The Unfair Exclusion of Marine Insureds from New York's 2008 Legislative Reform

James M. Maloney*

Introduction

In 2008, New York's legislature put an end to a particularly harsh rule of law that had evolved in the state's courts. The rule had allowed insurers to deny coverage whenever late notice of claim or late notice of suit was provided to the insurer, even where the insurer's defense of the claim was not harmed ("prejudiced") by the delay in giving notice. Before this legislative reform, New York was one of the very few states whose courts had adopted and applied the "no-prejudice" rule. The 2008 legislative reform, enacted as Chapter 388 of the Laws of New York 2008, resulted from Governor David Paterson's own legislative initiative, formally known as Program Bill #65. The Memorandum of Governor's Program Bill #65 (the "Memorandum") described the proposed enactment as follows:

> An insured who files a late notice of claim must demonstrate that it was not reasonably possible to have given such notice within the prescribed time, and that notice of the claim was provided as soon as was reasonably possible. The insurer need not show any prejudice as a result of the late notice in order to disclaim coverage, leaving the burden of proof squarely on the insured. New York is in the minority of states in the country because most states require insurers to suffer some form of prejudice before coverage may properly be denied for late notice. Current law, therefore, leads to an inequitable outcome with insurers collecting billions of dollars in premiums annually, and disclaiming coverage over an inconsequential technicality.
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> This bill would prohibit insurers from denying coverage for claims based on the failure to provide timely notice unless the insurer has suffered "prejudice" as a result of the delay. Under the bill, the insurer's rights would not be deemed prejudiced unless the failure to timely provide notice materially impairs the ability of the insurer to investigate or defend a claim.[1]

The Memorandum thus addressed, in general terms, the bill's benefits to "insureds," as well as such inequities as "insurers collecting billions of dollars in premiums annually, and disclaiming coverage over an inconsequential technicality." But nowhere does the Memorandum, nor indeed any other document in the legislative history of the enactment of Chapter 388, mention marine insurance. As it turns out, virtually all marine insurance *is* excluded from the reform by virtue of the residual effect of legislation that was passed in 1940, and marine insureds will not benefit from the reform unless further steps are taken either by the courts or by the legislature. Somewhat disturbingly, it is apparent that the New York legislature did not even consider this result, which is especially troubling given that the harsh "no-prejudice" rule evolved in state-court cases involving non-marine insurance, but now will remain in effect *only* to the detriment of marine insureds. As will be seen, it is even more troubling given the legislative history of the

1940 enactment that excluded marine insurance from virtually all of the state legislature's prior and subsequent reform efforts.

The background story of how this unfortunate situation came to pass illustrates two important principles. The first is that, as Justice Oliver Wendell Holmes put it, "a page of history is worth a volume of logic."[2] The second principle is that the American legal system is sometimes best understood not as any single cohesive system, but rather as several systems interacting in complex and at times inefficient or even counterproductive ways. Here, the federal and state judicial and legislative branches (for a total of four "systems") each took steps during the 20th Century that, in the aggregate, yielded this odd result. A brief chronology follows, subdivided into two sections, one for the state and one for the federal developments.

Chronology

1. The State of New York, 1939-1940

The legislative remedy to New York's common-law "no-prejudice" rule was codified in a revised subsection (c) of § 3420 of the Insurance Law. But at subsection (i) of that same section (i.e., § 3420(i)), a marine insurance exemption to the *whole section* exists. Except for the addition of that marine insurance exemption in 1940 and some statutory cross-referencing updates and cosmetic changes over the years, that exemption subsection remains essentially unchanged since its original enactment in 1939 (as part of what was a major legislative reform package at the time) as subsection 4 of § 167 of the Insurance Law. The subsection originally read:

> 4. The provisions of this section shall not apply to any policy or contract of insurance in so far as it covers the liability of an employer for workmen's compensation, if such contract is governed by the provisions of section fifty-four of the workmen's compensation law, or by any similar law of another state, province or country.[3]

One year later, in 1940, the marine insurance exemption was added, so that subsection 4 of § 167 of the Insurance Law was amended to read:

