THE EVOLUTION OF THE NOTICE PREJUDICE RULE

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On January 11, 2008 the Supreme Court of Texas issued its decision in *PAJ, Inc. v. The Hanover Ins. Co*., 51 Tex.Sup. J. 302 (Tex. 2008), ending the decades-long conundrum of whether or not an insurer is obligated to demonstrate that it has been prejudiced by an insured's failure to provide timely notice of a claim or suit falling within Coverage Part B of the CGL policy. *PAJ* arose out of a claim for copyright infringement filed by the Yurmin Company. Yurmin sought damages for PAJ's alleged marketing and sales of a jewelry line that Yurmin claimed infringed on its own distinct designs. PAJ failed to timely notify Hanover of the suit, and Hanover declined to defend and indemnify PAJ. PAJ brought suit, resulting in the Supreme Court's ruling 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." *PAJ v. The Hanover Ins. Co.*, 51 Tex. Sup. J. at 302. The battle over this longstanding issue, waged primarily in Federal District Courts, engendered a number of contradictory opinions that were destined to be resolved judicially or more appropriately, legislatively. In this regard, the Court's decision in *PAJ* is not surprising. In any event, to understand the significance of PAJ, one must look to the evolution of the notice-prejudice rule in Texas. To understand the future of the notice-prejudice rule however, one must look to *PAJ*.

I. HISTORY OF THE NOTICE-PREJUDICE RULE:

A. Texas Courts

The story begins in 1972 with the decision of *Members Mutual Ins. Co. v. Cutaia*, 476 S.W.2d 278 (Tex. 1972). There, the Texas Supreme Court was faced with the issue of whether the insured's duty to forward suit papers "immediately" was a condition precedent to coverage under a liability policy. The policy contained a separate condition, providing that "no action shall lie against [the insurer] unless, as a condition precedent thereto, there shall have been full compliance with all the terms of the policy." *Id.* at 278 (emphasis added). The insured failed to forward notice of suit filed against it for five months to Members Mutual. The Court, declining to overrule prior Supreme Court precedent, deferred the issue to the State Legislature, but noted the apparent injustice to the insured done in the case. A year later, in March, 1973, the State Board of Insurance addressed what the Supreme Court did not, issuing the following Board Order 23080:

> 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.

Importantly, at the time Board Order 23080 was issued, there was no standard coverage for advertising injury. PAJ *2. Almost two decades later, the Supreme Court of Texas imposed the prejudice rule in *Hernandez v. Gulf Group Lloyds*, 875 S.W.2d 691 (Tex. 1994) to the application of a policy exclusion. In *Hernandez*, the insured sought coverage under the uninsured/underinsured part of his auto policy. Gulf denied coverage because the insured had settled his claim with the carrier for the tortfeasor without its consent. There, the Supreme Court held:

> A fundamental principle of contract law is that when one party to a contract commits a material breach of that contract, the other party is discharged or excused from any obligation to perform.
>
> In determining the materiality of a breach courts will 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. The less the non-breaching party is deprived of the expected benefit, the less material the breach.

Hernandez, 875 S.W.2d *675. Citing, *Advance Components, Inc. v. Goodstein*, 608 S.W.2d 737 (Tex.Civ.App.-Dallas 1980, writ ref'd n.r.e.), the *Hernandez* Court held that the other factors to consider when determining the materiality of the breach were:

> (i) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived; (ii) the extent to which the party failing to perform or to offer to perform will suffer forfeiture; (iii) the likelihood that the party failing to perform or to offer to perform will cure

> his failure, taking account of all the circumstances, including any reasonable assurances; (iv) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

Hernandez, 875 S.W.2d *675. Noting that "there may be some instances when an insured's settlement without the insurer's consent prevents the insurer from receiving the anticipated benefit from the insurance contract," the Hernandez Court nevertheless held that if the insurer's expected benefit has no value (i.e. an extinguished subrogation right against a judgment proof tortfeasor), a breach of the settlement without consent clause by the insured will not operate to bar coverage.

