

## Choice of Law: State-Specific Pitfalls for the Unwary

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Choice of law questions necessarily arise at the beginning of a claim for insurance coverage of liability claims. There are often significant differences between how multiple states with interests in the policy may resolve questions of whether there is a duty to defend, how to interpret the policy's provisions for defense or indemnity obligations, the parties' settlement-related duties, and whether or when insurers can recoup payments for costs not within the scope of the policy's coverage. These conflicting rules may add to or subtract from the insurer's defense or settlement-related obligations.

The parties to the insurance policy have mutual risks in an underlying lawsuit, which they in turn rely on defense counsel to assess and develop recommendations about. The contracting parties' initial, justified expectations may ultimately prove incorrect regarding what state's laws will be applied to the policy and their related responsibilities, and location(s) of claim handling may continue to evolve as claims become litigation, or even become multi-state litigation.

### Considerations Governing Choice of Law Determinations

In order to resolve choice of law in an insurance coverage lawsuit, the party seeking a ruling demonstrates to the court that:

- (1) an actual conflict exists between the potentially applicable states' laws on relevant issues; and
- (2) the forum's choice of law test results in a determination that a particular state's law applies to those issues.

Defense counsel join last into the insurer and insured's "magic circle" of mutual interest under an insurance policy, and they typically remain focused on underlying evaluations. *In re Rules of Professional Conduct*, 2 P.3d 806, 820 (Mont. 2000). They are usually on the sidelines during any choice of law dispute. However, defense counsel could potentially benefit from an awareness of variances in controlling insurance law that may significantly influence decision making for their client(s).

### Express Clauses

When parties to a contract have chosen the laws of one state to apply to their contract, most states will enforce an unambiguous clause that makes an unambiguous choice. States that follow Restatement (Second) of Conflict of Laws (1971) ("Restatement") § 187 generally enforce insurance policies' choice of law clauses.

But Restatement § 187 also provides for exceptions. One is when the chosen state has no "substantial relationship" to the parties or their transaction. The other is when the chosen state's law is contrary to a "fundamental policy" of another state with materially greater interest in determination of the particular issue, a consideration further requiring that the other state would be chosen under the "rule of" Restatement § 188 (further detailed below). If an express insurance policy choice of law clause is not enforceable on these grounds, it constitutes a state-specific pitfall for counsel to be aware of.

Examples include states with enactments by statute, or that enunciate contractual unconscionability principles, as where Louisiana, Texas, and Washington neutralize clauses applying any other state's laws to policies issued for delivery there.

When there is a choice of law clause in the policy, another important initial question is whether its scope is limited. For example, the clause may state that it addresses matters that arise under the contract, or disputes about the policy's meaning, interpretation or operation. Either clause could leave room for argument that it does not prescribe governing law if pressing questions arise during the course of an underlying litigation that relate to (1) how the insurer must perform its defense obligation, or (2) the extent of the insurer's settlement-related obligations. In several jurisdictions, the default assumption is that the contracting parties would have intended for the clause to apply to all causes of action that are related to their contract, instead of leaving matters undesignated. *Nedlloyd Lines B.V. v. Superior Court* (1992) 3 Cal.4th 459, 469-470.

Only a few jurisdictions have held that the same state's law used to interpret an insurance agreement must also be used to interpret claims of insurance bad faith because such claims stem from the policy and are therefore "inextricably intertwined" with the contract claim. *Home Ins. Co. v. Serv. America Corp.*, 654 F.Supp. 157 (N.D.Ill. 1987). Where many other jurisdictions hold that "bad faith" lawsuits are torts independent from breach of contract claims, a different result is foreseeable based on the specialized assessment of choice of law factors applicable to tort claims (prescribed by *Restatement* §145). *Panthera Rail Car LLC v. Kasgro Rail Corp.*, 985 F.Supp.2d 677, 694-96 & 700-01 (W.D. Pa. 2013).

### Statutory Directives

Several states impose statutory requirements, impacting insurers that underwrite policies for multiple-state businesses. *Restatement* §6 notes, preliminarily, that "[a] court, subject to constitutional restrictions, will follow a statutory directive of its own state on choice of law."

