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Prodigy + *XL* = Prejudice Requirement Even with a Claims-Made Policy and That's No April Fool's Joke

On March 27, 2009, the Supreme Court of Texas extended the state's notice-prejudice rule to claims-made insurance policies, so long as notice of the claim at issue is provided during the policy period (or any extended reporting period). *See Prodigy Commc'ns Corp. v. Agric. Excess & Surplus Ins. Co., et al.*, 2009 WL 795530 (Tex. Mar. 27, 2009). *See also Fin. Indus. Corp. v. XL Specialty Ins. Co.*, 2009 WL 795529 (Tex. Mar. 27, 2009) (answering a certified question from the Fifth Circuit Court of Appeals). In doing so, the Court followed the same logic as it did in its decision last year in *PAJ, Inc. v. Hanover Insurance Co.*, 243 S.W.3d 630, 636–37 (Tex. 2008), in which the Court found that an insurer under an occurrence-based CGL policy must show that it has been prejudiced by an insured's late notice before it can preclude coverage. (For an in-depth analysis of the Court's *PAJ* decision, see Volume 2, Issue 1 of the *insurance law newsletter*, which can be found at www.vsfirm.com/publications.)

A. Background Facts

In May 2000, when Prodigy Communications merged with FlashNet Communications, FlashNet was insured under a D&O insurance policy issued by Agricultural Excess & Surplus Insurance Company ("AESIC") and underwritten and administered by Great American Insurance Company ("Great American"). The policy insured FlashNet for "claims first made" against the company and its directors and officers during the policy period, which ran from March 16, 2000 to May 31, 2000. In anticipation of the merger, FlashNet purchased a 3-year discovery period, extending the claims-made coverage to May 31, 2003. The policy contained a "Notice of Claim" provision that stated as follows:

> **The [Insureds] shall, as a condition precedent to their rights under this Policy, give the Insurer notice, in writing, as soon as practicable of any claim first made against the [Insureds] during the Policy Period, or Discovery Period (if applicable), but in no event later than ninety (90) days after the expiration of the Policy Period, or Discovery Period, and shall give the Insurer such information and cooperation as it may reasonably required.**

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Happy Early April Fool's Day!!

***Prodigy*, 2009 WL 795530, at *1. Accordingly, notice of any claim was to be given no later than August 29, 2003. *Id.* at *1 n.5.**

On November 28, 2001, FlashNet was named a defendant in a class-action lawsuit, and Prodigy received notice of the lawsuit on June 20, 2002. Prodigy, however, did not first notify AESIC of the lawsuit until June 6, 2003. At that time, Prodigy requested permission to enter into a settlement agreement, presumably because it believed AESIC already knew of the lawsuit. On June 18, 2003, AESIC responded to Prodigy, denying coverage because the letter did not comply with the policy's notice requirements. AESIC noted that both the policy period and the Discovery Period had expired before the June 6 letter was sent. Nevertheless, Prodigy countered that the 90-day window following the Discovery Period had not ended and thus its notice to the insurer was not late. AESIC, however, continued to disagree. *Id.* at *2.

Thereafter, Prodigy filed a declaratory judgment action against AESIC, seeking a declaration that it was entitled to coverage and that AESIC had violated numerous insurance code provisions. On cross-motions for summary judgment, the trial court denied Prodigy's motion and granted AESIC's in part, finding that Prodigy had failed to adhere to the policy's notice requirement, which "avoids coverage, with or without prejudice to AESIC." AESIC and Great American subsequently moved for summary judgment on the alleged insurance code violations, obtaining a final summary judgment in their favor. *Id.*

On appeal, the judgment was affirmed. That court held the following: (1) Prodigy was obligated to give notice "as soon as practicable" notwithstanding the allowance of notice within ninety days after the expiration of the discovery period; (2) notice given almost one year after the lawsuit was filed was not "as soon as practicable" as a matter of law; (3) AESIC did not have to show that it was prejudiced; and (4) none of the insurance code provisions prevented AESIC from enforcing the notice provision. *Id.* (citing *Prodigy Communications Corp. v. Agricultural Excess & Surplus Insurance Company*, 195 S.W.3d 764, 766–69 (Tex. App.—Dallas 2006, pet. granted)). Prodigy then petitioned the Supreme Court to review the decision.

B. The Majority Opinion follows *PAJ*

The Court stated the issue before it as follows: "We must decide whether, under a claims-made policy, an insurer can deny coverage based on its insured's alleged failure to comply with a policy provision requiring that notice of a claim be given 'as soon as practicable,' when (1) notice of the claim was provided before the reporting deadline specified in the policy; and (2) the insurer was not prejudiced by the delay." *Id.* at *3.

