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Supreme Court of Texas.
FINANCIAL INDUSTRIES CORPORATION, Appellant,
v.
XL SPECIALTY INSURANCE COMPANY, Appellee.
No. 07-1059.

April 1, 2008

Appearances:
FREDERICK B. WULFF, Shackelford, Melton & McKinley, LLP, Dallas, TX, FOR APPELLANT.
GABRIELA RICHEIMER, Ross, Dixon & Bell, LLP, WASHINGTON, DC, FOR APPELLEE.

Before:

CHIEF JUSTICE WALLACE B. JEFFERSON, NATHAN L. HECHT, HARRIET O'NEILL, DALE WAINWRIGHT, SCOTT A. BRISTER, DAVID MEDINA, PAUL W. GREEN, PHIL JOHNSON, DON R. WILLETT, TEXAS SUPREME COURT JUSTICES, EN BANC.

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CHIEF JUSTICE JEFFERSON: Thank you. Please be seated. The Court is ready to hear argument in 07-1059, Financial Industries Corporation v. XL Specialty Insurance Company.

MARSHAL: With the Court's permission, argument for the petitioner. Petitioner has reserved five minutes for rebuttal.

ORAL ARGUMENT OF FREDERICK B. WULFF ON BEHALF OF THE PETITIONER

FREDERICK B. WULFF: May it please the Court. In the -- in the previous argument in another case, which presents much the same issue, there was a fair amount of speculation about what underwriters do or do not do and what insurance companies do or do not do. I think to properly analyze the -- the two cases that are before you this morning, we really need to start at the most basic level, and that is the long-standing rule that an insurance policy is a contract and the normal rules of contract interpretation apply to insurance policies. There are two of those rules of construction, which I think are significant to us here today. The first, simply stated, is that forfeitures are disfavored. The second is that only a material breach of a contract provision excuses performance of that contract and that the test for a material breach is that it prejudices the party whose contract has been

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breached. This rule was discussed most pertinently in this context, first in the Hernandez (S.W.2d 691)case in 1994, which, as your question in the earlier argument indicated, is the beginning or -- or a point in the continuum that you were dealing with in the PAJ (S.W.3d 630) case only a brief time back. Hernandez dealt in the terms of a consent-to-settle issue, but it stated the rule generally that insurance contracts are treated as any other contracts for purposes of contract interpretation.

JUSTICE O'NEILL: So what --

MR. WULFF: It did not -- oh, I'm sorry.

JUSTICE O'NEILL: Is it your position, then, that after Hernandez and PAJ, there can be no such things as conditions of precedent in contracts -- insurance contracts. You have to judge them all by materiality?

MR. WULFF: I -- I think there can be such thing -- I mean I think there can be things called 'conditions precedent,' but I don't think the modern view is that that completely eliminates the requirement that there be materiality to a breach in order for it to excuse performance.

JUSTICE O'NEILL: But --

MR. WULFF: -- and I think the reason for that is -- is discussed in -- in some detail in PAJ, which is: You can simply take a contract and say everything in this contract is a condition precedent. And if you then apply to that the theory that, well, that means there's no materiality required, you get to horrible, draconian, unfair results.

JUSTICE O'NEILL: But I guess that's my question is -- would you then say that insurance companies can negotiate strict conditions precedent, so long as it's over a material piece of the policy, a bargained- for part of the policy?

MR. WULFF: I think, as Mr. Powers indicated in the earlier argument, you would need to put it in the insuring agreement in order to really do that. That -- that's --

CHIEF JUSTICE JEFFERSON: What -- What cases say that? Are there any -- Is there any precedent on [inaudible]

MR. WULFF: I -- I'm not sure there really is a case that says that, your Honor.

JUSTICE JOHNSON: Well, what difference does it make?

MR. WULFF: I -- I think there aren't any cases that don't -- that say that isn't the case either. I think you will find a lot of cases, which look to the insuring agreement to determine what the core risk-transfer is that is being accomplished by the insurance policy.

JUSTICE JOHNSON: But if we're going to say that if you -- if they're saying the condition precedent doesn't mean what it says, what difference does it make if they put it in a different paragraph?

MR. WULFF: Well, I -- I don't think, really, that's the way to look at it. I -- I think if you look at the general rule of contract interpretation -- that a breach has to be material -- that could be said the same way on anything. I mean, what you're always doing when you say a breach isn't material and therefore it doesn't excuse performance is you're saying: Notwithstanding that the contract says this is a requirement and that it has been breached, we're not going to give that any effect because it didn't really harm the other party to the contract.

