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ALERT

Untimely Notice Not Bar to Coverage Where Insurer Could Not Prove Actual Prejudice

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The United States District Court for the Eastern District of Texas has held that an excess insurer did not prove that it was sufficiently prejudiced by the insured's late notice of a claim to justify a denial of coverage. *East Texas Medical Center Regional Healthcare System v. Lexington Insurance Company*, WL 773452 (E.D. Tex. Feb. 25, 2011).

The insurer issued an excess medical malpractice policy to the insured, a hospital, which required the insured to provide written notice to the insurer of any medical incidents, claims, or lawsuits "as soon as practicable" and to "immediately" send the insurer copies of any demands, notices, summonses or legal papers received in connection with a claim or lawsuit. Additionally, the policy granted the insurer a right to participate in the defense of claims, but did not impose on it a duty to defend. In March 2003, the hospital received notice of a medical malpractice claim involving a former patient. The policyholder forwarded information about the claim to the insurer but did not provide the insurer with underlying documents. In May 2003, an actual lawsuit was filed on the patient's behalf. The policyholder defended the suit but failed to notify the insurer of the lawsuit until January 2004. Based on the insured's failure to comply with the notice requirements, the insurer denied coverage. The parties settled the underlying lawsuit in February 2005, largely based on two nurses' damaging deposition testimony taken in December 2003.

After settlement, the insured sued the insurer for its denial of the claim. A jury verdict was returned in favor of the insured on all claims, but the judge overturned the verdict, holding for the insurer. The Fifth Circuit reversed, holding that the insurer must prove it was prejudiced by the insured's breach of the policy's notice provisions in order to avoid payment under the policy. At the time of trial in 2006, Texas did

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not require such proof of prejudice following breach of a claims-made policy, but the state now applies a strict "notice-prejudice" rule for both occurrence and claims-made policies. The Fifth Circuit remanded for consideration of the proof of prejudice.

On remand, the court held that the insurer did not meet the burden of proof required to establish that it suffered prejudice as a result of the insured's breach of the notice provision. According to the court, under Texas law, the promise to provide timely notice is not material to the insurance contract. The court further noted that, although a complete lack of notice until after a judgment prejudices the insurer as a matter of law, in the case of notice that is merely untimely, the insurer can only avoid payment under the policy if it proves that it lost a specific and valuable right or benefit, suffered a "material adverse change in position," and experienced damages that "would have been avoided or minimized with timely notice."

The court held that the insurer did lose the right to participate in the defense of the lawsuit for the first eight months, but stated that the insurer must "demonstrate a substantial likelihood that exercising the lost right [to participate in the underlying litigation] would have made a difference in the underlying action" and that the insurer actually would have taken advantage of the right to participate. The insurer claimed that the nurses' damaging deposition testimony, which affected the outcome of the case, would not have been given had the insurer been involved in the defense and been able to properly prepare the nurses for deposition. An internal memo detailing the insurer's plan for handling the claim, drafted after receiving the untimely notice in January 2004, contains what the court calls a "glaring omission." It does not indicate anywhere a plan for the insurer "to participate in depositions or deposition preparation," even though discovery was ongoing at that point. Additionally, the insurer provided no evidence that it had ever previously participated in deposition preparation as an excess insurer. The court held that the insurer therefore did not demonstrate that it actually would have participated in the deposition preparation if it had the opportunity, and the court further held that the insurer did not prove that the nurses' deposition testimony would have differed if the insurer had better prepared them. Thus, although the nurses' testimony was deemed damaging, it "did not rise to the level of a *material* change in [the insurer's] position." Because the insurer failed to demonstrate prejudice, it could not avoid its coverage obligation based on untimely notice.