As noted by the Court in *PAJ*, following the *Hernandez* decision, Texas officially adopted the notice prejudice rule as applicable to coverage for bodily injury or property damage liability – a fact readily acknowledged by the Fifth Circuit. See e.g. *Hanson Prod. Co. v. Ams. Ins. Co*., 108 F.3d 627 (5th Cir. 1997). *Hanson*, however, was only the beginning of a debate that would ensue at the District Court level on the applicability of the notice-prejudice rule in cases involving "personal injury" and "advertising injury" liability coverage. In the following years, Federal District Courts issued a number of conflicting decisions on this issue, engendering both venue shopping and outcome uncertainty in Coverage B cases.

B. Federal Courts

In *Gemmy Industries Corp. v. Alliance Ins. Co*., 190 F.2d 195 (N.D. Tex. 1998), aff'd 200 F.3d 816 (5th Cir. 1999), the Court held that the adoption of the notice prejudice rule in *Hanson* did not extend to cases involving claims for "advertising injury." In support of its decision, the Court in *Gemmy* held that *Hanson* was based on Board Order 23080, which made no reference to advertising injury claims. The District Court for the Southern District of Texas reached a similar conclusion in *New Era of Networks, Inc., v. Great Northern Ins. Co*., 2003 U.S. Dist. LEXIS 14259 (S.D. Tex. August 1, 2003), holding:

> Therefore, contrary to the Plaintiff's assertions, the facts in this case are analogous to the facts in *Gemmy*, an advertising injury claim case, rather than *Hanson*, a property damage liability coverage case. In addition, this Court ages that the State Board Order requiring prejudice as an element in late notice defenses is clearly limited to bodily injury and property damage liability cases. If the Texas State Board had wanted to include all liability coverage, then it clearly could have done so.

New Era of Networks, Inc., *20, 21 (August 21, 2003). Notably, the dissent in PAJ also made this point, arguing that more than two decades had passed since advertising injury coverage was offered in the standard ISO CGL policy, which the State Board could have addressed had it so desired. Then, in *St. Paul Guardian Ins. Co. v. Centrum G.S., Ltd.*, 383 F.Supp.2d 891, 895-897 (N.D. Tex. 2003)., the Northern District declined to follow *Gemmy*, holding:

> The court declines to follow *Gemmy Industries*, as it reflects the traditional view that an insurer need not prove prejudice to prevail in a late notice case. This position is inconsistent with *Hernandez*, which recognized that only a material breach of an insurance contract excuses performance. Moreover, as stated before, the Fifth Circuit has recognized a modern trend in the case law away from the traditional contractual approach towards a view that considers prejudice to an insurer a relevant factor in determining whether to enforce a condition precedent to insurance coverage. *See Hanson*, 108 F.3d at 631.
>
> This court also rejects St. Paul's contention that *Hanson* only applies to claims under a general liability policy for bodily injury and property damage, and not personal injury. In cases decided both before and after *Hanson*, the Fifth Circuit has stated that the impact of untimely notice has on coverage depends upon the type of insurance policy issued, not the type of coverage provided under the policy as St. Paul seems to suggest.
>
> Given that the CGL policy does not expressly provide that the notice requirement is a condition precedent to liability, an in light of the holdings of *Hanson* and *Hernandez*, the court predicts that Texas courts would require St. Paul to show that it was prejudiced by Defendant's late notice of Perdue's personal injury claims before it may legitimately deny coverage or benefits under the policy.

St. Paul Guardian Ins. Co. v. Centrum G.S., Ltd., 383 F.Supp. at 895-897. *See also Travelers Indemnity Co. of Connecticut v. Presbyterian Healthcare Resources*, 2004 U.S. Dist. LEXIS 6373 (N.D. Tex. February 25, 2004.) Interestingly, aside from *St. Paul Guardian Ins. Co. v. Centrum G.S.*, none of the cases cited discuss the crux of the issue addressed by the Supreme Court in *PAJ*, namely, whether the notice provision of a liability policy is a covenant or a condition precedent to coverage.

