IN THE SUPREME COURT OF TEXAS

NO. 05-0849

PAJ, INC., D/B/A PRIME ART & JEWEL, PETITIONER,

v.

THE HANOVER INSURANCE COMPANY, RESPONDENT

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

Argued October 18, 2006

JUSTICE O'NEILL delivered the opinion of the Court, in which CHIEF JUSTICE JEFFERSON, JUSTICE BRISTER, JUSTICE MEDINA, and JUSTICE GREEN joined.

JUSTICE WILLETT filed a dissenting opinion, in which JUSTICE HECHT, JUSTICE WAINWRIGHT, and JUSTICE JOHNSON joined.

In this case, we must decide whether an insured's failure to timely notify its insurer of a claim defeats coverage under the policy if the insurer was not prejudiced by the delay. We hold, as we did in *Hernandez v. Gulf Group Lloyds*, 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. 875 S.W.2d 691, 692 (Tex. 1994). Accordingly, we reverse the court of appeals' judgment, render judgment that the insurer could not deny coverage because of untimely notice, and remand the remaining issues to the trial court.

I.

PAJ, Inc., a jewelry manufacturer and distributor, purchased a commercial general liability ("CGL") policy from Hanover Insurance Company that covered, among other things, liability for advertising injury. The policy required PAJ to notify Hanover of any claim or suit brought against PAJ "as soon as practicable." In 1998, Yurman Designs, Inc. demanded that PAJ cease marketing a particular jewelry line, and a month later sued PAJ for copyright infringement. Initially unaware that the CGL policy covered the dispute, PAJ did not notify Hanover of the suit until four to six months after litigation commenced.

PAJ brought this suit against Hanover seeking a declaration that Hanover was contractually obligated to defend and indemnify PAJ in the copyright suit, and asserting several extracontractual claims. The parties stipulated that PAJ failed to notify Hanover of the Yurman claim "as soon as practicable" and that Hanover was not prejudiced by the untimely notice. Both parties moved for summary judgment on the notice issue based on these undisputed facts. The trial court granted Hanover's motion and denied PAJ's, holding that Hanover was not required to demonstrate prejudice to avoid coverage under the policy. The court of appeals affirmed. 170 S.W.3d 258, 259. We granted PAJ's petition for review to determine the effect on coverage when an insured fails to timely notify its insurer of a claim but the insurer suffers no harm as a result.

II.

The Hanover policies issued to PAJ provide coverage for "advertising injury," which the policy defines to include injury arising out of copyright infringement. The policy contains a prompt-

notice provision that requires PAJ to notify Hanover of an occurrence or an offense that may result in a claim "as soon as practicable." The parties dispute whether the policy's prompt-notice requirement constitutes a condition precedent or merely a covenant. Hanover contends the policy language creates a condition precedent, the failure of which defeats coverage under the policy irrespective of prejudice to the insurer. *See Hohenberg Bros. Co. v. George E. Gibbons & Co.*, 537 S.W.2d 1, 3 (Tex. 1976). PAJ, on the other hand, contends the prompt-notice language creates a covenant, the breach of which excuses performance only if the breach is "material." *See Centex Corp. v. Dalton*, 840 S.W.2d 952, 956 (Tex. 1992). PAJ further asserts that even if the policy language creates a condition precedent to coverage, Texas law nonetheless requires an insurer to demonstrate prejudice before it may avoid coverage based on untimely notice. We agree with PAJ that only a material breach of the timely notice provision will excuse Hanover's performance under the policy.

III.