JUSTICE JOHNSON: Well, I'm saying: What difference does it make whether it's in the initial insuring agreement, or in an exclusion, or somewhere else if we're going to just ignore the policy language? What difference does it make where it is?

MR. WULFF: Well, I -- I think probably the best answer to that is

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that you're positing a difficult question, which isn't before us today. If -- if for instance, this was a true claims-made -- and-reported policy, in which the --

JUSTICE JOHNSON: Well, I was just asking --

MR. WULFF: Well, no, I -- I think it's a fair question.

JUSTICE JOHNSON: I'm just addressing your -- your statement that if we put it in the insuring agreement, that's better. And I was -- that's all I was addressing.

MR. WULFF: Right. Yes, all I'm saying is it's better. I'm not saying it's necessarily the end of the discussion, but I think -- I think to try to move it out of the rules of normal contract interpretation, that gets you closer. But that's not the issue that's here today. And it's not an issue I think you need to decide to resolve these two cases.

JUSTICE HECHT: I -- I don't understand why you refer to normal contract construction principles, because if we had a contract that said, If you produce a buyer by 'x' day, and time is of the essence - - it's important to us -- we'll pay you, and if you don't, we don't. We would look at that contract a lot differently if the producer was two days late or a day late than an insurance policy where they come in with another subpoena. So do -- do contract construction principles really apply for insurance policies? Mr. Powers says, in the first argument, we should be honest and say they don't.

MR. WULFF: I -- I think they do. I think that -- I think that's -- that's -- that's the road the Hernandez started us down, that that was the -- that was the proper way to analyze it. And I think, fairly viewed, that's the decision -- that's the path that you continued to follow in PAJ.

JUSTICE HECHT: Well, but I guess my point is: We used to think, all right, is this -- does this say -- is this a condition precedent or not? And one of the questions -- one of the issues will be: Does it say so? Now we're saying: Well, even if it says so, is it really? And then the next step is: Even if it says so, can it be? And it seems to me that's a long way from general contract construction.

MR. WULFF: Well, I -- I don't really think so, your Honor. I mean, I think that what -- what really has happened over probably the last 30 or 40 years is that the courts, more and more, have required materiality in a breach, however the contract is phrased. And I think the reason that that is is because the drafters of contracts have reacted every time it is moved by declaring more and more things to be more and more important things. And then that results in -- in results that are so inequitable that courts feel that they have to step in and do something about it.

JUSTICE O'NEILL: Well, what -- but -- but we were very careful in PAJ, I think, to say that we're basing it on a legislative policy choice, for policies that the legislature regulates. And in the Board order the -- the Department spoke in terms of we don't like this unless there's prejudice. This notice of a provision thing in occurrence-based policies. But in areas that the Department doesn't regulate, why would not we just apply general contract principles in those contexts? I mean --

MR. WULFF: Well, I -- I think that the --

JUSTICE O'NEILL: I guess what I'm saying is --

MR. WULFF: -- I think that the --

JUSTICE O'NEILL: -- courts have -- courts are reluctant to step into making policy choices like the -- like the Department made in the Board order.

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MR. WULFF: I think -- I think, to be honest, your Honor, that although there is some discussion of the Board order in PAJ, you can't use the Board order as the basis for PAJ. The holding of PAJ is '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.'

JUSTICE O'NEILL: But we did not -- We did not ever rule Cutaia. We said, here was Cutaia. And -- and we enforced it as a condition precedent in the contract. And then we said -- in Cutaia we said, legislature or Department step in, if you want to. They did. Then Hernandez came and we said, okay, Department said 'x.' This is a policy choice that Department made, and therefore we're going to apply the materiality analysis here.

MR. WULFF: I -- I don't think that's exactly right. Cutaia is decided. The state Board then enters two Board orders which do not say, we're declaring a public policy of 'x.' They just say, you are going to put a certain endorsement on two very particular kinds of policies that will say prejudice is required. You then go for a ten-year period in which the Board does not extend that and does not decline to extend it. It doesn't -- it doesn't express an opinion one way or the other, nor does the legislature work one way or the other. You then decide Hernandez, which is a consent-to-settle case, not a notice case. And you say, notwithstanding Cutaia, we're going to require prejudice because that's the normal rule of contract interpretation. And this insurance policy is a contract. You then go far another many years without the Board doing anything further or the legislature doing anything further to indicate that they disapproved of what the court had done in Hernandez. And you're presented with PAJ, which is a coverage that is clearly not covered by either of the Board orders. And you decide that, notwithstanding the fact that there is not a Board order, which says there is a requirement of prejudice in this area, you are going to have a requirement of prejudice in this area --

CHIEF JUSTICE JEFFERSON: What do you do --

MR. WULFF: -- and you -- and you -- I'm sorry.