At the outset, the Court addressed its holding in *PAJ*, where it held that an "'insured's failure to timely notify its insurer of a claim or suit does

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not defeat coverage if the insurer was not prejudiced by the delay.'" *Id.* (quoting *PAJ*, 243 S.W.3d at 636–37). Further, the court recognized that that holding was premised upon its prior decision in *Hernandez*, in which it found that "'an immaterial breach does not deprive the insurer of the benefit of the bargain and thus cannot relieve the insurer of the contractual coverage obligation.'" *Id.* (quoting *PAJ*, 243 S.W.3d at 631 (citing *Hernandez v. Gulf Group Lloyds*, 875 S.W.2d 691, 692 (Tex. 1994))). The parties, however, did not agree that *PAJ* was applicable.

The Court agreed with AESIC that certain distinctions exist between the policy in *PAJ* and the policy before it in the instant case. *Id.* For instance, the Prodigy policy specified that giving notice "as soon as practicable" was a "condition precedent" to coverage. But, as the majority noted, the decision in *PAJ* did not distinguish between covenants and conditions precedent. Rather, *PAJ* adhered to "fundamental principle[s] of contract law" where if one party materially breaches a contract, then the other contracting party is excused from performing the contract. *Id.* (citing *PAJ*, 243 S.W.3d at 633). And, in determining whether a breach is material, the Court said that one consideration is "'the extent to which the non-breaching party will be deprived of the benefit that it could have reasonably anticipated from full performance.'" *Id.* (citing *PAJ*, 243 S.W.3d at 633). Accordingly, the Court said that, despite the inclusion of "condition precedent" language, it still had to determine whether prejudice is required.

The Court then acknowledged the second distinction between the policies—the one in *PAJ* was an "occurrence-based" policy and the one before it was a "claims-made" policy. And, a "critical distinction" between the role of notice in such policies is clear, as notice was not an "essential part of the bargained-for exchange in PAJ's occurrence-based policy" and is "subsidiary to the event that triggers coverage." *Id.* (citing *PAJ*, 243 S.W.3d at 636; *Matador Petrol. Corp. v. St. Paul Surplus Lines Ins. Co.*, 174 F.3d 653, 658 (5th Cir. 1999)).

Thus, in order to determine whether the inclusion of "notice as soon as practicable" was an essential part of the parties' bargained-for exchange in the instant case, the Court dove into the intricacies of the different types of insurance policies. In particular, the Court found that claims-made policies "provide unlimited retroactive coverage and no prospective coverage." And some claims-made policies include an additional requirement that the claim also be reported during the policy period (i.e., a "claims-made-and-reported policy"). Meanwhile, an occurrence-based policy provides the opposite coverage—no retroactive coverage and unlimited prospective coverage. As such, a claims-made policy is advantageous for an insurer because it provides an avenue for calculating risks and premiums with greater precision. *Id.* at *4. Moreover, different kinds of notice requirements in claims-made policies serve different purposes. For example, requiring an insured to provide notice "as soon as practicable" allows an insurer to investigate the claim, set reserves, and actively participate in negotiations with third parties.

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Meanwhile, the requirement that notice be provided during the policy period places temporal boundaries on the insurer's obligation. *Id.* at *5. And, when an insurer provides such boundaries, it provides itself with a precise date on which it is no longer liable for claims under the policy. Such notice requirements in claims-made policies has been described as follows:

> **Claims made or discovery policies are essentially reporting policies. *If the claim is reported to the insurer during the policy period, then the carrier is legally obligated to pay;* if the claim is not reported during the policy period, no liability attaches. Claims[-]made policies require notification to the insurer to be within a reasonable time. *Critically, however, claims made policies require that that notice be given during the policy period itself.***

***Id.* (citing 20 HOLMES' APPLEMAN ON INSURANCE 2D § 130.1(A) 1 (emphasis added)). Thus, in a claims-made-and-reported policy, notice during the policy period or within a specific number of days thereafter is essential to coverage and insurers need not show prejudice when notice of claim falls outside the specified time frame. *Id.* (citing numerous non-Texas cases).**

The Court paid particular attention to two non-Texas cases: (1) *Chas. T. Main, Inc. v. Fireman's Fund Ins. Co.*, 551 N.E.2d 28 (Mass. 1990); and (2) *T.H.E. Insurance Co. v. P.T.P. Inc.*, 628 A.2d 223 (Md. 1993). In *Main*, that court held that a distinction exists between requiring notice "as soon as practicable" and notice "within the policy year." According to the court, the former was subject to Massachusetts' statutory notice-prejudice rule, but the latter was not. *Prodigy*, 2009 WL 795530, at *5–*6 (citing *Main*, 551 N.E.2d at 30). And, in *T.H.E.*, Maryland's high court found that a statutory notice-prejudice requirement did not apply when the claim at issue was not made and reported until after the end of the policy period. The same court "observed that the insurer would be required to demonstrate prejudice, however, to deny coverage based on the policy's provision requiring the insured to give notice of a claim 'as soon as practicable,' assuming that the claim had been made and reported within the extended reporting period." *Id.* at *6 (citing *T.H.E.*, 628 A.2d at 227 n.7).

