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insurance law newsletter

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Texas Algebra: *PAJ* + *XL* = Prejudice Requirement?

Previously, in Volume 1, Number 3 of the *insurance law newsletter*, we discussed Texas' position regarding the showing of prejudice by an insurer before precluding coverage for late notice. On January 11, 2008, the Supreme Court of Texas reversed the Dallas Court of Appeals in *PAJ, Inc. v. Hanover Insurance Co.*, 2008 WL 109071 (Tex. Jan. 11, 2008) and accepted a certified question from the United States Fifth Circuit Court of Appeals. *See XL Specialty Insurance Co. v. Financial Industries Corp.*, 2007 WL 4461190 (5th Cir. Dec. 19, 2007). By doing so, the Court signaled a clarification in Texas insurance law regarding the notice-prejudice rule.

A. *PAJ, Inc. v. Hanover Insurance Co.*

1. Background Facts

PAJ, Inc. ("PAJ"), a jewelry manufacturer and distributor, was an insured under a CGL policy issued by Hanover Insurance Company ("Hanover") when it was sued for copyright infringement by Yurman Designs in 1998. PAJ, unaware that its policy covered the dispute under Coverage B ("personal and advertising injury"), did not provide notice to its insurer until four to six months after the *Yurman* lawsuit commenced. PAJ sought a declaration that Hanover owed it a defense and indemnity in the *Yurman* suit. PAJ and Hanover stipulated that PAJ failed to provide Hanover with notice of the suit "as soon as practicable," as required under the policy. Moreover, and more importantly, the parties stipulated that Hanover was not prejudiced by the untimely notice. Accordingly, both parties moved for summary judgment on the notice issue. At the trial court level, Hanover's motion was granted and PAJ's was denied because the trial court found that Hanover was not required to demonstrate prejudice to avoid coverage under the policy. The Dallas Court of Appeals affirmed the trial court's ruling.

On appeal, Hanover alleged that its prompt-notice requirement was a condition precedent to coverage, which, if not adhered to, defeats coverage irrespective of prejudice to the insurer. On the other hand, PAJ contended that the provision is merely a covenant under which performance is excused only if the breach is material. And, PAJ claimed, even if it is a condition precedent, Texas law requires Hanover to prove

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CASES TO WATCH:

Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc., 2005 WL 1252321 (Tex. May 27, 2005) (pending on rehearing) (whether Texas recognizes a right of recoupment by an insurer against its insured)

Fairfield Ins. Co. v. Stephens Martin Paving, 381 F.3d 435 (5th Cir. 2004) (certified to the Supreme Court of Texas and argued on November 9, 2004) (whether an award of punitive damages is insurable under an employers liability policy)

Ulico Cas. Co. v. Allied Pilots Ass'n, 187 S.W.3d 91 (Tex. App.—Ft. Worth 2005, pet. granted) (argued on April 11, 2007) (whether Texas recognizes coverage by waiver and/or estoppel when an insurer undertakes the defense without adequately reserving rights)

American Home Assur. Co., Inc. v. Unauthorized Practice of Law Comm., 121 S.W.3d 831 (Tex. App.—Eastland 2003, pet granted) (argued on September 28, 2005) (scope of the tripartite relationship between insurer, insured, and defense counsel retained by insurer)

that it was prejudiced by the untimely notice. The Supreme Court agreed that "only a material breach of the timely notice provision will excuse Hanover's performance under the policy." *PAJ, Inc.*, 2008 WL 109071, at *1.

2. The *Cutaia* Decision

Hanover's position hinged upon the Supreme Court's 1972 decision in *Members Mutual Insurance Co. v. Cutaia*, 476 S.W.2d 278 (Tex. 1972). In *Cutaia*, the policy at issue mandated that the insured forward any suit papers immediately to the insurer and that "no action shall lie against the [insurer] unless, *as a condition precedent thereto*, there shall have been full compliance with all of the terms of this policy." *PAJ, Inc.*, 2008 WL 109071, at *2 (citing *Cutaia*, 476 S.W.2d at 278–79). When the insured failed to forward suit papers to the insurer for five months and the insurer stipulated that it was not prejudiced by the insured's lack of action, the Supreme Court agreed with the insurer that the insured's failure to comply with the policy's condition precluded the insurer's liability regardless of a showing of prejudice.