II. PAJ

In the Appellate Court decision of *PAJ, Inc. v. Hanover Ins. Co*., 170 S.W.3d 258 (Tex.App.-Dallas 2005, overruled 51 Tex.Sup. J. 302 (2008)), the Court noted:

> Texas courts have consistently held that compliance with an insurance policy's notice provision is a condition precedent to the insurer's liability on the policy. *See, e.g., Harwell v. State Farm Mut. Auto. Ins. Co*., 896 S.W.2d 170, 173-74, 38 Tex. Sup. Ct. J. 458 (Tex. 1995) (quoting *Weaver v. Hartford Acc. & Indem. Co*., 570 S.W.2d 367, 369, 21 Tex. Sup. Ct. J. 453 (Tex. 1978)). Given the settled nature of this classification, we look at the policy at issue to determine whether it expresses a clear intention to the contrary. At the outset, the policy's notice requirements fall under the heading "Commercial General Liability Conditions." The provisions require that "If a claim is made or 'suit' is brought against any insured, you must notify us as soon as practicable." Under the same heading, the policy states that no one may "sue [Hanover] on this Coverage Part unless all of its terms have been fully complied with." The placement and language of these provisions support the conclusion that the insurer's obligations are conditioned on compliance with the policy's notice requirements. Accordingly, we do not find the provisions' language to be antithetical to the well-settled understanding that notice to an insurer is a condition to the insurer's obligations under the policy. *See Hohenberg Bros*. Co., 537 S.W.2d at 3 (no particular words necessary for existence of condition). This classification of the notice provision as a condition rather than a covenant defeats PAJ's first argument for the requirement to show prejudice from the untimely notice.

PAJ v. The Hanover Ins. Co., 170 S.W.3d at 262.

Taking up this line of reasoning, the Supreme Court disagreed, diminishing the distinction between whether the notice provision of a policy is a covenant or a condition precedent:

> The dissent today attempts to distinguish Hernandez by characterizing the settlement without-consent clause at issue in that case as a covenant rather than a condition, even though in Hernandez we made no distinction between the two. They arrive at the conclusion only through reasoning, backwards, that because we required a showing of prejudice in Hernandez, the policy language at issue must have been a covenant. In truth, the policy language we construed in Hernandez is indistinguishable from that presented here. As under PAJ's policy, the language before the Court in Hernandez provided:
>
> This insurance does not apply: a) to bodily injury or property damage with respect to which the insured, without written consent of the company, makes any settlement with any person…who may be legally liable therefor.875 S.W.2d at 694 (policy language quoted by ENOCH, J.., dissenting). The dissenting justice in Hernandez, like the dissenting justices today, saw this language as rather clearly indicating a condition to coverage. See id. ('[T]his case is not about a breach of contract. This case is about coverage.'). Nevertheless, we made no distinction between the two in deciding that the insurer had to show prejudice before it could avoid its coverage obligation.

PAJ, Inc. v. The Hanover Ins. Co., 51 Tex.Sup. J 302, 306.

In short, the Court held that whether the notice provision of a CGL policy constitutes a condition or a covenant is immaterial – an insurer is required to demonstrate prejudice, regardless. But in further discussion, the Court opined that the language of the CGL policy stating that no action shall lie against the insurer unless "as a condition precedent", the insured shall have fully complied with all the terms of the

policy had been removed, lending further credence to the categorization of the notice provision as a covenant rather than a condition precedent. *See Id.* The dissent, vehemently disagreed with the majority, noting that the Texas State Board had had more than two decades to resolve the issue and having failed to do so, implicitly pronounced its view. Having ruled without really determining whether the conditions of a policy are conditions or covenants -- a principal fundamental to basic contract law -- the decision in *PAJ* may have created more questions than it answered. *Hohenberg Brothers Co. v. Gibbon s & Co*., 537 S.W.2d 1 (Tex. 1976).