The Supreme Court of Texas agreed with those cases and found that when notice of a claim is provided within the policy period (or other specified reporting period) in a claims-made policy, "the insurer must show that the insured's noncompliance with the policy's 'as soon as practicable' notice provision prejudiced the insure before it may deny coverage." Under the facts before it, no dispute existed that notice was provided within the 90-day reporting period and thus, even if that did not constitute notice "as soon as practicable," AESIC was not denied the benefit of its policy, "as it could not 'close its books' on the policy until ninety days after the discovery period expired." *Id.* (citing *F.D.I.C. v. Mijalis*, 15 F.3d 1314, 1330 (5th Cir. 1994)). Thus, according to the Court, the provision of notice "as soon as practicable" was not material

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to the parties' bargained-for exchange and, because AESIC conceded that it was not prejudiced by the late notice, it could not deny coverage for Prodigy's failure to provide notice "as soon as practicable." *Id.* As a result, the Court reversed the court of appeals' opinion, rendered judgment that coverage could not be denied for late notice, and remanded the case to the trial court so that the remaining issues in the case could be addressed.

C. The Concurring Opinion: Like It or Not, *PAJ* is the "Law of the Land"

In a one-paragraph opinion, Justice Wainwright concurred in the Court's opinion. *Id.* at *6. But, he noted his unhappiness with the ruling. He opined that *PAJ*—a case in which he joined the dissent—"largely controls the outcome of this case." Justice Wainwright, however, agreed with the dissent's claim that contracts are supposed to be enforced as written and the Court's opinion in *PAJ* is concerning in that it seemingly would "thwart even the enforcement of a policy's notice requirement that explicitly states, 'time is of the essence.'" *Id.* He concluded: "Nevertheless, *PAJ* is the law of the land, and I join in the Court's opinion today for that reason." *Id.*

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D. The Dissent: Stick to the Policy Language

In dissenting from the Court's opinion, Justices Johnson, Hecht and Willett argued that the Court's decision rewrote an unambiguous insurance contract and, as a result, changed the parties' agreement, departing from "well-established insurance policy construction rules as well as by failing to adhere to a choice made by the Court in *Members Mutual Insurance Co. v. Cutaia*, 476 S.W.2d 278, 280–81 (Tex. 1972), to interpret insurance contracts as written and leave changes to the Legislature or insurance regulatory agency." *Id.* at *7.

The dissent further stated that the Court's opinion in *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & rental Tools, Inc.*, 246 S.W.3d 42, 50 (Tex. 2008), rejected such action when an insurer attempted to rewrite the parties' contract or add to its language when it sought equitable reimbursement from its insured. Moreover, in that opinion, the Court quoted the decision in *Fortis Benefits v. Cantu*, 234 S.W.3d 642, 649 (Tex. 2007), in which the Court said it was "loathe to judicially rewrite the parties' contract by engrafting extra-contractual standards." *Id.* Nevertheless, and despite these decisions, the majority had essentially re-written the policy by holding that AESIC could not deny coverage to Prodigy even if the insured breached explicit contract language that required notice "in writing, as soon as practicable." The dissent also explicitly disagreed with the majority's conclusion that the record did not show that the notice provision was not an "essential part of the parties' agreement." In fact, the dissent argued, the evidence showed the opposite because "timely notice was clearly and explicitly a condition precedent to any rights under the policy." *Id.* at *8–*9. Simply

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put, the original form of the policy made timely notice a condition precedent and that same language was carried forward into an endorsement that added the 90-day extended reporting period. Thus, the dissent said: "Certainly the record does not show as a matter of law that the notice language was *not* essential to the parties' agreement. The Court's conclusion otherwise is in derogation of the parties' intent as expressed by policy language." *Id.* at *9.

Moreover, the dissent criticized the majority's reliance on *Main* and *T.H.E.*, finding that those cases actually supported following the Court's decision in *Cutaia*. Specifically, in *Main* and *T.H.E.*, "the notice-prejudice issue was addressed by statute and the courts were considering how notice provisions should be treated in light of the statutes." *Id.* at *10. In *Main*, the court stated that "the requirement that notice of the claim be given in the policy period or shortly thereafter in the claims-made policy is of the essence in determining whether coverage exists." *Id.* (quoting *Main*, 551 N.E.2d at 30). Nevertheless, that court held, "in summary fashion," that the notice-prejudice statute applied only to the "as soon as practicable" language and not to the "within the policy period" language because doing so "would defeat the fundamental concept on which claims-made policies are premised, and it would be unreasonable to think that the Legislature intended such a result." *Id.* (citing *Main*, 551 N.E.2d at 30). *See also T.H.E. Ins. Co.*, 628 A.2d at 226–27 (relying on a state statute of which a similar type does not exist in Texas for claims-made policies).

