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A Little TLC: Tender, Liability, and Covenants Vis-A-Vis Recovery of Pre-notice Defense Costs After Paj, Incorporated v. Hanover Insurance Company and Its Progeny

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A LITTLE TLC: TENDER, LIABILITY, AND COVENANTS VIS-À-VIS RECOVERY OF PRE-NOTICE DEFENSE COSTS AFTER *PAJ, INCORPORATED v. HANOVER INSURANCE COMPANY* AND ITS PROGENY

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I. INTRODUCTION

An oil and gas operator (operator) contracted with a drilling company (driller) to drill an oil well in Texas.[2] The contract contained

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2. Note, the arguments and authorities contained in this article are applicable to all contracts containing valid defense and indemnity language and not just scenarios in the oil and gas context.

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valid defense and indemnity language providing that the driller would defend and indemnify the operator and its group, including its subcontractors, from any claims, damages, or suits arising out of the driller's work. The defense and indemnity clause was also supported by insurance. The operator's subcontractors were not parties to the contract and had no knowledge of the language contained in the contract.

On January 2, 2009, an employee of the driller was severely injured in an accident. The employee sued the operator and one of its subcontractors on March 1, 2009. The subcontractor answered the suit and began defending itself by completing written discovery, hiring experts, and taking numerous depositions. The subcontractor paid for all of these defense efforts out of its own pocket.

On November 1, 2009, the operator produced copies of its contract with the driller and the driller's insurance policy. After reviewing these documents, the subcontractor immediately made a demand for defense and indemnity and treatment as an additional insured from the driller and its insurer. The case was settled on December 1, 2009. The driller's insurer participated in the settlement negotiations and paid the subcontractor's portion of the settlement. The driller's insurer also paid for the subcontractor's defense from the date of tender but refused to reimburse the subcontractor for its substantial defense costs incurred in the eight months before tender.

Insurance companies increasingly contend comprehensive or commercial general liability policies exclude coverage for defense costs incurred before the insured has provided notice.[3] To deny pre-tender costs, insurance companies in Texas often argue they are not responsible for any costs incurred before notice, they are not responsible for voluntary payments, and they cite the following cases: *E&L Chipping, Company v. Hanover Insurance Company*; *Nagel v. Kentucky*; and *LaFarge Corporation v. Hartford Casualty Insurance Company.*

This article analyzes the impact of *PAJ, Inc. v. Hanover Insurance Company* and similar cases on the arguments by insurers to deny pre-notice defense costs.[4] This article also analyzes decisions in other jurisdictions that support the recovery of pre-tender defense costs.

3. Stephen A. Klein, *Insurance Recovery of Prenotice Defense Costs*, 34 TORTS & INS. L.J. 1103 (1999).

4. *Compare* PAJ, Inc. v. Hanover Ins. Co., 243 S.W.3d 630, 631 (Tex. 2008), *with* Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Crocker, 246 S.W.3d 603, 609 (Tex. 2008) (holding that "an insurer's actual knowledge that an additional insured has been served with process does not establish as a matter of law that the insurer has not been prejudiced by the additional insured's failure to notify the insurer of the receipt of process"). *See also* Pecan Grove Assocs. v. John L. Wortham & Son, No. 01-98-01020-CV, 1999 WL 460086, at *3 (Tex. App.—Houston [1st Dist.] July 8, 1999, pet. denied) (not designated for publication) (holding insured's failure to provide notice until months after settlement barred recoupment of pre-tender defense costs and/or settlement monies paid by insured). The difference between *PAJ* and *Crocker* is the appellant provided late notice of suit in *PAJ*; whereas, in *Crocker*, the appellant never

II. *PAJ, INC. V. HANOVER INSURANCE COMPANY*

On January 11, 2008, the Supreme Court of Texas handed down its opinion in *PAJ, Inc. v. Hanover Insurance Company*.[5] The *PAJ* court was tasked with deciding "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."[6]