CHIEF JUSTICE JEFFERSON: -- given the fact that we -- we cited Matador (174 F.3d 653) and PAJ, and said, unlike an occurrence policy and a claims-made policy, the timely notice is an essential bargained-for element. And that distinction means that, you know, you can have that sort of condition precedent. Didn't we say that in PAJ and in --

MR. WULFF: Well, what you did cite to Matador -- In Matador, there are a couple of issues there. One is: Matador, if you assume it is good law, relies upon three Texas cases, which predated Hernandez. And all of those cases dealt with the issue in the context of a claims-made-and-reported policy. And -- and as -- as we've pointed out at some length in our brief, one thing you have to be very careful with in this area is that many, many courts simply say 'claims-made' without making the distinction between 'claims-made' and 'claims-made-and-reported.' And you have to look at what the actual policy and fact situation is in the case to determine what they're talking about, rather than just taking the quote out of context. So, I think you can -- you can make a perfectly well-principled argument that Matador is referring to claims-made in the sense of claims-made-and-reported, and has to be, looking at the three Texas cases it relied on. You could make an argument that those cases were to some extent undercut by Hernandez. And the Matador court did not realize that. And that essentially is what the Fifth Circuit said when it certified this question in our case to you, is: One of the things we see is that our Federal cases have been making a distinction between 'claims-made' and 'occurrence.' It isn't

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necessarily precedent in the Texas [inaudible]

CHIEF JUSTICE JEFFERSON: But after -- But after the certification, we cited Matador for the proposition that now you're saying is -- had been undermined by PAJ or Hernandez.

MR. WULFF: Right. Well, I mean I -- I think, again, that's really probably something you don't have to get to today, is -- is: In a claims-made-and-reported case, what do you do? I think -- I think what you -- what you have to get to today is that in a simple claims-made policy, in which there's no notice -- no mention of notice whatsoever in the insuring agreement, is there any reason to treat it differently than the policy in PAJ? And the answer is no. Neither --

JUSTICE HECHT: But -- But we didn't get to -- we didn't get to this case in PAJ.

MR. WULFF: And I know, and that -- that's why we're here arguing today.

JUSTICE HECHT: So we should at least think about --

MR. WULFF: Right, yes.

JUSTICE HECHT: -- what's going to happen --

MR. WULFF: And -- But --

JUSTICE HECHT: And what is going to happen next in the claims-made-and-reported?

MR. WULFF: Well, I think -- I think you have to deal with that when you get to it. I mean if --

JUSTICE HECHT: Well, that's what we said about this case --

MR. WULFF: Right, but --

JUSTICE HECHT: -- when we decided PAJ, but [inaudible]

MR. WULFF: -- but that's how the common-law works, isn't it, your Honor, it's that you take it one bite at a time and you don't try to figure out where you're gonna go? I mean, the next case may have a showing of some sort of prejudice that helps you to say, well, we're going to require prejudice, but it's a pretty easy showing to make if the policy is drafted this way.

JUSTICE HECHT: Well, that's an issue --

MR. WULFF: -- and one of the things that hasn't been dealt --

JUSTICE HECHT: -- issue though, is: Are we going to require that showing in a claims-made-and-reported policy?

MR. WULFF: Right, but I -- but I don't think that's something you can properly decide today. I mean, I suppose you could, but it's not -- you're not required to decide it by either of the two cases that are before you today, both of which are simple claims-made policies, which -- which -- which require reporting as soon as practicable in a notice provision, not in the insuring agreement, and therefore are, I believe, indistinguishable from the PAJ policy, which was set up exactly the same way.

JUSTICE WAINWRIGHT: How many of the important or material provisions of an insurance policy have to be in the insuring agreement?

MR. WULFF: I -- I don't -- I just don't think I can answer that, your Honor. I think that's a very broad question that --

JUSTICE WAINWRIGHT: Let me ask it the other way.

MR. WULFF: Okay.

JUSTICE WAINWRIGHT: If a provision is not in the insuring -- or a requirement -- an obligation is not in the insuring agreement, does that mean it's not essential?

MR. WULFF: No, it doesn't mean it's not essential. It just means that a breach of it has to be material to excuse performance. I mean in the end --

JUSTICE WAINWRIGHT: [inaudible]

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MR. WULFF: -- you've got to -- you've got to remember, your Honor, all of the --

JUSTICE WAINWRIGHT: Well, let me ask you this. I'm trying to understand your position here. If it's in the insuring agreement, the breach of it does not have to be material? Is that what you're saying?