In addition, the dissent rejected the majority's general discussion of claims-made policies. *Id.* at *11. In doing so, the justices noted that—as written—the policy's "notice requirements terminate the insurer's obligations (1) as the policy period passes without notice of claim being given, or (2) at the latest, ninety days after the Discovery Period ends." *Id.* Yet, when the policy is rewritten as it was by the majority, it disrupts the insurer's actuarial predictions and the process of setting premiums. Simply put, according to the dissent:

> **Policy language and its effects on the insurer's business are matters better addressed through the legislative and regulatory processes than through the judicial process. The legislative and regulatory processes allow prospective implementation of changes to policy language and prospective calculation of premiums based on risks assumed by the insurer. Modifications to agreements through the judicial process, however, are primarily retrospective, long after the contracts were entered into and premiums calculated and paid based on agreed-to policy language.**

***Id.* In *Cutaia*, those policy reasons were recognized and respected. According to the dissent, however, in the instant case the majority did not respect the parties' agreement or exercise restraint like was done in *Cutaia*. *Id.* (discussing *Cutaia* and the Court's refusal—at that time—to**

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override the insurance policy language and add a prejudice provision). Instead, the majority "injected itself" into the contractual relationship of sophisticated parties and, in doing so, added language to the policy that fundamentally changed its meaning and "looks remarkably similar to language in notice prejudice statutes, regulations, and agency orders." *Id.* at *12 (citations omitted).

Because the dissent felt that the Legislature was in a better position to investigate and review all the relevant information necessary for such important issues, it chose to adhere to the dissent in *PAJ*, which would have reaffirmed the holding in *Cutaia*. *Id.* (quoting *PAJ*, 243 S.W.3d at 641 (Willett, J., dissenting)). Accordingly, the dissent would have found that no evidence existed that the condition precedent language that required notice to be given "as soon as practicable" was not essential to the issuance of AESIC's policy.

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

On the same day that the Court issued its opinion in *Prodigy*, it also answered a certified question from the Fifth Circuit Court of Appeals in *Financial Industries Corp. v. XL Specialty Insurance Co.*, 2009 WL 795529 (Tex. Mar. 27, 2009). There, the Fifth Court asked whether "an insurer must 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?" *Id.* at *1. In delivering the opinion for the Court, Chief Justice Jefferson found the Court's contemporaneous decision in *Prodigy* to be controlling. The Court acknowledged a subtle difference in the policies, however, as the policy in *XL* simply required notice "as soon as practicable" but did not include a clear-cut reporting deadline. *Id.* at *2. Yet, the Court found that the same reasons require the demonstration of prejudice: "[Financial Industries Corp.] gave notice of the claim within the policy's scope of coverage, i.e., before XL could 'close its books' on the policy." *Id.* As such, XL was not denied the benefit of its claims-made policy and could not deny coverage simply based on its insured's immaterial breach of the notice provision. Accordingly, the Court answered the certified question in the affirmative and held that an insurer must show it was prejudiced in order to deny payment on a claims-made policy, when such denial is premised on a breach of the prompt-notice provision although notice is given within the policy's coverage period. *Id.*

Commentary:

It had long been the law in Texas that no prejudice was required for claims-made policies—regardless of whether the claim was reported during the policy period or any extended reporting period. In fact, to be fair, that is the majority rule across the United States. In reaching its decision in *Prodigy* and *XL*, however, the Supreme Court continued down its path of treating insurance policies as contracts. While one certainly

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can argue that *Prodigy* and *XL* differ from the contract-based approach taken by the Supreme Court of Texas in other cases in that the Court actually circumvented specific policy language regarding notice, the Court still applied "fundamental principles of contract law." Simply put, after reviewing the insurance policy as a whole, the Court concluded that notice "as soon as practicable" is not an essential part of the bargained-for exchange in the claims-made policy—at least when the notice is provided *within* the claims-made policy period or any extended reporting period.

While the decision will be attacked by insurers, the fact remains that the Court reached the right result. No reasonable basis exists for distinguishing between occurrence-based policies and claims-made policies when it comes to a prejudice requirement—provided that the notice is given within the claims-made period or extended reported period. The majority correctly recognized this fact and applied its earlier decision in *PAJ* accordingly.

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 Secretary 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. Lee 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 2008, and is ranked as a top insurance coverage lawyer by Chambers USA and Who's Who Legal. Lee recently was elected a Fellow of the Texas Bar Foundation.

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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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