Hanover pins its analysis on our decision in *Members Mutual Insurance Co. v. Cutaia*, 476 S.W.2d 278 (Tex. 1972), and that is where we will begin. The policy at issue in *Cutaia* required the insured to forward any suit papers immediately to the insurer and provided 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." *Id.* at 278 (emphasis added). The insured failed to forward the suit papers to his insurer until five months after the occurrence in question. *Id.* at 278–79. Stipulating that it had suffered no harm, the insurer denied liability, contending a condition precedent

to coverage had not been met. *Id.* at 279. We agreed that the insured's failure to timely comply with the policy's forwarding condition precluded the insurer's liability whether or not prejudice resulted. *Id.* at 281. But we emphasized "the apparent injustice which results in this particular case," and deferred consideration of the issue to the State Board of Insurance or the Legislature. *Id.*

The State Board of Insurance responded the very next year by issuing Board Order 23080, which requires a mandatory endorsement to all Texas CGL policies that precludes forfeiture of coverage for an insured's failure to comply with notice or forwarding conditions unless the insurer is prejudiced thereby. *See* State Board of Insurance, *Revision of Texas Standard Provision For General Liability Policies—Amendatory Endorsement-Notice*, Order No. 23080 (Mar. 13, 1973). The endorsement provides:

> 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. It is important to note that, at the time the State Board of Insurance created this endorsement, there was no standard coverage for advertising injury.[1]

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[1] The Insurance Services Office, Inc. ("ISO") is the industry organization responsible for issuing nearly all standard CGL forms. *See* Ernest Martin, Jr., et al., *Insurance Coverage for the New Breed of Internet-Related Trademark Infringement Claims*, 54 SMU L. REV. 1973, 1984 (2001). The standard 1973 ISO form provided coverage for only "bodily injury" and "property damage," and did not itself cover "advertising injury." *Id.* at 1988. Not until 1981 did the ISO issue an "advertising injury" Broad Form Comprehensive General Liability Endorsement that could be purchased as a supplemental endorsement to the 1973 form. *Id.* at 1988. In 1986, sweeping changes were made to the ISO CGL policy form, and "advertising injury" coverage was incorporated into the body of the form. *Id.* at 1992. Since October 2000, the ISO version of the mandatory Texas Department of Insurance endorsement has included a provision that requires a showing of prejudice for notice defects in personal and advertising injury cases to avoid liability under the policy.

Two decades after Board Order 23080 became effective, we decided *Hernandez*. 875 S.W.2d 691. There, the insured sought recovery under the uninsured/underinsured motorist provision of an automobile policy. The insurer denied liability because the insured had settled the underlying claim without the insurer's consent in violation of the policy's "settlement without consent" exclusion. Applying "fundamental principle[s] of contract law," we held that when one party to a contract commits a material breach, the other party's performance is excused. *Id.* at 692. In determining the materiality of a breach, we said, 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." *Id.* at 693 (citing RESTATEMENT (SECOND) OF CONTRACTS § 241(a) (1981)). Without distinguishing between covenants and conditions or classifying the exclusion as one or the other, we concluded that the insured's breach of the settlement-without-consent provision was immaterial and thus the insurer could not avoid liability under the policy. *Id.* at 694. Notably, we recognized that "[m]ost other jurisdictions presented with this issue have likewise imposed a prejudice requirement, primarily on public policy grounds."[2] *Id.* at 693 n.4. The sole dissenting justice in *Hernandez*

[2] Like our treatment of the exclusion in *Hernandez*, the courts in many of the cases we cited made no attempt to classify the policy provisions as either covenants or conditions, nor did they even employ those terms. *See Hernandez*, 875 S.W.2d at 693 n.4. Those courts that did focused principally on the issue of prejudice regardless of how the provision was classified. *See MacInnis v. Aetna Life & Cas. Co.*, 526 N.E.2d 1255, 1257–58 (Mass. 1988) (noting the insurer's argument that compliance with the consent-to-settlement clause was a condition precedent to recovery but holding that the insurer must demonstrate material prejudice in order to rely on that violation as an affirmative defense); *Silvers v. Horace Mann Ins. Co.*, 378 S.E.2d 21, 26 (N.C. 1989) (holding that conditions precedent concerning timely notice will not be given greater scope than required to fulfill their purpose, which is to protect the insurer's ability to defend by preserving its ability to fully investigate the accident); *Newark Ins. Co. v. Ezell*, 520 S.W.2d 318, 321 (Ky. 1975) (stating that an insurer cannot rely upon an insured's noncompliance with a policy condition to avoid coverage if the insurer has sustained no prejudice because "to enforce the 'consent' clause in these circumstances would be to let form prevail over substance"); *Thompson v. Am. States Ins. Co.*, 687 F. Supp. 559, 564 (M.D. Ala. 1988) (noting that a consent-to-settlement clause created a condition to coverage but holding that breach of the clause must prejudice the