Importantly, though, the Court noted that in *Cutaia* it had emphasized "the apparent injustice which results in this particular case" and deferred the issue to the Legislature or the State Board of Insurance. *Id.* Accordingly, a year later, the State Board of Insurance issued Board Order 23080, which read, in pertinent part, as follows:

> As respects bodily injury liability coverage and property damage liability coverage, unless the company is prejudiced by the insured's failure to comply with the requirement, any provision of this policy requiring the insured to give notice of action, occurrence or loss, or requiring the insured to forward demands, notices, summons or other legal process, shall not bar liability under this policy.

Id. at *2 (citing State Board of Insurance, *Revision of Tex. Standard Provision for General Liability Policies-Amendatory Endorsement-Notice*, Board Order No. 23080 (Mar. 13, 1972)). Notably, at that time, Coverage B (i.e., standard coverage for "personal and advertising injury," which was at issue in *PAJ*) did not yet exist. Accordingly, the Board Order did not mention "personal and advertising injury." As a result, several courts have ruled that no prejudice requirement exists for Coverage B cases. *See, e.g.*, *Gemmy Indus. Corp. v. Alliance General Ins. Co.*, 190 F. Supp. 2d 915 (N.D. Tex. 1998), *aff'd without opinion*, 200 F.3d 816 (5th Cir. 1999); *McCutchin v. Trinity Universal Ins. Co.*, 1999 WL 793367 (Tex. App.—Dallas Oct. 6, 1999, no pet.) (noting the Board's failure to subsequently amend the endorsement language to include personal and advertising injury). *But see St. Paul Guardian Ins. v. Centrum G.S. Ltd.*, 383 F. Supp. 2d 891, 900–01 (N.D. Tex. 2003) (holding that prejudice is required irrespective of the nature of the claim).

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CASES TO WATCH:
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OneBeacon Ins. Co. v. Don's Building Supply, Inc., 2007 WL 2258192 (5th Cir. Aug. 8, 2007) (certifying trigger issue to the Supreme Court of Texas)

Pine Oak Builders, Inc. v. Great Am. Lloyds Ins. Co., 2006 WL 1892669 (Tex. App.—Houston [14th Dist.] July 6, 2006, pet. granted) (scope of the eight-corners rule and proper trigger theory to apply to "property damage" cases)

Johnson v. State Farm Lloyds, 204 S.W.2d 897 (Tex. App.—Dallas 2006, pet. granted) (scope of the standard appraisal clause)

Crocker v. National Union Fire Ins. Co. of Pittsburgh, Pa., 466 F.3d 347 (5th Cir. 2006) (certified to the Supreme Court of Texas and argued on January 25, 2007) (whether notice by the named insured inures to the benefit of an additional insured)

3. Turning to *Hernandez* and Extending Its Holding

Twenty-one years after the Board Order was issued, the Supreme Court decided *Hernandez v. Gulf Group Lloyds*, 875 S.W.2d 691 (Tex. 1994), in which the court held that one party's material breach of an insurance contract excused the other party's performance. In *PAJ*, the Court explained that its *Hernandez* decision specified that courts must consider, among other things, "the extent to which the nonbreaching party will be deprived of the benefit that it could have reasonably anticipated from full performance." *PAJ*, 2008 WL 109071, at *2. Looking specifically at the settlement-without-consent provision, the Supreme Court found in *Hernandez* that, regardless of whether a provision is a condition precedent or covenant, the immaterial breach of the settlement-without-consent provision was not sufficient to allow the insurer to avoid coverage under the policy.

The *PAJ* court recognized that, since its decision in *Hernandez*, Texas has been known as a notice-prejudice state (i.e., an insurer must be prejudiced by late-notice before it can escape coverage). In its recognition, the court cited the Fifth Circuit's decision in *Ridglea Estate Condominium Association v. Lexington Insurance Co.*, 415 F.3d 474, 480 (5th Cir. 2005), which relied upon *Hernandez* when holding that Texas requires prejudice for late notice, including in first-party property policies, that were not subject to the Board Order.

Addressing the dissent in *PAJ*, the majority criticized their belief that *Hernandez* distinguished between conditions precedent and covenants. Rather, the Court said that the policy language in *Hernandez* was the same as was before the Court in *PAJ*, and the Court never made a distinction between conditions and covenants in reaching its conclusion that prejudice was required before an insurer could preclude coverage. The Court also questioned "the dissent's fundamental premise that the timely notice provision before us creates a condition precedent rather than a covenant." *PAJ*, 2008 WL 109071, at *4. While the *Cutaia* policy specifically provided that the provision at issue was a condition precedent, that language was removed from the standard CGL language and was not included in PAJ's policy. Moreover, "timely notice" was not a central part of PAJ's and Hanover's bargained-for agreement for occurrence-based insurance coverage, which is distinctly different from claims-made policies. *Id.* at *5 (citing *Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653, 658 (5th Cir. 1999)). "The dissent, by focusing on the type of coverage rather than the type of *policy*, entirely disregards this important distinction." *Id.* (emphasis in original). The Court in *PAJ* went on to say:

> Finally, and perhaps most disturbingly, the dissent's analysis of the policy language would impose draconian consequences for even *de minimis* deviations from the duties the policy places on insureds. The policy in this case requires, in the same section at issue, not only notice of suit "as soon as practicable," but also

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> that PAJ "immediately send . . . copies of any demands, summonses or legal papers." Thus, under the dissent's construction, an insured's failure to promptly forward a deposition notice or a certificate of conference would work a forfeiture of coverage, even when the insurer is not at all harmed. This is precisely the result that Board Order 23080 attempted to avoid and we rejected in *Hernandez*.

Id. Accordingly, the Court held that "an insured's failure to timely notify its insurer of a claim or suit does not defeat coverage if the insurer was not prejudiced by the delay." *Id.*

B. *XL Specialty Insurance Co. v. Financial Industries Corp.*

The same day it issued its ruling in *PAJ*, the Supreme Court of Texas also accepted a certified question from the Fifth Circuit Court of Appeals. *XL Specialty Ins. Co. v. Financial Indus. Corp.*, 2007 WL 4461190 (5th Cir. Dec. 19, 2007). At issue in *XL* is a claims-made, management liability policy, which requires Financial Industries Corporation ("FIC") to notify XL Specialty Insurance ("XL") of any claim against it "as soon as practicable after it is first made" "[a]s a condition precedent" to payment under the policy. Seven months after being sued in Texas state court for breach of contract and fraud, FIC notified XL of the suits. Importantly, the notice was provided within the XL claims-made policy period. Further, the parties stipulated, as in *PAJ*, that the late notification breached the policy's prompt-notice provision but did not prejudice XL.

XL sought a declaratory judgment in federal district court that the policy at issue did not cover FIC because notice was not timely provided. The district court granted summary judgment in XL's favor, finding that Texas law does not require an insurer to show prejudice to avoid coverage on a claims-made policy. In fact, no court in Texas had recognized any sort of prejudice requirement applicable to claims-made policies. *See, e.g.*, *Fed. Ins. Co. v. CompUSA, Inc.*, 319 F.3d 746 (5th Cir. 2003); *Emcode Reimbursement Solutions, Inc. v. Nutmeg Ins. Co.*, 512 F. Supp. 2d 603 (N.D. Tex. 2007); *Hirsch v. Tex. Lawyers' Ins. Exch.*, 808 S.W.2d 562, 565 (Tex. App.—El Paso 1991, writ denied) ("To require a showing of prejudice for late notice would defeat the purpose of 'claims made' policies, and in effect, change such a policy into an 'occurrence' policy."). FIC appealed that ruling to the Fifth Circuit.

On appeal, the Fifth Circuit noted the Supreme Court's decisions in both *Cutaia* and *Hernandez*. It acknowledged that the Court's *Hernandez* opinion arguably was broad enough to encompass policy provisions other than the consent-to-settle provision because it reasoned that "[i]nsurance policies are contracts, and as such are subject to rules applicable to contracts generally," including the rule that a breach must be material—i.e., cause prejudice—to excuse performance by the non-breaching party.

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The Fifth Circuit recognized that four cases related to the notice-prejudice rule were before the Supreme Court of Texas on December 19, 2007. *See, e.g.*, *Prodigy Commc'ns Corp. v. Agric. Excess & Surplus Ins. Co.*, 195 S.W.3d 764 (Tex. App.—Dallas 2006, pet. granted). In *Prodigy*, which also addressed a claims-made policy, the Dallas Court of Appeals upheld a summary judgment finding in favor of an insurer that denied coverage because of late notice by its insured even though notice was provided within the policy's reporting period. (Notably, on January 11, 2008, the Supreme Court accepted the petition in *Prodigy* and oral arguments are set for April 1, 2008.) Because of *Prodigy* and the other cases pending before the Court, the Fifth Circuit refused to follow its earlier precedent that required a showing of prejudice for occurrence-based policies but not claims-made policies. Rather, it certified the following question to the Supreme Court:

> Must an insurer show prejudice to deny payment on a claims-made policy, when the denial is based upon the insured's breach of the policy's prompt-notice provision, but the notice is nevertheless given within the policy's coverage period?

