IN THE SUPREME COURT OF TEXAS

NO. 06-0598

PRODIGY COMMUNICATIONS CORP., PETITIONER,

v.

AGRICULTURAL EXCESS & SURPLUS INSURANCE COMPANY, N/K/A GREAT AMERICAN E & S INSURANCE COMPANY AND GREAT AMERICAN INSURANCE COMPANY, RESPONDENTS

ON PETITION FOR REVIEW FROM THE
COURT OF APPEALS FOR THE FIFTH DISTRICT OF TEXAS

Argued April 1, 2008

JUSTICE JOHNSON, joined by JUSTICE HECHT and JUSTICE WILLETT, dissenting.

Today the Court rewrites an unambiguous insurance contract and changes the agreement of the parties. It holds that AESIC cannot deny coverage to Prodigy even if Prodigy breached explicit contract language making it a condition precedent for it to give notice of the claim "in writing, as soon as practicable." The Court does so by departing from well-established insurance policy construction rules as well as by failing to adhere to the 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. I dissent.

The rules governing interpretation of contracts in general apply to interpreting insurance policies. *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. CBI Indus., Inc.*, 907 S.W.2d 517, 520 (Tex.

1995). The parties do not contend AESIC's policy is a form promulgated by the State or a regulatory authority, so we seek to ascertain the intent of the parties and interpret the policy accordingly. *See Fiess v. State Farm Lloyds*, 202 S.W.3d 744, 746 (Tex. 2006). In ascertaining the parties' intent, we look first and primarily to the written words used. *Id.* ("As with any other contract, the parties' intent is governed by what they said . . . ."); *Balandran v. Safeco Ins. Co. of Am.*, 972 S.W.2d 738, 741 (Tex. 1998) ("Our primary goal, therefore, is to give effect to the written expression of the parties' intent."); *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 133 (Tex. 1994). Despite regular invitations to add to or ignore language when interpreting insurance policies, this Court has generally adhered to the principle that judges interpret language to which parties have agreed, not alter it. *E.g.*, *Fortis Benefits v. Cantu*, 234 S.W.3d 642, 647, 649 (Tex. 2007) (noting that contract rights arise from the parties' agreement, not principles of equity and declining to "judicially rewrite the parties' contract by engrafting extra-contractual standards"); *Fiess*, 202 S.W.3d at 753 ("For more than a century this Court has held that in construing insurance policies 'where the language is plain and unambiguous, courts must enforce the contract as made by the parties, and cannot make a new contract for them, nor change that which they have made under the guise of construction.'") (quoting *E. Tex. Fire Ins. Co. v. Kempner*, 27 S.W. 122, 122 (1894)); *but see PAJ, Inc. v. Hanover Ins. Co.*, 243 S.W.3d 630, 636-37 (Tex. 2008) (holding that as to an occurrence-based policy, an insured's breach of its obligation to timely notify the insurer of a claim or suit does not defeat coverage if the insurer was not prejudiced by the delay).

In *Excess Underwriters at Lloyd's, London v. Frank's Casing Crew & Rental Tools, Inc.*, we rejected an insurer's claim for equitable reimbursement from its insured, in part, because allowing

reimbursement would have required us to "'rewrite the parties' contract or add to its language.'" 246 S.W.3d 42, 50 (Tex. 2008) (quoting *Am. Mfrs. Mut. Ins. Co. v. Schaefer*, 124 S.W.3d 154, 162 (Tex. 2003)). In *Excess Underwriters* we also quoted with approval language the Court used in *Fortis Benefits* where we said we are "'loathe to judicially rewrite the parties' contract by engrafting extra-contractual standards.'" *Id.* at 51 (quoting *Fortis Benefits*, 234 S.W.3d at 649).

But today the Court holds AESIC cannot deny coverage to Prodigy even if Prodigy breached the explicit contract language requiring notice of the claim "in writing, as soon as practicable" because (1) that part of the notice provision was not an essential part of the bargained-for exchange; (2) AESIC did not show it was prejudiced by the timing of written notice; and (3) written notice was given within the time period allowed by another part of the policy's notice provision. ___ S.W.3d ___, ___. The Court poses the issue as "whether 'notice as soon as practicable' is an essential part of the bargained-for exchange in the claims-made policy at issue here." I disagree that the record shows the "as soon as practicable" notice provision was not an essential part of the parties' agreement.