posited, as Hanover does here, that *Cutaia* likewise involved a coverage condition and thus precluded liability irrespective of harm. *Id.* at 694 (ENOCH, J., dissenting). The Court apparently rejected this position.

Since our decision in *Hernandez*, courts and several major treatises have acknowledged Texas as a state that has adopted a notice-prejudice rule. *See, e.g.*, *Ridglea Estate Condo. Ass'n v. Lexington Ins. Co.*, 415 F.3d 474, 480 (5th Cir. 2005) (relying on *Hernandez* and stating that Texas requires a showing of prejudice for insurer to avoid coverage because of untimely notice under an occurrence policy, even for types of insurance not covered by Board Order 23080); *Booking v. Gen. Star Mgmt. Co.*, 254 F.3d 414 (2d Cir. 2001) (citing *Hernandez* and stating Texas courts allow an insurer to deny coverage only for a material breach of its insurance contract); *Hanson Prod. Co. v. Ams. Ins. Co.*, 108 F.3d 627, 630–31 (5th Cir. 1997) (same); ERIC MILLS HOLMES, 22 HOLMES' APPLEMAN ON INSURANCE LAW AND PRACTICE § 139.4 (2d ed. 2003). In *Hanson*, for example, the Fifth Circuit read *Hernandez* to require a demonstration of harm for an insurer to avoid its coverage obligation when the insured fails to comply with a policy's prompt-notice provision. 108 F.3d at 630. Summarizing our holding as "a material breach by one contracting party excuses performance by the other party, and an immaterial breach does not," the Fifth Circuit concluded this "fundamental principle of contract law" applied with equal or greater force to notice clauses:

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insurer to relieve it of liability); *Kapadia v. Preferred Risk Mut. Ins. Co.*, 418 N.W.2d 848, 855 (Iowa 1988) (holding insurer had to demonstrate actual prejudice from insured's noncompliance with settlement-without-consent clause rather than allow complete destruction of the insured's right to recover); *Tegtmeyer v. Snellen*, 791 S.W.2d 737, 740 (Mo. Ct. App. 1990)(holding insurer must show prejudice to escape liability under its policy for insured's breach of settlement-without-consent provision).

> If anything, we believe that the failure to give notice of a claim poses a smaller risk of prejudice than failure to obtain consent to a settlement. In many instances of untimely notice of a claim, the insurer is not prejudiced at all, and ultimately may not face any coverage obligation. Conversely, in many if not most cases where an insured settles a case without the insurer's consent, the insurer faces at least some liability. If the Texas Supreme Court does not presume prejudice in a settlement-without-consent case, we are persuaded that it would not presume prejudice in a failure-of-notice case.

Id. at 631. The Fifth Circuit noted "a modern trend in favor of requiring proof of prejudice" in this context and emphasized that in *Hernandez*, our Court considered the law of other jurisdictions and that our analysis "is entirely consistent with [this modern trend]." *Id.*; *see St. Paul Guardian Ins. Co. v. Centrum G.S. Ltd.*, 383 F. Supp. 2d 891, 901 (N.D. Tex. 2003) (rejecting traditional view that an insurer need not prove prejudice to prevail in a late-notice case as inconsistent with *Hernandez* and the modern trend that considers prejudice to an insurer a relevant factor in determining whether to enforce a condition precedent to insurance coverage); *see also Prince George's County v. Local Gov't Ins. Trust*, 879 A.2d 81, 94 n.9 (Md. 2005) (counting thirty-eight states, including Texas, as having adopted a notice-prejudice rule in some form, with only six states and the District of Columbia identified as adhering to the traditional rule).[3]