> 4. The provisions of this section shall not apply to any policy or contract of insurance in so far as it covers the liability of an employer for workmen's compensation, if such contract is governed by the provisions of section fifty-four of the workmen's compensation law, or by any similar law of another state, province or country, *nor to the kinds of insurances set forth in paragraph (c) of subsection two of section one hundred twelve*.[4]

The sole change in that year was the addition of the final phrase (italicized above but not in the original), which contains the statutory cross-reference to the marine insurance that would thereafter be excluded from all provisions of the Insurance Law. Notably, § 167, which contains numerous statutory protections for insureds, has grown considerably in scope over the ensuing decades as the state legislature has acted. That section was, along the way, recodified as § 3420

of the Insurance Law. Before examining the legislative history of the 1940 amendment that added the marine insurance exclusion, it would be well to complete this historical review of the marine insurance exemption by setting forth the provision as it appears today, as subsection (i) of § 3420 of the Insurance Law:

> (i) Except as provided in subsection j of this section, the provisions of this section shall not apply to any policy or contract of insurance in so far as it covers the liability of an employer for workers' compensation, if such contract is governed by the provisions of section fifty-four of the workers' compensation law, or by any similar law of another state, province or country, nor to the kinds of insurances set forth in paragraph three of subsection (b) of section two thousand one hundred seventeen of this chapter.[5]

As can be seen, the cumulative changes to the subsection since the 1940 amendment until today thus amount to: (1) a reference to an "exception to the exception" as set forth in subsection j (relating to comprehensive personal liability insurance on an owner-occupied dwelling that in turn relates to workers' compensation); (2) a cosmetic change from "workmen's" to "workers'"; and (3) a change in the statutory cross-reference to the excluded types of marine insurance (now defined at § 2117(b) rather than § 112(2)(c)). That statutory cross-reference, in turn, lists the excluded marine insurance as "insurance against perils of navigation, transit or transportation upon hulls, freights or disbursements, or other shipowner interests, goods, wares, merchandise and all other personal property and interests therein, in course of exportation from or importation into any country, or transportation coastwise, including transportation by land or water from point of origin to final destination and including war risks and marine builders' risks" and marine protection and indemnity ("P and I") insurance.[6] These were the same types of marine insurance as those originally excluded in 1940. Thus, the only significant change to the section for present purposes occurred in 1940, when the original exemption for marine insurance was added.

A review of the sparse legislative history of the 1940 enactment reveals that marine insurance of the type at issue here was excluded from the then-recently-enacted (1939) reforms because of a perceived need for New York insurers to be "competitive" with their "unauthorized" London counterparts, i.e., underwriters such as those at Lloyds who were not regulated by the State of New York. The prime mover in this regard was the American Institute of Marine Underwriters ("AIMU"), which, through its counsel, urged the introduction of the bill that would later become Chapter 507 of the Laws of New York 1940. A letter dated April 8, 1940, from AIMU's counsel to Superintendent of Insurance Louis H. Pink (the "AIMU Letter") noted that AIMU had been behind the introduction of the bill, articulating the position that New York marine insurers should be treated similarly to their "unauthorized" foreign competitors:

> In requesting this particular amendment to the Insurance Law, marine underwriters are asking no more than that they receive the same consideration as their unauthorized competitors . . . . The marine underwriters are not seeking any special privileges or favors in respect of the kinds of insurance which other authorized companies write. . . . Authorized [American] companies should be placed on the same plane as unauthorized

[foreign] insurers . . . .[7]

The particular state regulatory measures (then barely a year old) from which the American marine insurers, through AIMU and counsel, were seeking an exemption included provisions relating to the bankruptcy of the insured. It was this set of measures that the AIMU letter addressed first and foremost, arguing that, "[i]n the majority of marine insurance contracts. . . the bankruptcy of the insured is rarely, if ever, important[,]" and going on to provide a hornbook description of the security available to claimants in the admiralty by virtue of vessel arrest, *in rem* jurisdiction, etc.[8]