The most protective statutes direct the application of a particular state's law to insurance policies. For example, South Carolina Code 10-3861 §provides that "all contracts of insurance on property, lives, or interests in this state are considered to be made in the state ... and are subject to the laws of this state." Texas Insurance Code's "Article 21.42 Texas Laws Govern Policies", has a title succinctly stating its intent: insurance policies are governed by Texas laws if issued to a Texas "citizen or inhabitant" by a company doing business in Texas. In practice, there may be more exceptions than meet the eye, if courts requested to apply a statute narrowly construe threshold requirements so as to avoid giving it undue extraterritorial effect. *Austin Bldg. Co. v. Natl. Union Fire Ins. Co.*, 432 S.W.2d 697, 700-01 (Tex. 1968). Other caveats include when a surplus lines insurer is involved, state insurance departments may regulate them indirectly or to a limited extent (Texas controls little more than eligibility to do surplus lines business).

To illustrate a protective choice of law statute with restricted reach, the Oregon Environmental Cleanup and Assistance Act has provided since 1999 that Oregon law shall apply to all cases involving contaminated property in Oregon. Its controlling definitions have notable carve outs, including its application to a so-called "general liability insurance policy" but not to "claims-made policies". ORS 465.475(2) & 465.480(2)(a).

Less intrusive statutes prescribe the choice of law test, but not its result. For example, California Civil Code § 1646 states that "[a] contract is to be interpreted according to the law and usage of the place where it is to be performed; or, if it does not indicate a place of performance, according to the law and usage of the place where it is made." However, this test remains subject to considerations such as whether there was an "understanding of the parties at the time they entered into the contract" regarding the intended place of performance by "mounting and funding" the insured's defense and/or by paying indemnity to resolve liabilities. *Frontier Oil Corp. v. RLI Ins. Co.* (2007) 153 Cal.App.4th 1436, 1461-62.

### ***Restatement Considerations—Most Significant Relationship***

In the absence of choice of law clauses or statutes, several states have retained the predictable *lex loci contractus* rule, whereby the law of the “place of contracting” applies to govern the contract application and interpretation. Although states like Florida have long applied this doctrine for insurance contracts, some rulings have made exceptions to the general rule. *LaFarge Corp. v. Travelers Indem. Co.*, 118 F.3d 1511, 1515-16 (11th Cir.1997).

Most states with no such “bright line” common law rule begin from the proposition that they intend to apply the *Restatement*’s tests, aimed at determining what state has the most “significant relationship” to the transaction and the parties. The level of complexity increases for analysis of a forum state’s choice of law test when legal analysis is required of various *Restatement* factors in that state’s common law. There is still more complexity when the insurance agreement being analyzed involves a wide variety of multiple-state risks, such as a large corporation’s management liability policy.

To resolve conflicts of laws for insurance policies, *Restatement* § 193 states that the “principal location of the insured risk” is the most important factor with respect to choice of law decisions for fire, surety or casualty insurance contracts. However, some states regard *Restatement* § 193 as inapplicable to general liability policies that are not specifically tied to the location(s) of insured properties, because they have no “principal” location of the risks insured.

If *Restatement* § 188 applies, the following five contacts are used to determine choice of law:

- a) Place of contracting,
- b) Place of negotiation of the contract,
- c) Place of performance,
- d) Location of the subject matter of the contract,
- e) Domicile, residence, nationality, place of incorporation, and place of business of the parties.

These factors are not to be applied mechanically, but qualitatively to determine which state has the most significant relationship to the parties and their contracting transaction. This can involve increasing (or conversely, reducing) the weight of certain factors given the existence of specifically relevant contacts, and also addresses the permissibly-considered interests of conflicting, involved states. Ultimately, in the absence of an effective choice of law by the parties, these § 188 contacts are required to be evaluated in light of the pertinent principles of *Restatement* § 6, which are considered in the absence of statutory directives or constitutional restrictions.

Even states that apply § 193 will also address the relevant above-listed § 188 contacts, due to an exception in § 193 when another state has a more significant relationship with respect to the particular issue. The majority of states continue to develop their choice of law test and apply them to new contracts and new scenarios, which may newly create effective or actual “bright line” rules.

## **Traps for the Unwary May Vary from State to State**

Resolving what law initially applies to analysis of an insurance policy's enforceability and interpretation may not prevent state-specific challenges from arising during the life cycle of a claim and its related litigation. Choice of law issues can present a "moving target" when defense funding and provision of settlement, judgment and post-judgment assistance are issues that may eventually arise. Unforeseen traps can lurk in each new, potentially applicable state's laws.