MR. WULFF: That there is a better argument than in that situation: the breach of it does not have to be material, or you could phrase it that a breach of the insuring agreement, or something that falls without the insuring agreement simply isn't covered by the policy, so you never get to the issue of whether it's material or not because it's not insured.

JUSTICE WAINWRIGHT: If -- if we say putting something in the insuring agreement makes it more important, then they're gonna put everything in the insuring agreement, aren't they?

MR. WULFF: That -- That certainly could be a trend.

JUSTICE WAINWRIGHT: Which -- Which will just beg the question.

MR. WULFF: Well, no, it'll just -- it'll just bring the court back to the same problem ten years from now or 20 years from now, with a rewritten policy trying to make everything [inaudible] prejudice again. But -- but -- but, again, you got to remember, all of these provisions that we're talking about remain in the policy and remain enforceable if there is a breach that causes prejudice. I mean if, for instance, the failure to report a claim as soon as practicable harms the insurance company in any way, that's still a fully enforceable requirement and provision of the policy. They've just got to show, as they do with any other contract provision, that the breach is material.

CHIEF JUSTICE JEFFERSON: Are there any other questions? Thank you, Counsel. The Court is ready to hear argument from the appellee.

CLERK: May it please the Court. Ms. Richeimer will present argument for the respondent.

ORAL ARGUMENT OF GABRIELA RICHEIMER ON BEHALF OF THE RESPONDENT

GABRIELA RICHEIMER: May it please the Court. I think it's noteworthy that FIC in its briefs relies principally on just sense, and PAJ and Hernandez, to argue that Cutaia has been overruled and there is now supposedly a universal notice-prejudice rule in Texas. Our client, on the other hand, your Honors, looks at what the majority speaking for this Court has said, as well as what Texas appellate courts and federal courts have done for -- for years in reliance upon the interpretive rules announced in Cutaia. Unlike with occurrence policies before PAJ, there is no certainty in the law in Texas when it comes to notice requirements and claims-made policies. Notice is considered in those policies to be a material part of the bargained-for exchange. And as is the case in our policy, it's expressly a condition precedent to coverage. In those circumstances, courts have strictly construed the notice requirement and have not imposed something that -- that an extratextural prejudice requirement. What this Court said in Cutaia is if you have a condition precedent in the insurance policy and you're uncomfortable with enforcing it, it's the responsibility of the legislature or the regulators to change that, to announce a rule in Texas. And I would even point out that with regard to an unregulated insurer, the Texas legislature can say that for unregulated parts of the industry, that this insurance company can't participate in the

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Texas market unless it -- it specifies a -- provides a particular -- complies with a particular public policy concern that's announced by the legislature. I --

CHIEF JUSTICE JEFFERSON: What is the -- What is the difference, if you can tell us, between claims-made policies on the one hand and claims-made-and-reported policies on the other?

MS. RICHEIMER: Let me -- to answer your question, I want to start with what -- what I believe is the same between the two. What's the same between the two -- and it came up in the first argument, so I'm not going to belabor it -- is that the idea is for the insurance company to be able to -- to close the books at the end of the period. And I think what -- some of the courts even have gone a little farther and said the reason notice is so important is the insurance company opens the file for the claim, and then when the policy period is over, they close the books on that policy. That's the same in both claims-made and claims-made-and-reported. What's different is really the specific notice requirement.

JUSTICE WAINWRIGHT: But let me -- let me -- let me ask you a question about that. So, you said the insurer closes the books at the end of the period. So, the books are gonna remain open when a claim occurs, if it's reported eight months before the end of the period, a day before the end of the period, or four months before the end of the period. Why does that not suggest that as soon as practicable is not that important, because the books are going to remain open till the end of the period regardless?

MS. RICHEIMER: This -- I -- I'm going to try and answer both questions at the same time so I don't lose my train of thought. The -- The difference between claims-made and claims-made-and-reported is exactly what you pointed to. It's -- in our policy anyway, the notice provision is as soon as practicable as opposed to being during the policy period. So what happens in a policy like -- such as ours, where the condition precedent is notice as soon as practicable as opposed to notice during the policy period, is that you could have a situation where a claim comes in at an end of the policy period and there is some amount of opening that is -- for additional claims to be reported as long as they were -- they were made during the policy period. Let me -- let me just rephrase that to make sure it's clear. The reason that as soon as practicable is the choice that was made in the context of this particular policy, which does leave open some flexibility at the end of the policy period for reporting, in which case the -- you're going to evaluate the late report as to whether or -- the report to determine whether it's late, is whether it was reported as soon as practicable. And as was pointed out in the first argument, that's somewhat of a loosey-goosey term, and is -- is based upon case law interpretation. And so there is some amount of more flexibility than in a policy that would have a specific reporting requirement, or a hard stop as was discussed earlier.