III. WHAT CONSTITUTES PREJUDICE?

An examination of the decision in *PAJ* naturally leads to the question of how does a carrier demonstrate that it has been prejudiced by the insured's failure to provide timely notice? Texas Courts have consistently held that an insurer is prejudiced from lack of notice when:

> (1) the insurer, without notice or actual notice of the suit received notice after he entry of a default judgment against the insured; (2) the insurer received notice of the suit, but the trial date was fast approaching, thereby depriving it of the opportunity to investigate the claims or mount an adequate defense; (3) the insurer received notice of a lawsuit after the case had proceeded to trial and judgment has been entered against the insured; and, (4) the insurer received notice of a default judgment against the insured after the judgment had become final and could not be appealed.

Harwell v. State Farm Mut. Auto. Ins. Co., 896 S.W.2d 170, 173 (Tex. 1995). *See also Liberty Mutual Ins. Co. v. Roque Cruz*, 883 S.W.2d 164 (Tex. 1993). While these rules appear seemingly simple, in reality, they are deceptively so, as the question of prejudice remains almost exclusively in the hands of a jury. One of the critical points of the stated rules is that the carrier does not have actual notice of the suit from another source. *Liberty Mutual*, 883 S.W.2d at 164. Here again, there is a lack of clarity in existing case law.

For instance, in *Struna v. Concord Ins. Servs., Inc*., 11 S.W.3d 359 (Tex.App-Houston [1st Dist.] 2000, no pet.), Concord received notice of a suit filed against its insured by counsel for the plaintiff. Concord also received notice of the default hearing and the default judgment, but took no action. After the entry of the judgment, Struna sued Concord as a judgment creditor. Concord defended on the premise that the insured had failed to forward suit papers. The Court of Appeals, deciding whether summary judgment was appropriately granted in the case, held that a fact issue existed as to whether Concord was prejudiced by the insured's failure to forward suit papers, since it had received notice of the suit from another source.

However, in *Crocker v. National Union Fire Ins. Co. of Pittsburgh*, Pa., 51 Tex. S. J. 58 (Feb. 15, 2008), the Texas Supreme Court held that National Union had no duty to notify an additional insured (i.e. an a former employee of the insured) of available liability coverage and that an insurer's actual knowledge that an additional insured has been served with process does not establish as a matter of law that the insurer has not been prejudiced by the additional insured's failure to notify the insurer of the receipt of process. *Crocker* does not expressly overrule *Struna* -- the decision was cited by the Appellate Court, but not the Supreme Court. Rather, the Court in *Crocker* cited the decision of *Weaver v. Hartford Accident & Indem. Co*., 570 S.W.2d at 370 (Tex. 1978) as its governing authority – a case that was superseded by statute on procedural grounds in 2007. In *Weaver*, the Texas Supreme Court similarly held that a carrier has no duty to gratuitously provide an uninvited, unsolicited defense to an additional insured.

So, do *Crocker* and *Weaver* prevail when suit is filed against the named policy holder as opposed to an additional insured? The answer to that question is less than clear. There is no governing authority as to whether a carrier owes the same duties to an additional insured as it does to the premium-paying policy holder under all circumstances. On the other hand, if *Crocker* and *Weaver* apply across the board without distinction, the cases at least afford some relief to the harsh effects of *PAJ*.

Next, there is a question as to whether a carrier can demonstrate prejudice if it receives notice of the suit after the entry of a default judgment but before the expiration of the time to appeal or file post trial motions. *See Ratcliff v. Nat'l. County Mut. Fire Ins. Co.*, 735 S.W.2d 955 (Tex.App.-Dallas 1987, writ denied w.o.j.); *But see Kimble v. Aetna Cas. & Surety Co.*, 767 S.W.2d 846 (Tex.App.-Amarillo 1989, no writ)(holding that prejudice exists as a matter of law where the insured forwards suit papers after the entry of a default judgment but prior to the deadline for new trial motions). Although the law favors insurers at the Appellate level, it will not come as a surprise if the Texas Supreme Court offers a clarification on this issue in the future, as well.

