S239510

IN THE SUPREME COURT OF CALIFORNIA

EN BANC

PITZER COLLEGE,
Petitioner,

vs.

INDIAN HARBOR INSURANCE COMPANY,
Respondent.

QUESTIONS CERTIFIED BY THE NINTH CIRCUIT COURT OF APPEALS
CASE NO. 14-56017

PETITIONER'S REPLY BRIEF

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INTRODUCTION

This Court granted review of two important questions of first impression in this case under California Rule of Court 8.548. These questions implicate important public policy issues regarding insurance coverage in the State of California, and are not straightforwardly controlled by existing law or precedent. California's strong public policy disfavoring forfeitures of insurance coverage based upon inconsequential technicalities compels the result sought by Pitzer—that the notice-prejudice rule should apply here to both the notice provision and consent provision, in spite of the policy's choice of law provision.

In its brief, Respondent Indian Harbor argues otherwise, by increasingly desperate means. Indian Harbor mischaracterizes this Court's governing precedent and invents a heretofore-unknown element of a well-understood test adopted by this Court. Indian Harbor plays word games, unmoored from substance, to belittle myriad precedential decisions describing California's public policy, and resorts to counting decisions of the California Courts of Appeal in an attempt to argue for a universal rule. Indian Harbor even mischaracterizes its own coverage and the structure of its own insurance policy.

These arguments must fail. At its core, this case presents the same question that insurers and insureds have brought to this Court and to the Courts of Appeal of this State on innumerable occasions: will California permit an insurer to disclaim coverage over a technical, non-substantive failure of the insured to comply with the terms of the policy without a showing of prejudice? This Court's answer—California's answer—has always been a resounding no. This basic jurisprudential principle of California law, applied to this case, should lead this Court to answer both certified questions in the affirmative.

ARGUMENT

I. INDIAN HARBOR REPEATEDLY MISCHARACTERIZES *NEDLLOYD*

This Court's seminal case on enforcement of contractual choice of law provisions is *Nedlloyd Lines B.V. v. Superior Court* (1992) 3 Cal.4th 459. In that case, this Court adopted the "fundamental policy" test, from Section 187 of the Restatement Second of Conflict of Laws, to serve as California's test for determining whether or not to give effect to a contractual choice of law provision. (*Nedlloyd*, *supra* at 464-466.)

In an attempt to breathe life back into its argument that a quirk of New York law allows it to disclaim coverage over an inconsequential delay in providing notice, Indian Harbor repeatedly mischaracterizes multiple aspects of the *Nedlloyd* case, including the test applied by the *Nedlloyd* Court, the authority relied upon (including both secondary authority and previous decisions), the causes of action and specific issues at stake in the case, and the application of the decision in subsequent cases. These mischaracterizations underlie nearly every argument raised by Indian Harbor on the subject of late notice.[1]

The proper reading of *Nedlloyd* compels a single conclusion: the notice-prejudice rule is a fundamental policy of the State of California.

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[1] The sole meaningful exception is Indian Harbor's argument concerning the application of the notice-prejudice rule to claims-made-and-reported policies, which is equally erroneous, but for different reasons, as discussed below.

A. Indian Harbor Mischaracterizes the Test Adopted in *Nedlloyd*

Indian Harbor contends, incorrectly, that (1) the *Nedlloyd* test includes a third prong restricting "fundamental policies" to those set forth in statutes or constitutions, and (2) the *Nedlloyd* Court articulated a distinction between "strong" and "fundamental" public policies. In making these arguments, Indian Harbor mischaracterizes the *Nedlloyd* test, the underlying authority relied upon by the *Nedlloyd* Court, and subsequent application of *Nedlloyd*, including by this Court.

1. Indian Harbor erroneously contends that the *Nedlloyd* test includes a third prong restricting "fundamental policies" to those set forth in statutes or constitutional provisions.