Next, the AIMU Letter argued that "there is the further question as to what extent the provisions of Sec. 167 [the 1939 reforms] are contrary to the federal statutes and to the general maritime law[,]" providing some examples and noting in conclusion of this portion of its advocacy that "[t]here are other possible conflicts with the Federal statutes and maritime law, but for the sake of brevity we shall not go into them at this time."[9]

But most importantly for present purposes, the AIMU Letter went on to make the following argument:

> It is also the practice in admiralty matters for the assured to defend the litigation and to pay any final judgment that is rendered. Claim is made against the marine underwriters only at the conclusion of the litigation when the total damages have been ascertained and paid by the assured. In the average case, particularly those of the types specified in subdiv. 2(c) of 112, the total damages which comprise the claim against underwriters have to be apportioned against many companies, possibly twenty-five or more, depending upon the size of the risk. *Moreover, the first notice of a claim that a marine insurance company may receive is when the so-called adjustment or final statement of claim is presented to it, which may be long after the litigation has been concluded, and in some cases years after the claim arose.*[10]

Thus, the AIMU Letter, after having posited that the new insurance reforms would be at odds with admiralty law in several respects, noted with approval the fact that marine liability and indemnity insurers routinely received late notices of claim and/or suit. Paradoxically, today it is *only* marine insureds who will not benefit from the 2008 New York legislative reform meant to protect other insureds from arbitrarily being denied coverage for giving late notices of claims!

The foregoing amply illustrates the validity of the Holmes principle that "a page of history is worth a volume of logic," since the result that we see today is wholly illogical, but it does not explain exactly how and why state law came to be so important in deciding marine insurance disputes, which, after all, would seem to be issues that ought to be decided under the general maritime law in a manner that is uniformly applied throughout the United States. In order to understand this phenomenon, it is necessary to look at two other 20th-Century landmark events, both of which occurred within fifteen years of New York's 1940 legislative marine

insurance exemption. Each was the result of decisive steps taken first by the legislative and later by the judicial branch of the United States, i.e., Congress and the Supreme Court, respectively.

2. The United States, 1945-1955

In 1945, Congress passed the McCarran-Ferguson Act, giving states the authority to regulate the business of insurance without interference from federal regulation, except where federal law specifically provides otherwise. As can be seen from New York's 1939 insurance reforms, some states were aggressive in regulating insurance; others were not. But the passage of McCarran-Ferguson paved the way for statutory regulation of insurance to become, over a few decades, a matter of primarily state, not federal, concern.

In the marine insurance context, the federal law that would still apply and preempt state law included, and continues to include, judicially established or "judge-made" federal rules of law, which form what is known as the "general maritime law." These legal principles for deciding specific issues of marine insurance disputes evolved mainly during the 18th, the 19th, and the first half of the 20th Centuries, but the frequency with which new issues were and are now decided as a matter of federal law began to decline in the mid-20th Century, particularly after the next significant event just ten years after the enactment of McCarran-Ferguson: the Supreme Court's 1955 decision in *Wilburn Boat Co. v. Fireman's Fund Insurance Co.*[11]

In *Wilburn Boat,* the Supreme Court articulated the principles for deciding the question of what law to apply to the interpretation of a marine insurance contract. The case involved a dispute between an insurance company and the owners of a small houseboat destroyed by a fire on a small artificial lake located between Texas and Oklahoma. The company denied liability for the loss on the grounds that the owners of the boat, who had used it to carry paying passengers around the lake, had breached a warranty in the policy stating that they would use the boat for private pleasure purposes only.[12] Although the Court noted that the insurance policy was "a maritime contract" and therefore within the federal jurisdiction conferred by the Admiralty Clause of the Constitution, it concluded that "it does not follow . . . that every term in every maritime contract can only be controlled by some federally defined admiralty rule."[13] The Court reasoned that when admiralty law intersects with a field traditionally left to regulation by the states, such as insurance,[14] and when Congress has passed no federal statute on the question, the Court must ask two questions: (1) is there is a judicially established federal admiralty rule that governs the issue, and (2) if not, should the court fashion one?[15] If the answer to both questions is in the negative, as the Court found in the case of *Wilburn Boat*, state law may govern the question, despite the existence of admiralty jurisdiction.