In determining whether the notice provisions of AESIC's policy were essential to the agreement, the first place to seek the answer is the policy itself. AESIC's policy consists of a declarations page, a cover page, three pages setting out the terms of the insurance, plus endorsements. The statement "THIS IS A CLAIMS MADE POLICY, READ IT CAREFULLY" appears at the top of the declarations page and the first page of the policy. The first section of the policy is "Section I. Insuring Agreements" made up of two paragraphs—one applicable to Flashnet's directors and officers and the other applicable to Flashnet as a company. Page three of the policy

contains "Section VII. Notice of Claim." The Notice of Claim provision originally contained condition precedent language and a hard-and-fast requirement that written notice of any claim be given within ninety days after the claim was made. It was amended to require written notice to AESIC as soon as practicable "but in no event later than ninety (90) days after the expiration of the Policy Period or Discovery Period." The entire endorsement reads as follows:

> The Directors or Officers 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 Directors and Officers 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 require.

(emphasis added). Timely notice was clearly and explicitly a condition precedent to any rights under the policy. Prodigy does not contend the endorsement language is unclear or that Flashnet ever sought any other notice language. Nor does Prodigy contend that Flashnet, a company involved with sophisticated legal matters such as public stock offerings and securities law was misled about or protested the notice provisions when it purchased the policy and the endorsement.

The record and sequence of events indicate that all the notice language, including timing of notice, was an important part of the policy: timely notice was a condition precedent in the original policy and the condition precedent language was carried forward into the endorsement. 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.

The Court concludes, relying on decisions from other jurisdictions and legal treatises, that in order for an insurer to deny coverage under claims-made policies for breach of a reporting requirement, the insurer (1) must show prejudice if the insured gives notice of a claim within the policy period or a specified time after policy termination, even though the notice was not "as soon as practicable," but (2) need not show prejudice if the insured gives notice of a claim outside the policy period or the time allowed in the policy for reporting claims after policy termination, if any. ___ S.W.3d at ___. The Court says a requirement of notice "as soon as practicable" is more part of the investigative process and not as much a part of the coverage bargain between the insurer and insured as is an end-of-policy notice requirement. But the insuring agreements and notice provisions of AESIC's policy are completely separate. That separation militates against classifying one notice provision in Section VII as more important because it is a coverage-type provision and the other notice provision as less important because it is an investigation-type provision. Neither of those classifications for the notice provisions is indicated by policy language.

Furthermore, the record demonstrates no logical reason to apply a different rule to AESIC's end-of-policy notice provision. There is no basis in the record for concluding Prodigy's one-year delay in reporting the claim was any more or less important to AESIC's insurance business than if Prodigy had delayed for a year reporting a claim made on the last day of the Discovery Period. In the latter circumstance, the Court says AESIC would not be required to show prejudice and the condition precedent language would preclude the insurer's liability because the insurer needs to close its books as to the policy. We should be bound by the record the parties bring, and the record does not support either the latter statement or treating the delays differently. But first and foremost, the

policy language shows AESIC and Prodigy intended for the two notice provisions to have the same effect: both are conditions precedent to Prodigy's rights under the policy. We should respect the agreement.

In holding a showing of prejudice is required for failure to give notice as soon as practicable, but not for notice failing to comply with the end-of-policy provision, the Court relies on cases from other states. But two cases emphasized by the Court highlight the very point made long ago in *Cutaia* that the Court should defer to legislative and regulatory entities to (1) address the notice-prejudice question, and (2) change policy language if change was deemed necessary. *Cutaia*, 476 S.W.2d at 280-81. In *T.H.E. Insurance Co. v. P.T.P.*, 628 A.2d 223 (Md. 1993) and *Chas. T. Main, Inc. v. Fireman's Fund Insurance Co.*, 551 N.E.2d 28 (Mass. 1990), referenced by the Court, the notice-prejudice issue was addressed by statute and the courts were considering how notice provisions should be treated in light of the statutes. In *Chas. T. Main*, the Supreme Judicial Court of Massachusetts considered a claims-made professional liability policy in light of a statute that provided, in part, as follows:

> An insurance company shall not deny insurance coverage to an insured because of failure of an insured to seasonably notify an insurance company of an occurrence, incident, claim or of a suit founded upon an occurrence, incident or claim, which may give rise to liability insured against unless the insurance company has been prejudiced thereby.