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[3] *See generally* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 4.02(c)(2), (3d ed. 2006), (citing cases). *See, e.g.*, *Tush v. Pharr*, 68 P.3d 1239, 1250 (Alaska 2003); *Holt v. Utica Mut. Ins. Co.*, 759 P.2d 623, 624 (Ariz. 1988); *Clemmer v. Hartford Ins. Co.*, 587 P.2d 1098, 1107 (Cal. 1978); *Clementi v. Nationwide Mut. Fire Ins. Co.*, 16 P.3d 223, 230 (Colo. 2001); *Aetna Cas. & Sur. Co. v. Murphy*, 538 A.2d 219, 223 (Conn. 1988); *Nationwide Mut. Ins. Co. v. Starr*, 575 A.2d 1083, 1088 (Del. 1990); *Bankers Ins. Co. v. Macias*, 475 So. 2d 1216, 1218 (Fla. 1985); *Standard Oil Co. v. Haw. Ins. & Guar. Co.*, 654 P.2d 1345, 1348 n.4 (Haw. 1982); *Ind. Ins. Co. v. Williams*, 463 N.E.2d 257, 261 (Ind. 1984); *Grinnell Mut. Reins. Co. v. Jungling*, 654 N.W.2d 530, 541-42 (Iowa 2002); *Atchinson, Topeka & Santa Fe Ry. Co. v. Stonewall Ins. Co.*, 71 P.3d 1097, 1139 (Kan. 2003); *Jones v. Bituminous Cas. Corp.*, 821 S.W.2d 798, 801 (Ky. 1991); *Lanzo v. State Farm Mut. Auto. Ins. Co.*, 524 A.2d 47, 50 (Me. 1987); *Sherwood Brands, Inc. v. Hartford Accident & Indem. Co.*, 698 A.2d 1078, 1082–83 (Md. 1997); *Goodman v. Am. Cas. Co.*, 643 N.E.2d 432, 434 (Mass. 1994); *Koski v. Allstate Ins. Co.*, 572 N.W.2d 636, 639 (Mich.

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 that 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.

1998); *Lawler v. Gov't Employees Ins. Co.*, 569 So. 2d 1151, 1159–60 (Miss. 1990); *Johnston v. Sweany*, 68 S.W.3d 398, 402 (Mo. 2002); *State Farm Mut. Auto. Ins. Co. v. Murnion*, 439 F.2d 945, 497 (9th Cir. 1971) (applying Montana law); *Mefferd v. Siler & Co., Inc.*, 676 N.W.2d 22, 26 (Neb. 2004); *Wilson v. Progressive N. Ins. Co.*, 868 A.2d 268, 271 (N.H. 2005); *Pfizer, Inc. v. Employers Ins.*, 712 A.2d 634, 644 (N.J. 1998); *Schroth v. N.M. Self-Insurer's Fund*, 832 P.2d 399, 402 (N.M. 1992); *Great Am. Ins. Co. v. C.G. Tate Constr. Co.*, 340 S.E.2d 743, 746 (N.C. 1986); *Finstad v. Steiger Tractor, Inc.*, 301 N.W.2d 392, 398 (N.D. 1981); *Ferrando v. Auto-Owners Mut. Ins. Co.*, 781 N.E.2d 927, 946 (Ohio 2002); *Indep. Sch. Dist. No. 1 v. Jackson*, 608 P.2d 1153, 1155 (Okla. 1980); *Carl v. Oregon Auto Ins. Co.*, 918 P.2d 861, 863 (Or. 1996); *Brakeman v. Potomac Ins. Co.*, 371 A.2d 193, 197 (Pa. 1977); *Avco Corp. v. Aetna Cas. & Sur. Co.*, 679 A.2d 323, 328–29 (R.I. 1996); *Vt. Mut. Ins. Co. v. Singleton*, 446 S.E.2d 417, 421 (S.C. 1994); *Am. Justice Ins. Reciprocal v. Hutchinson*, 15 S.W.3d 811, 813 (Tenn. 2000); *FDIC v. Oldenburg*, 34 F.3d 1529, 1546 – 47 (10th Cir. 1994) (applying Utah law); *Coop. Fire Ins. Ass'n of Vt. v. White Caps, Inc.*, 694 A.2d 34, 35 (Vt. 1997); *Benham v. Wright*, 973 P.2d 1088, 1092 (Wash. Ct. App. 1999); *Colonial Ins. Co. v. Barrett*, 542 S.E.2d 869, 874 (W. Va. 2000); *Neff v. Pierzina*, 629 N.W.2d 177, 185 (Wis. 2001).