PAJ was a manufacturer and distributor of jewelry that maintained a Commercial General Liability (CGL) policy with Hanover Insurance Company.[7] The CGL policy required PAJ to notify Hanover of any claim or suit brought against PAJ "as soon as practicable."[8] During the policy period, PAJ received a cease-and-desist demand to stop marketing a line of jewelry and was sued for copyright infringement.[9] PAJ waited four to six months after suit was filed before it notified Hanover of the lawsuit; Hanover denied coverage due to the failure of PAJ to provide notice of the lawsuit "as soon as practicable."[10] PAJ brought suit against Hanover seeking a declaration of its rights under the CGL policy. In that suit, PAJ stipulated it failed to notify Hanover of the claim "as soon as practicable" and Hanover stipulated it was not prejudiced by the untimely notice.[11] Both parties moved for summary judgment on the notice issue based on these undisputed facts.[12] The trial court granted Hanover's motion holding Hanover was not required to demonstrate prejudice to avoid coverage under the policy.[13] The trial court's judgment was affirmed by the Court of Appeals, and PAJ filed a petition for review with the Supreme Court of Texas.[14]

The Supreme Court of Texas reversed the Court of Appeals.[15] In doing so, the court determined "[c]onditions are not favored in the law; thus, when another reasonable reading that would avoid a forfeiture is available, [the court] must construe contract language as a covenant rather than a condition."[16] It then held "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."[17] Because timely notice is a covenant, the *PAJ* court expressly held the

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gave notice. *See* Jenkins v. State and County Mut. Fire Ins. Co., 287 S.W.3d 891, 898 (Tex. App.—Fort Worth 2009, pet. denied).

5. *PAJ*, 243 S.W.3d at 630.
6. *Id.* at 631.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.* at 631–32.
14. *Id.* at 632.
15. *Id.* at 637.
16. *Id.* at 636.
17. *Id.* at 631.

failure to timely provide such notice will not defeat coverage absent a finding of prejudice.[18]

The *PAJ* holding abrogated prior precedent that held when a notice provision is breached, "liability on the claim [is] discharged, and harm (or lack of it) resulting from the breach [is] immaterial."[19] The *PAJ* decision places Texas in alliance with the national majority position in regards to providing timely notice of a claim or suit to an insured's liability insurer.[20] Post-*PAJ*, it is clear the insurer may not refuse to defend or indemnify the insured unless the delay prejudiced the insurer's rights under the policy.[21]

III. *PRODIGY COMMUNICATIONS CORPORATION V. AGRICULTURAL EXCESS & SURPLUS INSURANCE COMPANY*

On the same day it handed down its opinion in *PAJ*, the Supreme Court of Texas granted the petition for review in *Prodigy Communications, Inc. v. Agricultural Excess & Surplus Insurance Company*,[22] and accepted a certified question from the Fifth Circuit in *XL Specialty Insurance Company v. Financial Industries Corporation*.[23] On March 27, 2009, the Supreme Court of Texas delivered its opinion in both cases.

In *Prodigy*, the Supreme Court of Texas had to determine:

> Whether . . . an insurer can deny coverage based on its insured's alleged failure to comply with a policy provision requiring that notice of a claim be given 'as soon as practicable,' when (1) notice of the claim was provided before the reporting deadline specified in the policy; and (2) the insurer was not prejudiced by the delay.[24]

Prodigy concerned a claims-made-and-reported policy[25] containing a condition precedent that required the insured to give "notice of a claim to its insurer 'as soon as practicable . . . but in no event later than ninety (90) days after the expiration of the Policy Period or Discovery Period.'"[26]

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18. *Id.* at 636–37.

19. *See, e.g.*, Members Mut. Ins. Co. v. Cutaia, 476 S.W.2d 278, 279 (Tex. 1972).

20. *PAJ*, 243 S.W.3d at 634 n.3 (counting thirty-eight states, including Texas, as having adopted a notice-prejudice rule in some form versus only six states and the District of Columbia identified as adhering to the traditional rule).

21. *Id.*

22. Prodigy Commc'ns Corp. v. Agric. Excess & Surplus Ins. Co., 288 S.W.3d 374 (Tex. 2009).

23. *See* J. Price Collins, Ashley E. Frizzell & Omar Galicia, *Insurance Law*, 61 SMU L. REV. 877, 895 (2008).