In *Nedlloyd*, this Court adopted the test set forth in section 187 of the Restatement Second of Conflict of laws:

> In determining the enforceability of arm's-length contractual choice-of-law provisions, California courts shall apply the principles set forth in Restatement section 187, which reflect a strong policy favoring enforcement of such provisions. [fn. omitted][¶] More specifically, Restatement section 187, subdivision (2) sets forth the following standards: 'The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable

law in the absence of an effective choice of law by the parties.'[fn. omitted] (*Nedlloyd*, *supra* at 464-465.)

This Court then provided a brief, authoritative summary of the test:

> Briefly restated, the proper approach under Restatement section 187, subdivision (2) is for the court first to determine either: (1) whether the chosen state has a substantial relationship to the parties or their transaction, or (2) whether there is any other reasonable basis for the parties' choice of law. If neither of these tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice of law. [fn. omitted] If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a *fundamental* policy of California. [fn. omitted] If there is no such conflict, the court shall enforce the parties' choice of law. If, however, there is a fundamental conflict with California law, the court must then determine whether California has a 'materially greater interest than the chosen state in the determination of the particular issue . . . .' (Rest., § 187, subd. (2).) If California has a materially greater interest than the chosen state, the choice of law shall not be enforced, for the obvious reason that in such circumstance we will decline to enforce a law contrary to this state's fundamental policy. [fn. omitted] (*Nedlloyd*, *supra* at 466.)

This Court carefully and explicitly twice set forth the proper test, once quoting the Restatement, and once in its own words. The Court described a two-prong test (once a substantial relationship between the chosen state and the parties or their transaction is established):

> (1) Does the chosen state's law conflict with a fundamental California policy? and
>
> (2) Does California have a materially greater interest than the chosen state in the outcome of the dispute?

Curiously, however, Indian Harbor contends that the *Nedlloyd* test contains a third prong: that the "fundamental policy" in question must arise from a statute or constitutional provision. (Respondent's Brief, p. 26-28.) This third prong cannot be found in this Court's lengthy, explicit description of the proper test, quoted above. In fact, the words "statute" and "constitution" do not appear in that section of the opinion, or in any of the footnotes in that section. (*Nedlloyd*, *supra* at 464-466, fn. 2,3,4,5,6.) Instead, this Court repeatedly used the broader terms "law" and "policy." (See *Nedlloyd*, *supra* at 465-466, fn. 4,5,6.) The only place that the words "statute" or "constitution" appear in *Nedlloyd* is in connection with the Court's *application* of the test to the breach of fiduciary duty cause of action at issue therein. (*Nedlloyd*, *supra* at 471.) Notably, under the facts of *Nedlloyd* itself, Indian Harbor's third prong (if it existed) should have neatly disposed of the plaintiff's cause of action for breach of the implied covenant of good faith and fair dealing, a judicially-created doctrine not found in any statute or constitutional provision; instead, this Court holistically considered whether that doctrine constituted a fundamental policy on its own merits, and concluded that it did not. (*Nedlloyd*, *supra* at 468.)

Indian Harbor's supposed third prong also cannot be found in the Restatement section adopted by the Court in *Nedlloyd*. Like this Court's description of the test in *Nedlloyd*, the Restatement speaks in terms of

"law" and "policy," not "statutes" or "constitutions." (Restatement 2d Conflict of Laws, § 187.) Moreover, comment (g) to the Restatement makes clear that there is no such third prong: "No detailed statement can be made of the situations where a 'fundamental' policy of the state of the otherwise applicable law will be found to exist."

The cases that have followed *Nedlloyd* have all cited (and typically quoted) the language from *Nedlloyd* quoted above in describing the appropriate test. This Court's decision in *Washington Mutual Bank, FA v. Superior Court* (2001) 24 Cal.4th 906, 916-917 is a typical example. Indian Harbor cannot identify even a single post-*Nedlloyd* case that applies this alleged third prong.