The fact that *Hernandez* involved a policy exclusion rather than a policy provision does not supply a valid ground for distinguishing its application here. Exclusions and conditions are in effect two sides of the same coin; exclusions avoid coverage *if* the insured does something, and conditions avoid coverage *unless* an insured does something. The dissent's construction would have the absurd consequence that identical policy language creates a condition precedent as to one type of coverage (advertising injury) but a covenant as to the other (bodily injury and property damage). We have said unequivocally that "when a condition would impose an absurd or impossible result, the agreement will be interpreted as creating a covenant rather than a condition." *Criswell v. European Crossroads Shopping Ctr., Ltd.*, 792 S.W.2d 945, 948 (Tex. 1990).

Moreover, we question the dissent's fundamental premise that the timely notice provision before us creates a condition precedent rather than a covenant. The policy language in *Cutaia* specifically provided that "no action shall lie against the company unless, *as a condition precedent thereto*, the insured shall have fully complied with all the terms of this policy." 476 S.W.2d at 278 (emphasis added). The "as a condition precedent" language was deleted from the standard CGL policy following our decision in *Cutaia*, and it does not appear in PAJ's policy. While Section IV is entitled "Commercial General Liability *Conditions*," the notice-of-claim requirement appears in a subsection entitled "*Duties* in the Event of Occurrence, Claim or Suit" and speaks in terms of what the insured "must do" if a claim is made against it, language that more closely resembles a covenant. *See* 8 CATHERINE M.A. MCCAULIFF, CORBIN ON CONTRACTS § 30.12 (Joseph M. Perillo ed., 1999); *Landscape Design & Constr., Inc. v. Harold Thomas Excavating, Inc.*, 604 S.W.2d 374, 376 (Tex.

Civ. App.—Dallas 1980, writ ref'd n.r.e.). Conditions are not favored in the law; thus, when another reasonable reading that would avoid a forfeiture is available, we must construe contract language as a covenant rather than a condition. *See Criswell*, 792 S.W.2d at 948; *see also ATOFINA Petrochemicals, Inc. v. Cont'l Cas. Co.*, 185 S.W.3d 440, 444 (Tex. 2005).

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" polices 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.

Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co., 174 F.3d 653, 658 (5th Cir. 1999) (citations omitted); *see also FDIC v. Booth*, 82 F.3d 670, 678 (5th Cir. 1996); *Centrum G.S.*, 383 F. Supp. 2d at 900–01; *Hirsch v. Tex. Lawyers' Ins. Exch.*, 808 S.W.2d 561, 563 (Tex. App.—El Paso 1991, writ denied). The dissent, by focusing on the type of *coverage* rather than the type of *policy*, entirely disregards this important distinction.

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 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*.

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We hold 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. Accordingly, we reverse the court of appeals' judgment, render judgment that the insurer could not deny coverage because of untimely notice, and remand the remaining issues to the trial court.

Harriet O'Neill
Justice

Opinion delivered: January 11, 2008