Regardless, deciding whether to defend a suit forwarded in an untimely manner is complicated by the fact that if the carrier does defend, proving prejudice becomes relatively moot once the insurer steps in. Short of an unsupported landslide victory in favor of the plaintiff, or the insured's absolute refusal to cooperate

in the defense, it is hard to imagine a situation in which the insurer could demonstrate that it has been irreparably damaged by the insured's failure to forward suit papers after it has mounted a defense on the insured's behalf. Conversely, if the insurer refuses to defend, and is held to have wrongfully breached that duty, the insurer loses its ability to rely on any policy defenses, including a breach of policy conditions. *See e.g. Nutmeg Ins. Co. v. Employers Ins. Co. of Wausau*, 2006 U.S. Dist. LEXIS 7246 (N.D. Tex. February 24, 2006). Thus, despite the holding in *Crocker*, a very practical question exists as to what steps a carrier should take to protect its interests in a late notice case.

Our recommendation here is direct communication with the insured. In any case involving an occurrence based policy, if the insurer receives untimely notice of a suit from its insured, an initial investigation can be undertaken under a reservation of rights in order to determine whether there is any discernable prejudice from the late notice. If, on the other hand, notice is received from another source that the named insured has been sued, a simple letter requesting that the insured provide direction for handling offers an obvious measure of protection for an insurer, creating the additional defense of failure to cooperate in the event the insured does not respond.

Less clear is whether a carrier must undertake post-trial remedies in the event a default judgment is entered against the insured, when notice is received prior to the expiration of the time to file motions for new trial. Appellate Courts appear to favor carriers under these circumstances. However, until the Supreme Court rules on the matter, the issue is subject to challenge. Our recommendation here is that a letter advising the insured to undertake remedial action on its own behalf, and to provide subsequent notification in the event of success should adequately protect a carrier's rights, without creating a breach of any contractual duties.

IV. WHAT DOES THE FUTURE HOLD?

A. Does The Notice-Prejudice Rule Apply To Claims-Made Policies?

Not surprisingly, since the Supreme Court accepted writ in *PAJ*, a number of other cases have been pressed to the Supreme Court's attention, all dealing with the issue of whether or not the notice-prejudice rule applies to claims-made policies. Typically, under a true claims-made policy, notice of the loss must be given during the policy period, which is part of the bargained-for exchange pertinent to the issuance of the policy itself. *See e.g. Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co*., 174 F.3d 653 (5th Cir. 1999); *East Texas Medical Center Regional Healthcare System v. Lexington Ins. Co*., 2007 U.S. Dist. LEXIS (July 12, 2007). In *PAJ*, the Supreme Court noted this important distinction:

> In addition, the timely notice provision was not an essential part of the bargained-for exchange under *PAJ's* occurrence-based policy. The Fifth Circuit, applying Texas insurance law, aptly describes the critical distinction between "occurrence" policies and "claims-made" policies as follows:
>
> > In the case of an "occurrence" policy, any notice requirement is subsidiary to the event that triggers coverage. Courts have not permitted insurance companies to deny coverage on the basis of untimely notice under an "occurrence" policy unless the company shows actual prejudice from the delay.
> >
> > The dissent, by focusing on the type of coverage rather than the type of policy, entirely disregards this important distinction.

PAJ, 51 Tex.Sup. J. at 306. Given the holding in *PAJ*, one wonders at why the Supreme Court is considering the applicability of the notice-prejudice rule to a claims-made policy in any case. An examination of these cases, however, reveals important distinctions.

For example, in *Prodigy Communications Corp. v. Agricultural Excess & Surplus Ins. Co*., 195 S.W.3d 764 (Tex.App.-Dallas 2006, writ granted), Prodigy purchased a D&O policy from AESIC. In November 2001, suit was filed against a predecessor in interest to Prodigy, alleging violations of various securities laws. Prodigy was served on June 20, 2002, but did not give notice to AESIC until June 3, 2003, nearly a year after being served. AESIC declined and Prodigy sued. The Trial Court awarded summary judgment in AESIC's favor, which was affirmed on appeal. While at first glance the issue in the case appears to be the enforceability of the notice condition of AESIC's policy, in reality the case bends on whether AESIC violated statutory rules in the issuance of the policy (a surplus lines policy), rendering the policy unenforceable. The issue of whether AESIC was prejudiced by Prodigy's untimely notice is a secondary to the primary case issue. Additionally, AESIC's policy contains a unique notice condition that may have provided Prodigy with a 90-day safe harbor that is not typical to standard claims-made forms. We do not view the *Prodigy* case as having wide-spread influence on the applicability of the notice-prejudice rule to claims-made policies.