Last, Indian Harbor's "statutes or constitutions only" conception of the definition of a "fundamental policy" under *Nedlloyd* runs into a major hurdle in this Court's decision in *Discover Bank v. Superior Court* (2005) 36 Cal.4th 148. In that case, this Court held that an adhesive consumer arbitration agreement with a class action waiver was unconscionable under California law. (*Discover Bank*, *supra* at 161-163.) Because the agreement at issue in that case also contained a choice-of-law provision, this Court also repeated the *Nedlloyd* test (as quoted above) and instructed the Court of Appeal to apply the test on remand – *to a judicially-created rule, not specifically embraced by any statute or constitutional provision.* (*Id.* at 173-174.) In subsequent cases, both the California Court of Appeal and the

Ninth Circuit held that this unconscionability doctrine was indeed a fundamental policy of the State of California. (*Klussman v. Cross Country Bank* (2005) 134 Cal.App.4th 1283; *Omstead v. Dell, Inc.* (9th Cir. 2010) 594 F.3d 1081.)

In an attempt to explain this away, Indian Harbor creatively argues that the *Discover Bank* Court changed ("expanded") the *Nedlloyd* rule. (Respondent's Brief, p. 26.) Nonsense. The *Discover Bank* Court simply "summarized California's choice-of-law provisions," rather than modifying them, and instructed the court below to apply them on remand. (*Discover Bank*, *supra* at 173.) Even Justice Baxter's dissent in *Discover Bank*, which argues at length that unconscionability should not be considered a "fundamental policy" of the State of California under *Nedlloyd*, does not posit that "fundamental policies" are limited to "statutes and constitutions" or that the majority in *Discover Bank* somehow altered the underlying *Nedlloyd* test. (*Discover Bank*, *supra* at 174-178 (Baxter, J., concurring and dissenting).) One might expect Justice Baxter to be particularly aware of changes to or errors in application of the *Nedlloyd* decision, if only because he wrote it. To accept Indian Harbor's characterization of *Discover Bank* is to conclude that this Court, in a closely split decision (4-3), significantly altered the nature of a basic conflict-of-laws rule in this state *without either the majority or the dissent commenting upon the change.*

In reality, *Discover Bank* merely contemplates the ordinary application of the holistic *Nedlloyd* "fundamental policy" test to a judicially-created rule. This result would be startling if Indian Harbor's purported third *Nedlloyd* prong existed—but there is no such prong, which makes the *Discover Bank* decision a natural one.

Indian Harbor's mischaracterization of the *Nedlloyd* test is an unwarranted attempt to change California's choice-of-law rules, which this Court should reject. In *Nedlloyd*, this Court adopted the Restatement test, which does not limit its application to statutes or constitutional provisions, and the Court reaffirmed that test in *Washington Mutual* and *Discover Bank*. There is no reason to alter it or depart from it in favor of an invented bright-line rule that both the Restatement and this Court's jurisprudence reject.

Finally, to the extent that the Court is concerned about the primacy of the Legislature in policymaking, Indian Harbor helpfully points out Insurance Code § 11580.23, which was originally enacted in 1988. (Respondent's Brief, p. 33, fn. 11.) As Indian Harbor points out, this statute enacts the notice-prejudice rule in the uninsured motorist context (and therefore does not apply here). (Id.) Indian Harbor fails to mention subsection (b) of the statute: "The Legislature hereby finds that this section is declarative of existing law. . . ." In other words, nearly thirty years ago the Legislature signaled its approval of the "existing" notice-prejudice rule.

2. Indian Harbor erroneously argues that *Nedlloyd* articulates a meaningful distinction between "strong" and "fundamental" public policies.

Indian Harbor contends that this Court, in adopting the Restatement test in *Nedlloyd*, established the rule that only "fundamental," *but not "strong,"* public policies could rise to a level sufficient to overcome a contractual choice of contrary law from another state. This argument fails for at least four reasons: (1) there is no authority in *Nedlloyd* or anywhere else for the proposition that "fundamental" means something meaningfully different from "strong" in this context; (2) this Court cited with approval decisions of the California Courts of Appeal and the Ninth Circuit using the "strong" formulation of the test in *Nedlloyd* itself; (3) this Court used the "strong" formulation on at least one occasion after *Nedlloyd*; and (4) Indian Harbor fails to offer any difference in meaning between the two words in terms of the application of the test (other than, conveniently, the conclusion that the notice-prejudice rule is merely "strong" and not "fundamental").