JUSTICE HECHT: But assuming that these underwriting concerns and being able to better quantify risk are important in the claims- made context, if they're not implicated in a particular claim, why shouldn't the same prejudice requirement apply?

MS. RICHEIMER: I -- The answer, I believe, was alluded to in your PAJ decision, because what you end up -- once you agree that notice is a material part of the bargained-for exchange in our policy, for example, as in -- well, I would submit all claims-made policies, then prejudice is immaterial at that point. It's -- the notice provision is a condition precedent. Prejudice is truly irrelevant. You would -- you

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enforce the policy provisions strictly as written, as -- in all cases. And so what I'm saying is: In the PAJ case, you mentioned a certain ludicrousness to interpreting the same policy provision differently depending on the type of claim. And I would submit it would be equally ludicrous to interpret the same, exact words, the same, exact policy language, if the claim is made during the policy period or after the policy period. I just -- I think that once you agree that the policy provisions should be enforced strictly as written, you do it, no matter when the claim occurs -- whether it's within or not within the policy period.

JUSTICE O'NEILL: But let me ask about --

JUSTICE WAINWRIGHT: Would -- Would you say the same thing applies to a green ink claim?

MS. RICHEIMER: Absolutely not, your Honor. And I wanted to -- again, I want to bring it back to the general rules of -- of contract interpretation. This Court has the -- as any court has the ability -- to look at the policy language and say: Is this a condition precedent? And even if it purports to be a condition precedent, if it results in an absurd -- if the results are absurd, you say that's not really a condition precedent. I also point out --

JUSTICE O'NEILL: Well, it's not that the results are absurd. It's that if it works at forfeiture.

MS. RICHEIMER: I think that it's really the -- the -- the cases that I've looked at in this context have also said that it's -- it's the absurdity of the result. I don't think you automatically say: It's a forfeiture, so we don't enforce it. I mean you can have a forfeiture if the condition precedent is not complied with, if the condition precedent is clear. And in our policy, I would submit the condition precedent language is very clear for two reasons. One, it says it. Two, the nature of the coverage is such that notice has to be a condition precedent because without a strict notice requirement, you essentially convert in a claims-made policy into an occurrence policy. I think the other -- so the other point that I would make on the green ink is specific to our policy.

JUSTICE MEDINA: Can you explain that statement that you just made with -- by converting a claims made --

MS. RICHEIMER: Sure.

JUSTICE MEDINA: -- policy to an occurrence policy?

MS. RICHEIMER: It's a function -- once you impose a prejudice requirement on a claims-made policy, that means you're at -- you're in the same boat with the occurrence policies. And essentially -- at least in Texas -- what the courts have said is: Unless you have a default judgment that can't be overturned, you don't have prejudice. Even if you get into other -- and that's generally where the battleground has been for prejudice, is: What's happened in this claim? Even if we decide for claims-made policies, we're gonna introduce a new battleground, this notion of an underwriting prejudice. What you end up happening is every case becomes a trial about prejudice because prejudice is inherent. Generally speaking, at least in Texas, it has been deemed to be a very inherently fact-specific argument. Again, going back to the essential part of the bargained-for exchange is that we don't need to argue about prejudice. We don't need to have trials in every case about prejudice, or, in our situation, this is the third time our -- our client has paid our law firm to come up and argue this point. I mean, it's been a very expensive proposition to argue about whether there should be -- whether even -- whether there should be prejudice.

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JUSTICE SCOTT BRISTER: But it's a straightforward matter whether a claim's -- a claim was made during the policy period.

MS. RICHEIMER: Absolutely, your Honor.

JUSTICE BRISTER: So you agreed to cover claims during this policy period? A claim was made during the policy period. And the same thing applies to an occurrence policy. This looks kind of like a, whoops. You didn't -- you didn't do something fast enough. You lose all your rights.

MS. RICHEIMER: Your Honor, the --

JUSTICE BRISTER: -- when the deal was you agreed to cover a claim. And nobody doubts the claim was made during that period.