2007 WL 4461190, at *2. Again, as noted, the Supreme Court accepted that certified question on January 11, 2008.

Commentary:

The Supreme Court of Texas' decision in *PAJ* represents another victory for insureds. Now, with the Court's 5-4 decision, insurers are presented an additional obstacle in denying coverage to insureds—they must show that they were prejudiced by any late notice of a claim. The policy at issue in *PAJ* was an occurrence-based policy that provided coverage for "personal and advertising injury." The Court, though, relied upon *Ridglea*, which extended the *Hernandez* ruling to a first-party commercial property policy. That reliance, then, calls into question two other opinions in which courts held that prejudice was not required for first-party homeowner's policies. *See Chiles v. Chubb Lloyds Ins. Co.*, 858 S.W.2d 633 (Tex. App.—Houston [1st Dist.] 1993, writ denied) (refusing to apply a prejudice requirement because the Board Order was limited to CGL policies); *Flores v. Allstate Texas Lloyd's Ins. Co.*, 278 F. Supp. 2d 810, 816 (S.D. Tex. 2003) (refusing to extend the prejudice requirement to a homeowner's policy because the Board Orders promulgated by the Texas Department of Insurance, which require a showing of prejudice, are restricted to automobile and CGL insurance policies). In essence, the Court has indicated that prejudice is a requirement for *any* occurrence-based policy, not just those discussed in Board Orders promulgated by Texas' Department of Insurance. Moreover, by its reasoning, it appears that the Court will apply a prejudice requirement beyond just notice and consent-to-settle policy requirements.

In the same vein, the Court, with *XL* now before it, has an opportunity to clarify whether a prejudice requirement applies to claims-made policies when the notice, while "late," still is within the claims-made policy period. Logic dictates that the same "prejudice" reasoning should apply in that situation, as long as the notice is made within the policy period.

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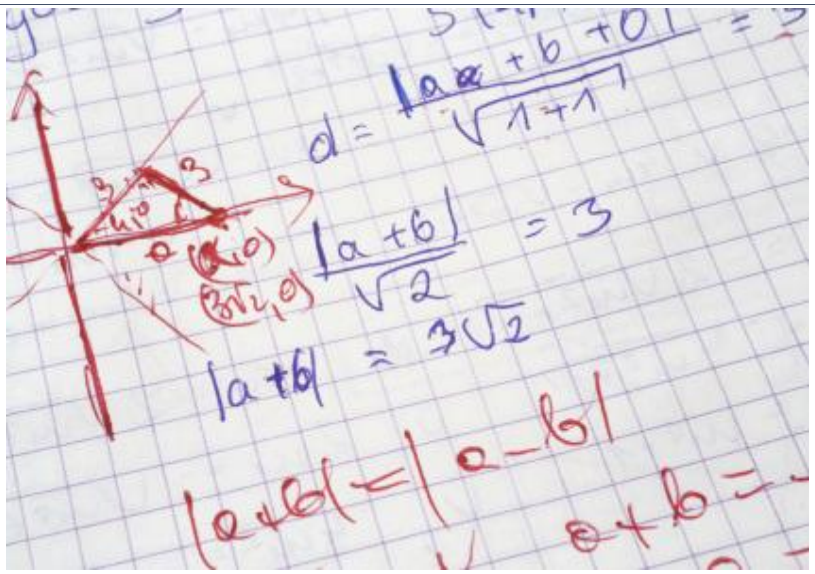

GETTING TO KNOW LEE H. SHIDLOFSKY AND THE INSURANCE LAW PRACTICE GROUP . . .

Lee H. Shidlofsky is a founding partner of Visser Shidlofsky LLP. His practice is devoted to representing and counseling corporate policyholders in the area of insurance law, risk management, contractual risk transfer, and extra-contractual issues. He is Treasurer of the Insurance Law Section and holds a council position in the Construction Law Section of the State Bar of Texas. He is the author of numerous articles and seminar papers and is a frequent speaker at continuing legal education seminars in Texas and across the country. Mr. Shidlofsky has been named a "Super Lawyer" by Texas Monthly Magazine each year since 2004, including a ranking as a Top 50 attorney in the Central and West Texas Region for 2007, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal.

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The Insurance Law Practice Group represents corporate policyholders that are in disputes with their insurance companies, provides advice to plaintiffs in complex litigation on how to best maximize an insurance recovery, and provides risk-management consultation in connection with a wide-variety of contractual risk transfer issues. The Insurance Law Practice Group handles first-party and third-party insurance claims in state and federal courts at both the trial and appellate court levels. The Insurance Law Practice Group is committed to practical and pragmatic solutions to insurance issues.

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