24. *Prodigy*, 288 S.W.3d at 377.

25. *See id.* at 379 n.7 (discussing the difference between claims-made and claims-made-and-reported policies).

26. *Id.* at 375.

In *Prodigy*, the insured was served with a suit on June 20, 2002, and notified its insurer of the suit on June 6, 2003.[27] The insurer denied coverage because notice was not given as soon as practicable.[28] The insured sued its insurer seeking a declaration that the claim was covered under the policy, and the insurer moved for summary judgment, which was granted.[29] The court of appeals affirmed holding:

> (1) Prodigy was required to give notice "as soon as practicable," even though the policy allowed notice within ninety days after the expiration of the discovery period; (2) notice given almost one year after the filing of the lawsuit against the insured was not "as soon as practicable" as a matter of law; (3) [the insurer] was not required to prove that it was prejudiced by Prodigy's late notice; and (4) Insurance Code provisions did not prevent [the insurer] from enforcing the policy's notice provision.[30]

The insured filed a petition for review and, based on *PAJ*, argued to the Supreme Court of Texas that any breach of duty to give notice "as soon as practicable" was immaterial and could not defeat coverage because the insurer was not prejudiced by the failure.[31] Conversely, the insurer argued *PAJ* was not on point because the policy at issue unambiguously stated "notice, in writing, as soon as practicable" was a condition precedent to coverage and timely notice is "always inherent to, and an essential part of, the bargained-for exchange in a claims-made policy."[32] The Supreme Court of Texas disagreed with the insurer and, "[f]ollowing *PAJ*, [held] in the absence of prejudice to the insurer, the insured's alleged failure to comply with the provision does not defeat coverage."[33]

IV. *FINANCIAL INDUSTRIES CORPORATION V. XL SPECIALTY INSURANCE COMPANY*

Financial Industries Corporation v. XL Specialty Insurance Company[34] concerns a traditional[35] claims-made insurance policy.[36] In *XL*

27. *Id.* at 376 (the "Discovery Period" expired on May 31, 2003).
28. *Id.*
29. *Id.* at 377.
30. *Id.*
31. *Id.* at 377–78.
32. *Id.* at 378.
33. *Id.* at 375.
34. Fin. Indus. Corp. v. XL Specialty Ins. Co., 285 S.W.3d 877, 877–78 (Tex. 2009).
35. *See* E. Tex. Med. Ctr. Reg'l Healthcare Sys. v. Lexington Ins. Co., 575 F.3d 520, 528 (5th Cir. 2009) (noting a "traditional claims-made policy" is one "without a 'clear-cut reporting deadline' for the reporting of claims to the insurer, but with an 'as soon as practicable' requirement").
36. *See* Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Willis, 296 F.3d 336, 343 (5th Cir. 2002) ("The purpose of claims-made policies, unlike occurrence policies, is to provide exact notice periods that limit liability to a fixed period of time 'after which an insurer knows it is no longer liable under the policy, and for this reason such reporting requirements are strictly construed.'").

Specialty, the United States Court of Appeals for the Fifth Circuit certified the following question to the Supreme Court of Texas: "Must an insurer show prejudice to deny payment on a claims-made policy, when the denial is based upon the insured's breach of the policy's prompt-notice provision, but the notice is nevertheless given within the policy's coverage period?"[37] Basing its opinion on the reasoning set forth in *Prodigy* and its holding in *PAJ*,[38] the Supreme Court answered the certified question in the affirmative. The court then held "an insurer must show prejudice to deny payment on a claims-made policy, when the denial is based upon the insured's breach of the policy's prompt-notice provision, but the notice is given within the policy's coverage period."[39]

V. THE EFFECT OF *PAJ* ON PRE-TENDER COSTS

There is no Texas precedent post-*PAJ* to determine whether pre-tender costs are recoverable; however, it is likely the Supreme Court of Texas will treat such cases the same as those courts where notice is treated as a covenant.[40] Therefore, other jurisdictions can provide guidance in determining responsibility for pre-tender defense costs.