As the United States Court of Appeals for the Sixth Circuit has noted, "[s]ome courts have mistakenly read *Wilburn Boat* to mean that any question related to marine insurance must be answered under state law."[16] That is a judicial understatement: it is rare indeed that, when there is no federal rule of law to apply in a given situation, a federal court fashions a new rule rather than simply adopting the state rule of law. In other words, the courts typically skip Step 2 under

Wilburn Boat, and look to state law immediately whenever there is no federal law. Sometime this in itself is problematic, because state law, arising as it does almost entirely in non-maritime contexts, may not always have the best answer to how to solve a marine insurance dispute.[17]

The judicial resolution of issues related to late notice of claim or notice of suit in marine insurance cases did not become part of the established general maritime law before state activity following McCarran-Ferguson and court deference to state law after *Wilburn Boat* cut short the development of the common law in this area by creating vast opportunities for state law to decide newly arising issues of law in marine insurance cases. So today the issue is invariably decided by looking to state law. Such was the case in a relatively recent (2010) decision by the United States Court of Appeals for the Second Circuit,[18] in which the relevant charterer's P and I policy was issued and delivered before the applicability date of New York's 2008 legislative reform. There, the court wrote:

> New York Insurance Law §§ 3420(a)(5) and 3420(c)(2)(A), enacted after commencement of this action, now provide that untimely notice shall not invalidate a claim unless, in the case of notice provided within two years, an insurer proves prejudice, and, in the case of notice provided outside two years, the insured fails to prove lack of prejudice. It appears that maritime insurance contracts are, and have been for decades, excluded from this section of New York insurance law. See N.Y. Ins. Law § 3420(i) (cross-referencing *id*. § 2117(b)(3)). In any event, the amended rule does not apply to this case. *See Ponok Realty Corp. v. United Nat'l Specialty Ins. Co.*, 69 A.D.3d 596, 596, 893 N.Y.S.2d 125, 127 (2d Dep't 2010) (holding amendments inapplicable to policies issued and delivered before January 17, 2009). The applicable rule--the pre-amendment version of the no-prejudice rule--is a creature of New York common law. *See Briggs Ave. LLC v. Ins. Corp. of Hannover*, 11 N.Y.3d 377, 382, 870 N.Y.S.2d 841, 843, 899 N.E.2d 947 (2008).[19]

The Aftermath

The "creature of New York common law" that the court referenced in the above block-quoted passage, New York's harsh "no prejudice" rule, was legislatively overruled in 2008 so as to benefit all insureds in liability policies subject to New York law--*except* marine insureds. That omission appears not to have been considered at all in Albany: the available legislative history is devoid of any debate on the subject whatsoever. Rather, the legislature simply added the new provision to § 3420, the section of the state's insurance law where most such legislative reforms are codified, apparently not considering that another subdivision, first enacted in 1940 in response to AIMU's lobbying, had exempted virtually all marine insurance from the provisions of the entire section, and certainly without any awareness that, as noted in the AIMU Letter, late notice of claim was considered quite ordinary and not a basis for denying coverage in marine insurance policies when the exemption was carved out in 1940.

What this means now is that the harsh common-law rule, which evolved in the state courts in non-maritime cases, will henceforth apply *only* in marine insurance cases, this despite the fact that New York was, until the 2008 reform measure, one of a very few states that retained the harsh "no-prejudice" rule that allows insurers to deny coverage due to late notice even if the defense of the claim has not been prejudiced as a result.[20] Moreover, the "creature of New York common law" is likely to remain unchanged, essentially "frozen in time" to the detriment of marine insureds, since the issues in non-maritime cases that drove its development in the state's courts for decades are now unlikely to arise again given the recent legislative "fix" to the problem.

The only remedies to this unfair situation are either: (1) corrective legislative action in New York (which is unlikely unless marine insureds devote far more resources to lobbying than to simply ensuring that timely notice is always given); (2) Congressional legislation on the subject (also unlikely for the same and additional reasons); or (3) federal courts' recognition of the need for a uniform rule, and the resultant fashioning of a federal rule that would apply the new statutory rule of law, or something similar to it, in marine insurance cases notwithstanding the codified exemption for marine insurance to virtually all of New York's legislative reforms of the insurance industry.