### ***Acceptance, Performance and Conclusion of Defense Duties***

An insurer or insured's alleged right to select counsel can present a time-sensitive issue, with short-term deadlines to file an answer and looming threats of default. This early question may be uncertain for insurers, defense counsel and their clients, simply because the performance of an insurer's defense obligation is not necessarily subject to the same law as interpretation of the insurance policy provisions. Jurisdictions may favor the location of contracting as supplying consistent governing law because contractual duties anchor the insured's and insurer's rights. Conversely, some courts seem untroubled that disputes arising out of one liability insurance policy may be governed by the laws of 50 states nationwide. California has reduced doubts by codifying in Civil Code § 2860 the insured's rights to select independent "Cumis" counsel, when California is where the underlying case proceeds and a possible ethical conflict of interest is created by the insured's reservation of rights to deny coverage, among other statutory requirements.

Whether a policy provision is enforceable that defense costs incurred will reduce the total policy limits could also influence choice of counsel, particularly the insured's acceptance of panel counsel subject to budget projections and other guidelines. Where limits-reduction provisions appear in a medical professional's liability policy, their enforceability may depend on whether applicable law imposes statutory restrictions (as in New York, pursuant to 11 CRR-NY 71.2 & 71.3), or freely allows the policies to so contract (as over the border, in New Jersey). Surplus lines insurers' policies may be exempt from such restrictions, in a jurisdiction that exempts the surplus lines market (e.g., New York's Nonadmitted and Reinsurance Reform Act) from claims-made policy standards or the state's defense-within-limits statutes.

These threshold issues can yield more pervasive questions of whether defense counsel's duties are initially owed, or may become no longer owed, to the defending insurer. *Paradigm Ins. Co. v. Langerman Law Offices, P.A.*, 24 P.3d 593 (Ariz. 2001) (when insurer assigns attorney to represent insured, the assigned attorney has a duty because the services are ordinarily intended to benefit both insurer and insured when their interests coincide). Moreover, the defending insurers may eventually consider whether to conclude their defense funding based on (1) an underlying ruling that ends the potentially covered claims, (2) their prosecuting rescission/voiding of the policy due to an insured's material misrepresentations, or (3) "exhaustion" of their policy's limits. Each right to conclude the defense would be state law-dependent. After providing the defense, the insurer may consider whether to obtain cost recoupment. Re-reading this author's "Reimbursement to Insurers for Defense of Non-Covered Claims", PLD Quarterly Vol. 10, #2 (Spring 2018) demonstrates that each issue warrants its own article to track the nuances nationwide.

### ***Indemnity Obligations and "Mixed" Obligations***

Technical requirements in California include the insurer's requirement to state written coverage positions with a notice, accompanying denial or rejection, of the insured's right to California Department of Insurance review. Cal. Code

Regs. Title 10 § 2695.7(b)(3). However, in practice, insurers often state such notices in reservation of rights letters, after scrutinizing available facts for clear California connections. California also statutorily bars coverage under liability insurance policies for punitive damage awards. Cal. Ins. Code § 533. Without such enactments, several other states (e.g. Illinois and New York) have held that it frustrates the punitive award's deterrence of wrongful conduct if the penalized defendant simply passes such penalties along to an insurer. For defense counsel to weigh the risks of proceeding to judgment, it is proper to consider whether punitive damages, if awarded, will be paid by their client and not by its insurer.

Duties to address an insured's settlement options are described in some states as part of the insurer's defense obligations, and elsewhere as indemnity obligations. This distinction alone may lead to unpredictable application of states' laws to the so-called "duty to settle". One common issue is whether sufficient limits remain available for settlement, after their reduction due to enforceable defense-within-limits provisions. Electronic settlement discussions, including "virtual" mediations conducted by video conference or in states other than the underlying suit's forum state or the parties' home office state(s), may yield further risks: the "duty to reasonably explore settlement" in the state where discussions are "deemed" to take place can newly be considered.

At this point, defense counsel may need a scorecard to keep up with all of the possibly applicable states' laws.

### **Conclusion—Choose Your Own Law Adventure, But Choose Wisely**

Choice of law consultations probably should happen more often than they do. If early (and ongoing) check-ins with supportive coverage counsel isn't possible, published resources include state-specific lists of procedural timelines for the insurer's decision-making and other controlling law. As to some above-specified issues, like punitive damages insurance coverage, 50-state surveys have become reliable online resources. Deskbook reference manuals are published on nationwide liability defense practices and insurance coverage, with their subscribers receiving periodic updates. Finally, localized coverage counsel with expertise in each state may have proprietary "resource guides" to make available, if requested.

**NOTE:** *Any opinions expressed are the author's own, rather than being issued on behalf of Forsberg & Umlauf, P.S., or their clients.*

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