MS. RICHEIMER: I'm gonna point out two provisions of the policy that may be important to this question and to some prior questions. One, the insuring agreement says specifically, subject to all terms, conditions and limitations. So, I don't think it's fair to say this policy covers claims-made during the policy period, no matter what, without reference to what are the terms, conditions, limitations of the policy. This policy says: As a condition precedent to coverage, you must provide notice as soon as practicable. That's in the policy. It's also consistent with the notion of the bargained-for exchange in the claims-made policy. The other thing I would point out in our policy is -- and this goes to the green ink question: It has a provision, for example, that says you have to provide notice to the address listed in the -- in the declarations, and it has to say, attention: Claims Department. That's a separate part of the notice provision. We're not saying that's a condition precedent at all. We're saying -- we're only saying there's conditions -- the conditions precedent in this policy are few. And in fact, I've only really -- I've been able to find three provisions in this policy that are conditions precedent. One is notice. One has to do with purchasing an extended reporting period. And it says, as you might expect: You, the insured, have to pay us before we're going to give you an extended reporting period. And then there's the no-action provision that was discussed in the first argument. So, we're not saying that everything in this policy has to be a condition precedent. We're just saying that notice is a condition precedent in this policy, under existing rules of contract interpretation. Going back to Cutaia, the condition precedent gets enforced as written without reference to prejudice, because it's deemed inherently material to the bargained-for exchange.

JUSTICE JOHNSON: Counsel, you said a moment ago, and let me take you back, that if we don't strictly enforce the notice provision, we effectively turn the policy -- the claims-made policy into an occurrence policy. I was thinking that in an occurrence policy -- a claims-made policy, if you had a claim made between the first day of the period and the last day of the period, that's what you cover. But in an occurrence policy, if the occurrence happened but you didn't find out about till three years later, the carrier had coverage for that. So, to the -- am I missing something here --

MS. RICHEIMER: No --

JUSTICE JOHNSON: -- in your statement? I'm not quite making them mesh.

MS. RICHEIMER: It -- It becomes like an occurrence policy because of the potential delay in the -- because of the potential delay in the insurer's knowledge of the risk. That's --

JUSTICE JOHNSON: You still are limiting your -- they cover two different -- one is claims-made -- they're covered -- and one is an occurrence, regardless of when it's reported or regardless of when the

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insurer finds out about it or anything else. Aren't they -- Aren't they still different, even though we -- we're requiring prejudice -- if we were to require prejudice on the notice to the carrier? We -- we're not making claims-made and occurrence policies the same.

MS. RICHEIMER: You're making them the same in terms of the delay between the event that gives rise to coverage and the reporting, the notice to the insurer that it has a risk. So in an occurrence policy, you're absolutely right. You have an occurrence occurring during the policy period. A claim may not be made or may not be reported for some period of time afterwards. I mean some of these -- as I'm sure, your Honors, know, in some of these long-term claims, it can be years, and years, and years. And so the insurer -- it's a -- it's a higher premium paid for that type of coverage, because a broken ankle in -- in 1976 was worth one thing. It's worth something different today in 2008. So that's the economic analysis of an occurrence policy is: Because of the uncertainty of the risk, the premiums are higher. There's an immediacy or urgency between -- that has to be for a claims-made policy, between the event that gives rise to coverage, which in the case of a claims-made policy is the claim and reporting. They have to occur close in time. That's part of the -- the premium calculation.

CHIEF JUSTICE JEFFERSON: Does the Department of Insurance regulate these -- do you know -- policies?

MS. RICHEIMER: They -- not the specific language. Not in the way that it's done with CGL, as in the PAJ case. Companies are certainly regulated. You have admitted insurers and nonadmitted insurers issuing coverage. So just, the prior case would be an example of that, but it is certainly within the jurisdiction of the regulators and the legislature to make changes, mandatory endorsements that would be required to be added for DNO or claims-made policies.

CHIEF JUSTICE JEFFERSON: So the legislature could say that -- to establish noncoverage because of a failure to report timely, the insurer must show prejudice? They could do that?

MS. RICHEIMER: They absolutely could do that. They -- or they could say -- and I think that was -- it was in my reading of PAJ -- was -- was critical, was that the legislature had spoken, and not just -- and -- and as a result of what the legislature did, or rather -- I'm sorry -- the Department of Insurance did after Cutaia, it resulted in the Board orders, but there were also significant changes in the policy form that made -- that as a matter of contract interpretation, it made sense to have a notice of prejudice rule that applied to occurrence policies. And there's been nothing similar like that to occur in the context of claims-made policies -- specifically Directors and Officers policies that are at issue here -- so again, going back to -- to first principles, it's not just that you have a claims-made policy that -- in which notice is a material part of the bargained-for exchange. We've tied it up for a bow with you in our policy and said that it is -- in the policy, it is a condition precedent. We've had a lot of discussion today about: Does this have to appear in the insuring agreement? And to me, that would make insurance policies very different from other types of contracts, because I'm not aware of other contracts where there's a, you know, a special part of the contract that you interpret strictly and the rest of it is -- is automatically deemed to be covenants. I think general rules of contract interpretation dictate you look at the policy as a whole. This policy says, subject to all terms, conditions, limitations, we are going to provide coverage for claims that are made during the policy period. I don't think that you can ignore what is an express condition precedent to coverage just because it does not appear

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in the insuring agreement.