The first reason is discussed in Pitzer's Opening Brief (at p. 34) and is self-explanatory – Indian Harbor fails to point to a single decision of this Court (or any other court applying California law) that distinguishes between a "strong" public policy and a "fundamental" public policy for choice of law purposes.

Pitzer's Opening Brief also discusses the second reason (at p. 33-34), namely that this Court cited with approval decisions of the California

Courts of Appeal and the Ninth Circuit using the "strong" formulation of the *Nedlloyd* test (or other similar formulations). Indian Harbor's only rebuttal to this argument is to suggest that Pitzer has misread *Nedlloyd*, and that in fact, this Court in *Nedlloyd* articulated a different standard from that previously set forth by the California Courts of Appeal and the Ninth Circuit. (Respondent's Brief, p. 25.)

Indian Harbor's reading of *Nedlloyd* is at odds with the plain language of the decision. As this Court wrote:

> Prior Court of Appeal decisions, although not always explicitly referring to the Restatement, also overwhelmingly reflect the modern, mainstream approach adopted in the Restatement. (*Mencor Enterprises, Inc. v. Hets Equities Corp.* (1987) 190 Cal.App.3d 432, 435-436, 235 Cal.Rptr. 464 [explicit reference to Restatement section 187]; *Hall v. Superior Court* (1983) 150 Cal.App.3d 411, 417, 197 Cal.Rptr. 757 [no explicit reference]; *Ashland Chemical Co. v. Provence* (1982) 129 Cal.App.3d 790, 794-795, 181 Cal.Rptr. 340 [no explicit reference]; *Gamer v. DuPont Glore Forgan, Inc.* (1976) 65 Cal.App.3d 280, 287, 135 Cal.Rptr. 230 [explicit reference to Restatement section 187].) [fn. omitted] [¶] **We reaffirm this approach**. (*Nedlloyd*, *supra* at 464 (emphasis added).)

Pitzer's Opening Brief also discusses the third reason that Indian Harbor's invented distinction between "strong" and "fundamental" policies fails (at p. 34) – that *this very Court* used the "strong" formulation of the test interchangeably with the "fundamental" formulation in the *Discover Bank* case, which was decided long after *Nedlloyd*. Here, again, Indian Harbor's only response is to argue that this Court, in *Discover Bank*, was

simply quoting *America Online, Inc. v. Superior Court* (2001) 90 Cal.App.4th 1, which quoted *Hall, supra*, which pre-dated *Nedlloyd.* (Respondent's Brief, p. 24.) Indian Harbor ignores (perhaps relying upon its argument debunked in the previous paragraph) that the *Nedlloyd* case itself cites *Hall* with approval. Indian Harbor also fails to explain why, if "fundamental" is so different from "strong," this Court used the two terms interchangeably and (under Indian Harbor's approach) instructed a lower court to apply a supposedly wrong and outdated standard. The (unlikely) implication of Indian Harbor's argument is that this Court simply made a mistake in applying its own precedent.

The last reason that Indian Harbor's argument on this point fails is less technical and more substantive. At its core, Indian Harbor's argument that "fundamental" is different from "strong" is driven by the fact that courts throughout the United States have repeatedly described California's notice-prejudice rule as a "strong" public policy of the State of California. (See, e.g., *Service Management Systems, Inc. v. Steadfast Ins. Co.* (9th Cir. 2007) 216 Fed.Appx. 662, 664 ("California's strong public policy"); *National Union Fire Ins. Co. of Pittsburg PA v. General Star Indem. Co.* (3d Cir. 2007) 216 Fed.Appx. 273, 280 ("strong public policy"); *National Semiconductor Corp. v. Allendale Mut. Ins. Co.* (D.Conn. 1982) 549 F.Supp. 1195, 1200 ("strong and abiding policy").) As a result, Indian Harbor is reduced to mere word games, arguing that previous courts using

the word "strong" should be ignored because they didn't use the word "fundamental."

