense by failing to respond to answer interrogatories, requests for production, appear for her twice scheduled deposition or trial, despite numerous efforts by State Farm to contact her. The trial court entered an order precluding the insured from offering any evidence in defense of the claim, including evidence that tended to establish liability on the part of her co-defendant. The jury found the insured solely negligent. State Farm denied coverage based on the insured's failure to cooperate.

In a subsequent declaratory judgment action, the trial court applied the standard for actual prejudice set forth in an earlier case, *Harleysville Ins. Co. v. Rosenbaum*, 30 Md. App. 74, 351 A.2d 197 (1976), that required the insurer to establish “a substantial likelihood that, if the cooperation clause had not be breached, [the insured] would not have been liable.” The court held that the insured breached her duty to cooperate and that State Farm was prejudiced by not being permitted to produce any evidence inasmuch as the liability of the co-defendant “would have been substantially increased and the likelihood of a joint judgment against [the insured and the co-defendant] was fairly high.” However, the court concluded “that State Farm's actual prejudice [was] limited to the

value of its loss of the Right of Contribution from [the co-defendant], that is to say responsibility for fifty percent (50%) of [Plaintiff's] damages up to the limits of State Farm's liability coverage on the [insured] vehicle.”

The intermediate appellate court disagreed with the limitation on State Farm's prejudice and concluded that insured's failure to cooperate resulted in actual prejudice, relieving State Farm entirely of its duty to defend or indemnify. The Court of Appeals granted the petition for *certiorari* to consider: (1) the correct standard for determining the actual prejudice an insurer must establish to disclaim coverage for an insured's failure to cooperate pursuant to §§ 19-110 of the Insurance Article, and (2) whether, upon a showing of some prejudice, the insurer is entitled to disclaim coverage altogether or only in proportion to the prejudice shown.

The Court of Appeals noted that §§ 19-110 provides that “[a]n insurer may not disclaim coverage for either lack of notice or failure to cooperate unless it demonstrates that the deficiency has resulted in actual prejudice to the insurer.” The Court considered standards adopted by other courts for determining actual prejudice ranging from requiring the insurer to prove that but for the breach, its insured would have won at trial, to a “*per se*” approach, that the insured's failure itself establishes prejudice. The Court rejected both the “substantially likelihood” approach of *Harleysville* and a “*per se*” approach based upon the insured fails to cooperate or give notice because of the many ways the issue may arise. For example, the witness may give late note, may give a statement and then fail to cooperate, or may fail to appear at trial. Where the insured fails to give prompt notice whether it results in prejudice (i.e. lost opportunities “to discover relevant evidence, particularly the identity of witnesses and their contemporaneous recollections”)

usually can not be known until trial. Even then determining whether there was actual prejudice is somewhat speculative. *Id. at* Md 124-125, A2d. 841. Where a disclaimer is based upon a failure of the insured to appear at trial, the loss of the jury's ability to hear the insured's story from his own lips is potentially prejudicial. However, even then the credibility of the insured, the availability of other witnesses and exhibits, must be weighed. Where the insured has given a statement prior to his failure to cooperate, "the nature of the lost evidence is known, and the uncertainty focuses on the effect and credibility of that evidence." *Id. at* Md 126, A2d 842.

The Court looked to *State Farm Mut. Auto. Ins. v Davies*, 310 S.E. 2d 167 (Va. 1983), which held that where the insured's willful failure to appear [at trial] deprived the insurer of evidence which would have made a jury issue of the insured's liability ... the insurer has established a reasonable likelihood the result would have been favorable to the insured and has carried its burden of proving prejudice." *Id. at* 126-127. The Court did not concur with the *Davies* court equating the creation of a jury issue with the likelihood of success, but agreed that the "proper focus should be on whether the insured's willful conduct has, or may reasonably have, precluded the insurer from establishing a legitimate jury issue on the insured's liability, either liability *vel non* or for the damages awarded." Thus, the insurer is not required to meet the almost impossible burden of proving that the unfavorable verdict was the result of the insured's failure to cooperate. However, the insurer must show that the insured's failure to cooperate "has, in a significant way, precluded or hampered it from presenting a credible defense to the claim."

The Court did not reach the issue of whether §§ 19-110 allows an insurer, upon a showing of some prejudice, to disclaim coverage entirely or only in proportion to the prejudice shown. “Even if ... the statute permits disclaimer only to the extent that the insurer can establish actual prejudice ..., in this case, based upon the standard we believe is appropriate, the prejudice was complete.” The Court concluded that “[t]he prejudice lies in the fact that there was a credible defense to be presented and that [the insured’s] non-cooperation precluded State Farm from even presenting a defense.” Hence, State Farm was entitled to disclaim all coverage.