JUSTICE HECHT: Just to be sure, you don't think it makes any difference whether the -- the notice was given within or outside the policy period?

MS. RICHEIMER: It should not. Once you get - - once you agree, which I hope you will, that notice is a material part of the bargained-for exchange and it's an express condition precedent to coverage, it gets enforced strictly as written. And you look at what courts have deemed to be as soon as practicable. And it doesn't matter whether it's within or without the policy period. As in our case, you could have late notice within the policy period. But you could also have a case for our type of policy, where notice is given a short period of time after the policy expires. If that's deemed to be as soon as practicable, there would be coverage for that claim under our policy in any event. So, no. It does not matter whether it's late notice within or without the policy period. I think that, just to provide another example as to why it's important to -- to -- to enforce these strictly as written, you've got the CompUSA (319 F.3d 746) case from the Fifth Circuit, which was a situation where at least it appeared, just based on the Fifth Circuit's discussion, that the -- the policyholder there had made a conscious decision not to report the claim so as not to potentially interfere with a -- a merger-and-acquisition that was being contemplated. So there are reasons to, even within the policy period, even putting aside what the underwriting reasons might be. There are other reasons why the insurer might want to have notice of the claim as soon as practicable during the policy period.

CHIEF JUSTICE JEFFERSON: If the insured does not give notice as soon as practicable, but the insurer begins the defense of the claim, can it still, under reservations of rights or just a withdrawal, saying that there is no timely notice or we're out -- we're out?

MS. RICHEIMER: Yeah, I think so, your Honor. I mean at least our position in general is that an insurer makes a choice as to whether it denies coverage or reserves rights based on the facts of a particular claim. And so if the insurer has adequately reserved rights on that basis consistent with -- with Texas law, then I believe that would be an appropriate way to handle the claim, but that would be the insurer's choice as to whether the facts of --

CHIEF JUSTICE JEFFERSON: So --

MS. RICHEIMER: -- that particular claim --

CHIEF JUSTICE JEFFERSON: -- So if they got notice from another source but not from the insured --

MS. RICHEIMER: Oh, okay.

CHIEF JUSTICE JEFFERSON: -- then they'd deny coverage? Well --

MS. RICHEIMER: I may have misunderstood your question.

CHIEF JUSTICE JEFFERSON: -- that's another aspect of it.

MS. RICHEIMER: Yes, a notice from another source -- I don't -- your Honor, I believe that to comply with the notice provision in this policy, notice must come from the policyholder to the insurer. And I believe, although I didn't study it for purposes of this argument, there are cases to that effect in Texas and elsewhere. So, while I would not agree that notice in green ink or notice that says, attention: claims department is a condition precedent, I would argue that notice from the policyholder to the insurer is part of the condition precedent. I think with the way some of the courts have looked at it, is that there's really two pieces to notice. It's not just the -- it's -- it's the insured -- it's the policyholder's coverage. It's the policyholder's choice what they do with that

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coverage. And they may have reasons not to provide notice. They don't want the premiums to go up. They don't want to get non-renewed. They want to continue the relationship with this insurer. There are multiple reasons a policyholder may decide not to provide notice of a claim. That's why, your Honor, some courts have said, no, notice must come from the policyholder. It's the policyholder's choice whether or not to invoke the coverage. It can't come from the claimant. I think there's other issue dealing with the rights of a claimant under an insurance policy and at what point they attach. And that also figures into the analysis as to whether notice from the claimant is sufficient under the policy. I see my time is up. If there's any other question, I'd be happy to answer them.

CHIEF JUSTICE JEFFERSON: Are there any further questions? Thank you, Counsel.

MS. RICHEIMER: Thank you very much.

REBUTTAL ARGUMENT OF FREDERICK B. WULFF ON BEHALF OF THE PETITIONER

JUSTICE JOHNSON: Counsel, in your mind, is there a difference between -- some financial difference, premiumwise or otherwise, between an occurrence policy and a claims-made policy?