Indian Harbor's only attempt at articulating a *substantive* difference between a "fundamental" public policy and a "strong" public policy is a citation to certain cherry-picked dictionary definitions of those words, with no attempt at explaining how the perceived difference plays out in terms of application of the test. (Respondent's Brief, p. 23.) The implication of Indian Harbor's argument is that there are certain public policies that are "strong" but not "fundamental," yet, other than the particular public policy at issue in this case, Indian Harbor fails to identify even a single such strong-but-not-fundamental public policy, or *even to explain why the notice-prejudice rule itself is strong but not fundamental* (except to point out that it does not arise from a statute or constitution).

Indian Harbor's desperate last attempt at supporting its invented "strong" versus "fundamental" distinction is a strange counting exercise. (Respondent's Brief, p. 24.) Indian Harbor counts 27 post-*Nedlloyd* decisions applying the *Nedlloyd* test, and contends that 20 of them use the formulation "fundamental policy" to describe the test. (Respondent's Brief, p. 24.) Indian Harbor then attempts to minimize the various post-*Nedlloyd* cases (including this Court's decision in *Discover Bank*, *supra*) that use the "strong" formulation. (Respondent's Brief, p. 24-25.)

Indian Harbor's numerical analysis actually supports Pitzer's position that "strong" public policies are the same as "fundamental" public policies in this context. While most courts understandably used the *Nedlloyd* "fundamental" formulation, verbatim, a significant number of courts, *including this Court*, used "strong" interchangeably with "fundamental" in this context. Moreover, the fact that none of these 27 cases discuss a difference between "strong" and "fundamental" policies, despite both formulations seeing significant use, strongly suggests that the two terms are interchangeable.

B. Indian Harbor Mischaracterizes the Issues at Stake in *Nedlloyd*

In an effort to deride the decision in *Tri-Union Seafoods, LLC v. Starr Surplus Lines Ins. Co.* (S.D. Cal. 2015) 88 F.Supp.3d 1156, Indian Harbor argues that it "runs directly afoul" of *Nedlloyd*, but arrives at that conclusion through a misreading of the underlying causes of action in *Nedlloyd*. (Respondent's Brief, p. 31.)

Tri-Union involved the application of the *Nedlloyd* "fundamental policy" test to California's rule of imposition of tort remedies, including punitive damages, for insurer bad faith. (*Tri-Union*, *supra* at 1167.) The *Tri-Union* court concluded that California's insurer bad faith tort remedy was a "fundamental policy" of the State of California, and based upon that

conclusion, declined to enforce the New York choice of law provision at issue. (*Id.* at 1170-1171.)

Indian Harbor contends that *Tri-Union* is directly contrary to *Nedlloyd* by arguing that the issues at stake in the two cases were the same – namely, the "tort of bad faith." Indian Harbor is simply mistaken. While *Tri-Union* did involve imposition of tort remedies for insurer bad faith, *Nedlloyd* involved an alleged breach of the *contractual* implied covenant of good faith and fair dealing between two shipping companies. (*Nedlloyd*, *supra* at 468.) In rejecting the *Nedlloyd* plaintiff's argument that the implied covenant of good faith and fair dealing was a fundamental policy of the state of California, the *Nedlloyd* court cited *Foley v. Interactive Data Corp.* (1988) 47 Cal.3d 654, which explains the significant distinction between the implied contractual covenant at issue in *Nedlloyd* and the tort of insurer bad faith.

In *Foley*, this Court wrote, "[j]ust as the law of contracts fails to provide adequate principles for construing the terms of an insurance policy, the substantial body of law uniquely applicable to insurance contracts is practically irrelevant to commercially oriented contracts . . . . These [unique] features characteristic of the insurance contract make it particularly susceptible to public policy considerations." (*Foley*, *supra* at 690 (quoting Louderback & Jurika, *Standards for Limiting the Tort of Bad Faith Breach of Contract* (1982) 16 U.S.F.L.Rev. 187, 200-201, fns.

omitted).) Relying on this reasoning, the Court distinguished between the exceptional case of tort liability for bad faith in the insurance context and ordinary contractual remedies for breach of the implied covenant in other contexts, rejecting the plaintiff's claim that tort liability of this kind should be extended into the employment context. The Court wrote, "[i]n our view, the underlying problem in the line of cases relied upon by plaintiff lies in the decisions' uncritical incorporation of the insurance model into the employment context, without careful consideration of the **fundamental policies** underlying the development of tort and contract law in general or of significant differences between the insurer/insured and employer/employee relationships." (*Foley*, *supra* at 689 (emphasis added).)