Likewise, in *XL Specialty Ins. Co. v. Financial Industries Corp.*, 2007 U.S.App. LEXIS 29373 (5th Cir. December 19, 2007), the Court of Appeals for the Fifth Circuit certified the question of whether the notice-

prejudice rule applies to claims-made policies, specifically in light of the petition for review granted by the Supreme Court in *PAJ;* supra, *Prodigy*, supra; and, *Coastal Refining*, infra. There, the insured provided notice of the suit within the policy period. However, notice was not given until seven month after suit had been filed. XL has argued that Coastal violated the notice condition, of the policy, not the trigger notice. Given that the type of policy at issue is not particularly relevant to that inquiry, it is not difficult to discern how this case will resolve. Unfortunately, the decision may also engender confusion as to the difference between trigger notice and condition notice under a claims-made policy.

B. Health Care Policies

In *National Family Care Life Ins. Co. v. Vann*, No. 01-06-00245-CV (Ct. App. 1st Dist., 2008),Vann's husband purchased a heart attack and cancer supplement policy from National in March, 1988. The policy paid certain amounts for each day of hospitalization, upon notice and proof of the illness. The policy contained a provision requiring that notice must be given to National within 30 days after the occurrence or commencement of any loss or illness covered by the policy.

Mr. Vann did not tell anyone he had purchased the policy and Mrs. Vann was unaware of its existence. Mr. Vann was diagnosed with cancer in November, 1998. He remained hospitalized until his death in April, 1999, leaving behind Leila Vann, who was 80 at the time of his death. In January 2002, Vann's daughter's discovered the policy and remitted the bills to National for payment. National declined, contending that Vann's failure to notify it violated the terms of the policy. The Trial Court granted judgment in favor of Vann and National appealed. The First District Court of Appeals held that in light of the Supreme Court's decision in *PAJ*, that an immaterial breach of a policy condition will not excuse an insurer's performance. The Court held that because National's policy required notice of an occurrence, that it was an occurrence-based policy as opposed to a claims-made policy, obligating National to demonstrate that it had been prejudiced by the delay in notice.

It is too soon to know whether the case will be appealed or whether the Supreme Court will agree to hear it, but the decision is one deserving of note as the policy in *Vann* is a type of first-party coverage, which appears to stand in direct contradiction to *PAJ*. If the decision stands, it may have significant impact on an insurer's right to rely upon policy conditions that are clearly part of the bargained-for exchange.

C. Refining the Notice-Prejudice Rule:

In *Coastal Refining & Marketing, Inc.*, 218 S.W.3d 279 (Tex.App.-Houston [14th Dist.] 2007, writ granted), the Court discusses at length the requirement of prejudice in late notice cases, refining the obligation further in holding that a carrier must demonstrate "actual prejudice," meaning, prejudice that is not theoretical in nature, but actually sustained. To illustrate its point, the Court noted that demonstrating actual prejudice in cases where a default judgment had been entered is relatively simple, as the harm sustained in tangible and obvious. As the case is currently pending on appeal before the Supreme Court, it is possible that additional clarification may shed light on the duties owed by an insurer in cases involving the notice-prejudice rule.

V. CONCLUSION

As can be gleaned from the progeny of decisions issuing from the Supreme Court and various Courts of Appeals, the applicability of the notice-prejudice rule continues to evolve in Texas. The decision in *PAJ* clearly indicates that the type of coverage at issue is a critical factor in determining the applicability of the notice-prejudice rule – a fact that may curtail future litigation on the issue. Additionally, further clarity may be forthcoming from the Supreme Court on the issue of what constitutes prejudice to a carrier, providing guidance as to the appropriate the handling of such claims.