MR. WULFF: I don't think so, your Honor. There's certainly no evidence in our record that there are any --

JUSTICE JOHNSON: Then why do we have the two different kinds of policies even in existence, I wonder --

MR. WULFF: Well --

JUSTICE JOHNSON: -- if there's no difference?

MR. WULFF: -- they're different because -- I'm trying to think of the best way to say this --

JUSTICE JOHNSON: What we've heard here today is the insurer has a finite exposure time. They -- they know, after a certain period of time on a claims-made, that risk is behind them. And they can go on down the road, whereas in an occurrence policy, five years down the road they may get a claim that happened five years ago, so they really don't know when to close their books on it. Do you disagree with that characterization?

MR. WULFF: Well, but by the -- but by the same token, if you write an occurrence policy this year, you know you're only going to cover what's happened this year.

JUSTICE JOHNSON: But you don't know what's happened until somebody tells you. Even that may happen -- you may get that --

MR. WULFF: Right --

JUSTICE JOHNSON: -- knowledge several years down the road.

MR. WULFF: -- but -- but by the same token, when your write a claims-made policy for this year, your insurer may get a claim for something that happened many years ago that you didn't --

JUSTICE JOHNSON: But --

MR. WULFF: know about, so it's --

JUSTICE JOHNSON: -- but the end of the year --

MR. WULFF: -- it's just -- it's just two different ways to -- to set the trigger in the insuring agreement.

JUSTICE JOHNSON: Okay, and so the insurance company must have some reason for writing those different kinds of policies, it would seem.

MR. WULFF: Correct.

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JUSTICE JOHNSON: Now, let me ask a question on prejudice. Let's say you have a policy, a claims-made policy with this reporting period as soon as practicable. A claim is made against your insured six months in there. They hire the best law firm in Texas -- and therefore the best law firm in the country, to some people -- to defend him. And they defend that claim and then pay their own -- their bills themselves for the next two or three years. And then they -- and then they find this policy -- the claims-made policy -- and so they notify the insurance company. The insurance company hires -- takes a reservation, right -- hires a lawyer, looks at what's happened; they said, we couldn't have done any better. Great job; no prejudice. In that case, you would say, under the claims-made policy's as soon as practicable notice, even though the notice came four years down the road, unless the insurance company could say, there's something that happened in here that we feel prejudiced. In that case, they're still on the hook on a claims-made policy because of no prejudice. And in fact they're better off because the insured paid their own bills for a long time. Is that -- would that be a fair characterization where we end up, under your scenario?

MR. WULFF: Not necessarily, your Honor. That -- That again is another issue that is -- is not really before us today, which is what happens if the report is made outside of the policy period.

JUSTICE JOHNSON: But just saying that --

MR. WULFF: And -- and I mean I -- I don't -- I mean my inclination would be to say if, truly, the insurance company has not been harmed in any way by that, then yeah, the answer may be right. I'm guessing it's a practical matter. That's never going to happen because their reinsurance is going to go away. Their -- you know, various things are going to happen so that they will be affected by it. It does, however, bring me back to one point that I wanted to make about this, that you need to be sure you understand in the context of one of these DNO policies, and that is: A claim, as it is defined under this policy, that has to be reported, is not a lawsuit; it's any written demand of any kind. So if the company gets a letter that says, we think you've done us wrong and you ought to make us whole for that. That's a claim, even if it doesn't progress to being a serious claim or -- or something bigger until later. And this policy does not have -- does not give the insurance company either a defense obligation or a right to control the defense. So, once they're put on notice of the claim, that doesn't mean they step in and run it. What happens is exactly what you just described: The insured hires counsel to -- to defend the claim. They pay for it. And then somewhere down the line they ask the insurance company to reimburse them for it. And I think that, again, gets back to one of the things that was -- that was said in the -- in the prior argument: If you look at the policy in this case, if you look at Section J -- action against the insurer, which appears in the Fifth Circuit record at page 354 -- you will find that if the policy provides -- Section J1: No action may be taken against the insurer, that is, no one can attempt to make the insurer pay a claim under this policy 'unless, as a condition precedent thereto: a) there has been full compliance with all the terms and conditions of this policy;' and then it goes on. So, the way this policy is set up, contrary to the representation being made by opposing counsel, is that everything in this policy is a condition precedent to being able to collect any claim under it.

CHIEF JUSTICE JEFFERSON: Are there -- Are there any further questions? Your time has expired. And therefore the cause is submitted. And the Court will take a brief recess. Thank you, Counsel.

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CLERK: All rise.

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