MASS. GEN. LAWS ch. 175, § 112 (1988). The Massachusetts court said, without reference to the record, "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." *Chas. T. Main*, 551 N.E.2d at 30. However, the court, in summary fashion, held the statute applied only to the "as

soon as practicable" notice and not to the "within the policy year" notice. *Id.* It stated that applying the statute to "within the policy year" notice provisions 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.*

And in *T.H.E. Insurance Co.*, the Maryland Court of Appeals considered the effect of a statutory notice-prejudice provision on a claims-made policy. 628 A.2d at 223. The statute involved provided:

> Where any insurer seeks to disclaim coverage on any policy of liability insurance issued by it, on the ground that the insured or anyone claiming the benefits of the policy through the insured has breached the policy by failing to cooperate with the insurer or by not giving requisite notice to the insurer, such disclaimer shall be effective only if the insurer establishes, by a preponderance of affirmative evidence that such lack of co-operation or notice has resulted in actual prejudice to the insurer.

MD. ANN. CODE of 1957 art. 48A, § 482 (1991 Repl. Vol.). The court noted that under one of its previous holdings, if a claim had been reported within the extended reporting period, the insurer would have had to prove actual prejudice. *T.H.E. Ins. Co.*, 628 A.2d at 226 n.7. However, the court held that the statute did not operate to revive the policy as to notice of a claim given after the end of the policy period. *Id.* at 227. Texas does not have a statute, regulation, or agency directive that similarly applies to AESIC's policy.[1]

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[1] Texas does have a State Board of Insurance Order relating to bodily injury or property damage liability claims covered by general liability policies. *See PAJ*, 243 S.W.3d at 632; State Board of Insurance, *Revision of Texas Standard Provision For General Liability Policies--Amendatory Endorsement-Notice*, Order No. 23080 (Mar. 13, 1973) ("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.").

Even disregarding the record, the general discussion of claims-made policies by which the Court eventually differentiates between the two types of notices does not support the step the Court takes. The claims-made policy involved here insures against claims first made against directors and officers during the policy period. As noted above, the notice and insuring agreements of AESIC's policy are separate: the Insuring Agreements are in Section I; the Notice of Claim provisions are in Section VII. For all practical purposes AESIC's policy insures against events—claims first made during the policy period—just as an occurrence policy insures against events—occurrences during the policy period. The difference is that under occurrence policies the insurer may not know of the event it has insured against for a long time after the event, whereas AESIC should know of the event it has insured against (a claim against its insured) during the policy period or within ninety days after expiration of the Discovery Period. Thus, under AESIC's claims-made policy as it is written, the 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. But when courts rewrite existing policy provisions as the Court does in this case, insurers' actuarial predictions of losses and expenses, and the process of setting premium rates to cover projected losses and expenses are disrupted. *See* Neil A. Doherty, *The Design of Insurance Contracts When Liability Rules are Unstable*, 58 J. OF RISK AND INS. 227, 227 (1991) ("[T]he recent liability insurance 'crisis' in the United States appears to be a response to a destabilization of the legal system. Insurers argue that they are able to insure the liabilities of clients arising under an unchanging set of liability rules, but they cannot insure against changes in the rules themselves."). 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.

In *Cutaia*, the Court recognized these policy reasons behind leaving changes to the Legislature or regulatory agency. *Cutaia*, 476 S.W.2d at 280-81. But here, the Court does not respect the agreement of the parties or exercise the restraint that it did in *Cutaia*. In *Cutaia* an automobile liability policy required, as one of several conditions precedent to the insured's rights under the policy, that the insured give notice of any accident to the insurer and immediately forward any suit papers. *Id.* at 278. Cutaia, the insured, was sued but failed to forward suit papers to the insurer. *Id.* Following a trial and entry of judgment against Cutaia, the insurer denied coverage because Cutaia did not forward the suit papers. *Id.* at 279. In rendering judgment for the insurer, we noted "[t]here is no provision in the policy that failure to comply with the conditions precedent would be excused if no harm or prejudice were suffered by the insurer; and *such a provision would have to be inserted into the policy by implication*." *Id.* at 278 (emphasis added). The Court declined to override the insurance policy language and by judicial fiat add a prejudice provision to the policy:

> We are, therefore, faced with plain wording of the contract and the holdings of this Court; and we are also faced with facts which show an apparent injustice. The problem then arises as to whether, or what, changes should be made, and by whom. Should this Court overrule its former decisions and say that provisions in the policy are Not conditions precedent to liability? Or should we imply into the policy a provision that failure to comply with the condition precedent will be excused if no harm or prejudice is shown? Or should we enforce the provisions as written and call

> the matter to the attention of those who, for the public, are charged with prescribing policy forms as well as with the approval or disapproval of the provisions of the policy?
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> . . . .
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> Our conclusion is, however, that *on balance it is better policy for the contracts of insurance to be changed by the public body charged with their supervision, the State Board of Insurance, or by the Legislature, rather than for this Court to insert a provision that violations of conditions precedent will be excused if no harm results from their violation*.

Id. at 280, 281 (emphasis added).

Similar to the situation in *Cutaia*, Prodigy's written notice did not comply with requirements agreed to as conditions precedent when the policy was purchased. Nevertheless, the court holds Prodigy's untimely notice of claim is now timely and presumably will require payment under a policy with limits of three million dollars. Unlike its choice in *Cutaia*, the Court's choice today is to inject itself into a contractual relationship between two sophisticated parties, insert language into the policy, and change the policy so it in effect provides:

> The Directors or Officers 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 Directors and Officers 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 require. *Notwithstanding the foregoing provision, the insureds shall not lose any rights under the policy if written notice of a covered claim is given not later than ninety (90) days after the expiration of the Policy Period or Discovery Period, (if applicable), unless the insurer proves it was prejudiced by the failure to give notice as soon as practicable*.

See Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co., 174 F.3d 653, 657 (5th Cir. 1999).

The language effectively added by the Court looks remarkably similar to language in notice-prejudice statutes, regulations, and agency orders. *See* State Board of Insurance, *Revision of Texas Standard Provision For General Liability Policies--Amendatory Endorsement-Notice*, Order No. 23080 (Mar. 13, 1973); MASS. GEN. LAWS ch. 175, § 112 (1988); MD. CODE ANN. of 1957 art. 48A, § 482 (1991 Repl. Vol.). But in matters such as this the Court cannot enact legislation or issue agency orders, and it should limit itself to interpreting or construing agreements—not changing them.

The better choice for courts, as the Court noted in *Cutaia*, is if changes to insurance policy language are to be mandated that affect timing and amount of insurers' actual or incurred loss provisions, other parts of the insurance companies' business, and policy clauses related to rate or premium calculations, the changes should be left to the Legislature and regulatory agencies. *See, e.g.*, J. David Cummins, *Statistical and Financial Models of Insurance Pricing and the Insurance Firm*, 52 J. OF RISK AND INS. 261 (1991). The Legislature and regulatory bodies such as the Texas Department of Insurance have the time, staff, resources and expertise to investigate and bring all relevant information to bear on such issues. I adhere to the opinion expressed by the dissent in *PAJ*:

> I would reaffirm *Cutaia's* recognition that the Legislature and the state agency overseeing the insurance industry are better suited to decide whether an insurer must show prejudice to deny coverage based on late notice. TDI and legislators are free to supplant *Cutaia's* no-prejudice rule with a more liberal notice-prejudice rule if they believe, on public policy grounds, that the latter is preferable.

PAJ, 243 S.W.3d at 641 (Willett, J., dissenting).

I would hold that on this record there is no evidence the condition precedent language requiring written notice of claim to AESIC "as soon as practicable" was not essential to AESIC's policy having been issued. I would affirm the judgment of the court of appeals as to that issue. I

would affirm the remainder of the court of appeals' judgment for the reasons stated in the court of appeals' opinion.

Phil Johnson
Justice

OPINION DELIVERED: March 27, 2009