

Insurer's Duty to Indemnify – Fourth Circuit Looks at Insured's Failure to Comply with Policy Provisions

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It is well established that an insurance policy is a contract, requiring each party to comply with its respective obligations thereunder. The scope of those obligations, the determination of compliance and any consequence is frequently high stakes – oftentimes leaving one party or the other facing substantial exposure. Because of the critical nature of the relationship between insurer and insured, our courts continue efforts to examine parties' respective duties and what constitutes fulfillment of those obligations. Further guidance was recently offered by the Fourth Circuit Court of Appeals in *Founders Insurance Company v. Richard Ruth's Bar & Grill, LLC, et al.*, 2019 WL 852137 (February 21, 2019)^[1]

Richard Ruth's Bar & Grill, LLC ("Ruth's Bar"), through its owners Richard and Jane Ruth, purchased a commercial general liability policy ("CGL") and a liquor liability policy from Founders. Founders does not sell directly to consumers. Rather, its products are marketed and sold through insurance wholesalers to local, independent agents. Here, the wholesaler was Hull & Company, Inc. ("Hull") who sold the policies to Cherie DuMez ("DuMez"), the Ruths' longtime agent. The policies required notice to Founders as soon as practicable of any occurrence that might result in a claim, notice of any claim made and notice of any suit brought against the Ruths. The policies also required the Ruths to provide to Founders copies of any demands, notices or other legal documents received relative to any claim or suit.

In September 2012, a bar customer, Emmanuel Kehagias, was assaulted while at Ruth's Bar and suffered serious injuries as a result. It is undisputed that the Ruths did not notify Founders, Hull or DuMez of the assault. In November 2012, Kehagias' attorney sent a letter of representation to the Ruths that they forwarded to DuMez, who in turn, forwarded the letter to the Hull. Mid-December 2012, Kehagias filed suit in state court against Ruth's Bar and the Ruths individually. The day after filing suit, Kehagias' attorney sent a copy of the action to the Ruths, requesting they forward it to their insurer or counsel. Despite the Ruths' claim they forwarded the summons and complaint to DuMez, there was no evidence to support that

claim. Furthermore , there was no evidence that either the Ruths or DuMez sent the suit to Founders.

Because the Ruths failed to forward the suit papers or otherwise appear in response to the state court action, the state court entered default against them in February 2013, and referred the case for a damages hearing. In May, Hull apprised Founders of the earlier notice of representation letter, following which Founders assigned an adjuster to the matter. Two days later, the adjuster secured a copy of the summons and complaint from the Ruths, after contacting them; Founders' first receipt of the action. Founders then retained counsel for the Ruths who sought Kehagias' consent to set aside the default. Kehagias refused, and the Ruths' counsel filed a motion to set aside the default, which was denied by the court. In April 2014, the state court entered judgment against Ruth's Bar and the Ruths individually in the amount of five million dollars. The Ruths appealed the judgment then assigned their rights against Founders to Kehagias in exchange for a covenant not to execute. Thereafter, the Ruths instructed Founders to withdraw the appeal. In November 2014, the state court entered final judgment against the Ruths.

While the state court action was pending, Founders filed a declaratory judgment action in the United States District Court against Ruth's Bar, the Ruths individually and Kehagias, seeking a determination that it was not obligated to indemnify Ruth's Bar or the Ruths individually. Kehagias answered and counterclaimed. Founders filed its motion for summary judgment as to its claims and Kehagias' counterclaims, which was granted. The matter came before the Fourth Circuit on Kehagias' appeal.

In support of his appeal, Kehagias argued the Ruths complied with the notice provisions of the policies by providing the notice of representation letter to Founders. Kehagias further argued that even if there was not technical compliance with the notice provisions of the policies, Founders suffered no prejudice due to the noncompliance of the Ruths.

South Carolina law, which governs this action, long ago established that the failure of an insured to comply with obligations that are, by the terms of the insurance contract, made conditions precedent to liability, would prevent recovery. This includes the obligation of an insured to provide notice of an occurrence or provide suit papers. Notice requirements in an insurance contract are designed to allow for the insurer's investigation of the facts and to assist the insurer in the defense of its insured. Here, Founders received notice of the suit only after the state court entered default in Kehagias' favor. Kehagias argued that despite failure of the Ruths to notify Founders of the assault or the suit, there was sufficient notice based upon the notice of representation letter sent by his attorney. Even though Hull received the notice of representation letter before the entry of default, Kehagias' argument failed. An insured is not relieved of his contractual obligations to provide suit papers to an insurer unless the insurer waives that policy requirement. Neither actual knowledge of a potential claim or an occurrence that may trigger coverage under the policy nor the insurer's knowledge that its insured has been served with process constitute waiver.

While the failure of an insured to comply with notice requirements may bar recovery by the insured, where rights of innocent parties are in jeopardy as a result of the insured's failure, the insurer must establish that its rights have been significantly prejudiced by the insured's failure to provide notice before recovery is barred. Having found the Ruths failed to comply the notice provisions of their policies, the court turned to a determination of whether Founders' rights were substantially prejudiced by that failure.

Prejudice is established upon the entry of a default judgment against an insured in an underlying action. Looking at the various factors involved here, including Kehagias' refusal to set aside the default, the inability of Founders to properly

investigate the case, raise defenses or negotiate a settlement without the impediment of the default and the Ruths' withdrawal of the appeal of the underlying case following assignment of their claims to Kehagias, the court found Founders was substantially prejudiced by the Ruths' failure to notify it of the lawsuit and provide copies of the suit papers. Consequently, the court affirmed summary judgment granted to Founders on its declaratory judgment.

The court next turned to Kehagias' argument that summary judgment in favor of Founders on his claim for medical payments under the CGL was in error. The CGL policy provided for medical payments in a limited amount provided expenses were incurred and reported within one year of the date of the accident. Kehagias argued he complied with that requirement through the settlement offer he sent to Founders that included evidence his medical bills were in excess of the limited medical payments coverage. The court disagreed. Kehagias was provided with copies of the policies in August 2013. Shortly thereafter, he sent his settlement demand that included his medical discharge forms, but failed to include medical bills showing he incurred medical expenses. Founders then requested copies of Kehagias' medical bills and an extension of time to respond to his demand. Kehagias refused both requests. While Kehagias did not dispute that he failed to provide the requested medical bills within a year of the accident, he argued his failure was not controlling, as Founders was not prejudiced by his failure.

Again, the court acknowledged that when an insured fails to comply with the requirements of the insurance contract, an insurer must show substantial prejudice where the rights of innocent third parties are at risk before recovery will be barred. Here, the court held Kehagias was not an innocent third party; Kehagias himself refused to provide his medical bills after a specific request therefor. He cannot prevail on a claim of innocence when his own failure resulted in the denial of coverage.

Founders is consistent with the myriad cases recognizing insurance policies as contracts, requiring compliance with the terms thereof by both the insurer and the insured. It goes farther, however, by finding strict compliance with notice provisions of a policy is required from an insured. Additionally, addressing those situations in which innocent third parties may be at risk because of an insured's failure to comply, the *Founders* court examined the prejudice an insurer must suffer before recovery will be barred. While the court did not provide a bright line test for determining such prejudice, it did provide guidance through its recitation of the facts in this case that resulted in prejudice to the insurer.

[1] *This is an unpublished opinion and citation is governed by Fed. Rule of Appellate Procedure 32.1. Also, see U.S. Ct. of Appeals 4th Cir. Rule 32.1*

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