The *Tri-Union* court, presented with the same argument Indian Harbor makes here, correctly determined that the rules applicable to insurance contracts are fundamentally different from those applied to ordinary contracts, like the stock purchase agreement at issue in *Nedlloyd*, and rejected the conclusion that *Nedlloyd*'s holding with respect to the *contractual* covenant of good faith and fair dealing in the ordinary commercial context governed the doctrine of *tort* liability for bad faith in the insurance context.

II. INDIAN HARBOR'S REFERENCES TO PITZER'S "SOPHISTICATION" HAVE NO EFFECT UNDER CALIFORNIA LAW

Indian Harbor places significant emphasis on the assertion that Pitzer is a "sophisticated private institution that had others (including insurance professionals) negotiating and buying specialized insurance on its behalf." (Respondent's Brief, p. 29, 40.) Indian Harbor argues that this "sophistication" transforms the insurer-insured relationship from a situation characterized by grossly unequal bargaining power and contracts of adhesion, as it is ordinarily regarded, into an ordinary, mutually-negotiated contract situation. (Respondent's Brief, p. 29, 40.) This Court long ago rejected Indian Harbor's argument: "the relationship of insurer and insured is *inherently* unbalanced; the adhesive nature of insurance contracts places the insurer in a superior bargaining position." (*Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809, 820 (emphasis added).) This line of reasoning has been applied by California courts (including this Court) to cases involving individual insureds, as in *Egan*, but also to insureds as sophisticated as a bank (*Downey Savings & Loan Assn. v. Ohio Casualty Ins. Co.* (1987) 189 Cal.App.3d 1072, 1097 (quoting *Egan*)), or a national manufacturer of toys with three layers of excess insurance (*Kransco v. American Empire Surplus Lines Ins. Co.* (2000) 23 Cal.4th 390, 404-405).[2]

[2] There is a single noteworthy exception to this general rule: when parties of equal bargaining power jointly negotiate and specially draft certain

In California, the insured-insurer relationship is generally considered to be "inherently unbalanced," and the insurer is considered, absent truly exceptional circumstances absent here, to have the upper hand.

III. CALIFORNIA LAW IS CONTRARY TO NEW JERSEY'S LAW ON CLAIMS-MADE-AND-REPORTED POLICIES, AND THIS COURT SHOULD NOT ADOPT NEW JERSEY'S ABERRATIONAL RULE

Indian Harbor contends that this Court should adopt the reasoning of a recently-decided case in the New Jersey Supreme Court, and decline to apply the notice-prejudice rule to claims-made-and-reported policies, regardless of whether the claim was reported within the policy period. (Respondent's Brief, p. 38.)

In *Templo Fuente De Vida Corp. v. National Union Fire Ins. Co. of Pittsburgh* (2016) 224 N.J. 189, the New Jersey Supreme Court considered whether to apply its notice-prejudice rule to a claims-made-and-reported policy covering directors' and officers' liability. (*Templo Fuente*, *supra* at 192.) The court decided that it would not apply the notice-prejudice rule because the insured (a financial services company with fourteen full-time employees) was a "particularly knowledgeable" insured, and because claims-made-and-reported policies typically are issued to such

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provisions of an insurance policy, courts will not necessarily strictly enforce those provisions, if ambiguous, against the insurer. (*AIU Ins. Co. v. Sup. Ct.* (1990) 51 Cal.3d 807, 823.) This rule is not applicable to form contracts like the one at issue in this case, which are considered contracts of adhesion. (*Id.*)