But Remedy #3, if it is to occur at all, must await the next case. That may take a while. In the meantime, marine insureds whose liability coverage disputes may possibly be decided in New York must not only pay their premiums (or "calls," as is usually the case in P and I policies), but must also be especially diligent in reporting claims and suits to their insurers with the utmost dispatch, so as not to give those insurers the opportunity of "disclaiming coverage over an inconsequential technicality."[21]

ENDNOTES

* B.S., S.U.N.Y. Maritime College, 1980; J.D., Fordham University, 1995; LL.M. (Federalism and Federal Systems), New York University, 2004. This draft has been prepared for online posting following presentation at Maritime College's "Groundhog Day Event" of February 2, 2012. Comments or queries are welcome, and may be sent to the author at maritimelaw@nyu.edu.

1. Memorandum of Governor's Program Bill #65, New York Legislative Annual for 2008, 261-263, at 262.

2. New York Trust Co. v. Eisner, 256 U.S. 345, 349 (1921).

3. Chapter 882, Laws of New York 1939.

4. Chapter 507, Laws of New York 1940 (emphasis added).

5. McKinney's Insurance Law § 3420(i).

6. McKinney's Insurance Law § 2117(b)(3) (cross-referencing Insurance Law § 1113(21) (which in turn defines marine protection and indemnity insurance)).

7. Letter dated April 8, 1940, from Barry, Wainwright, Thacher & Symmers to New York Superintendent of Insurance Louis H. Pink (found in Governor's Bill Jacket to Chapter 507 of the Laws of New York 1940), at 1, 3.

8. Id. at 3-4.

9. Id.

10. Id. at page 5 (emphasis added).

11. 348 U.S. 310 (1955).

12. Id. at 311.

13. Id. at 313.

14. It is worth bearing in mind that this "tradition" was by then only a decade old, having essentially been established by the enactment of McCarran-Ferguson.

15. 348 U.S. at 314.

16. Aasma v. American S.S. Owners Mut. Protection and Indem. Ass'n, Inc., 95 F.3d 400, 402 (6th Cir. 1996) (citing, inter alia, Ahmed v. American S.S. Owners Mut. Protection and Indemnity Ass'n, 640 F.2d 993, 996 (9th Cir.1981), cert. denied after remand on other grounds).

17. Michael F. Sturley, Restating the Law of Marine Insurance: a Workable Solution to the *Wilburn Boat* Problem, 29 J. Mar. L. Com. 41, 44-45 (1998) ("Even when a court decides that state law should apply, it is often a complicated and difficult question to decide *which* state's law should apply. Once a court has chosen to apply a particular state's law, there is rarely a relevant judicial decision or statute in the maritime context, and the court is thus forced to resolve a marine insurance dispute with reasoning designed for automobile or homeowners' insurance.") (footnotes omitted) (emphasis in original).

18. Pactrans Air & Sea, Inc. v. New York Marine and General Insurance Company, No. 09-4332-cv, 387 Fed. Appx. 43, 2010 WL 2838467 (2d Cir. 2010). The author was counsel for the appellant in that matter.

19. 387 Fed. Appx. 43, 45 n.2, 2010 WL 2838467 at **1 n.2.

20. Eric Tausend, Note, "'No-Prejudice' No More: New York and the Death of the No-Prejudice Rule," 61 Hastings L.J. 497 (2009). This rather comprehensive piece of legal scholarship does not mention the marine liability insurance exclusion at all. But this is unsurprising because that exclusion: (a) is not new, but dates back to 1940, having apparently not been meaningfully

reevaluated by the New York legislature since then; and (b) is buried elsewhere in the lengthy section of the Insurance Law (§ 3420) in which the 2008 enactment is codified. (The New York legislature seems to have missed it, too, and never to have considered whether marine insurance ought to have been excluded from the new provision.)

21. See text accompanying endnote 1, supra.