A. *Other state court opinions regarding pre-tender costs*

Other state courts have held the prejudice analysis should apply to the existence of a duty to defend after late notice. Furthermore, these courts have found the prejudice analysis should also be applied to pre-notice/pre-tender defense costs.

Like the *PAJ* court, in *Alcazar v. Hayes*, the Tennessee Supreme Court abandoned its long-standing adherence to the traditional common law approach that notice was a condition precedent to recovery under an insurance policy regardless of whether prejudice to the insurer was shown.[41] Instead, the *Alcazar* court "adopted the modern trend and held that in order for forfeiture of an insurance policy to result from an insured's breach of a notice provision, prejudice to the insurer must be shown."[42] The *Alcazar* court did not address whether pre-notice costs were recoverable; however, a Tennessee federal dis-

37. *Fin. Indus. Corp.*, 285 S.W.3d at 877.
38. *Id.* at 879.
39. *Id.*
40. *Compare* Griffin v. Allstate Ins. Co., 29 P.3d 777, 782 (Wash. Ct. App. 2001) (stating that even in policies where tender is a condition precedent, the insurer must show actual prejudice before the insured's breach will release the insurer from its duty to defend), *with* PAJ, Inc. v. Hanover Ins. Co., 243 S.W.3d 630, 636–37 (Tex. 2008) (holding that "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").
41. Alcazar v. Hayes, 982 S.W.2d 845, 849, 853 (Tenn. 1998); *see also PAJ*, 243 S.W.3d at 634 n.3.
42. *See Alcazar*, 982 S.W.2d at 853.

trict court, applying the holding in *Alcazar*, did find that such costs were recoverable subject to a prejudice analysis.[43]

As in *PAJ*, Maryland's Supreme Court treats the duty to notify as a covenant that, absent a showing of prejudice, does not excuse the insurer from complying with its duty to defend.[44] The Maryland court concluded "[t]he duty to defend, rationally, should attach at the same moment the correlative right to control attaches, i.e., . . . when an insured occurrence happens. If that is when the insurer has a right to exercise control, that is also when its duty to do so should arise."[45] Based on its analysis, the court held the insurer was liable for the pre-notice fees and expenses of the insured.[46]

In *Nationwide Mutual Fire Insurance Company v. Beville*, a Florida appellate court determined the insurer was liable for pre-tender defense costs because "there is no suggestion that the insured's expenses (prior to the tender) were unreasonable or in some way prejudiced the carrier."[47] In *Rovira v. LaGoDa, Inc.*, a Louisiana court of appeals held:

> [T]he duty to defend arises when the insurer receives notice of the litigation. Delayed notice of a claim relieves the insurer of the obligation if it was actually prejudiced by the delay. [The insurer] has not shown that it was prejudiced by the 20-day lapse between Rovira's filing of suit and LaGoDa's notice of claim and request for defense. The attorney's fees that LaGoDa incurred during this time are recoverable.[48]

Similarly, another Louisiana court of appeals indicated an insured is entitled to compensation for the value of the benefit provided by private defense counsel prior to the time the insured made demand upon the insurer for a defense.[49] In *Costagliola v. Lawyers Title Insurance Corporation*, a New Jersey appellate court determined an insurer must reimburse all defense costs despite untimely notice, absent a showing of appreciable prejudice.[50] Additionally, the Massachusetts Superior Court, in *Wyman-Gordon Company v. Liberty Mutual Fire Insurance Company*, rejected the argument that, even without prejudice, an insurer has no duty to reimburse pre-notice defense costs.[51] Finally, in

43. *See* Smith & Nephew, Inc. v. Fed. Ins. Co., No. 02-2455 B., 2005 WL 3434819, at *1, *3 (W.D. Tenn. Dec. 12, 2005).

44. Sherwood Brands, Inc. v. Hartford Accident & Indem. Co., 698 A.2d 1078, 1084 (Md. 1997); *see also PAJ*, 243 S.W.3d at 636–37.

45. *Sherwood Brands*, 698 A.2d at 1083–84.

46. *Id.* at 1087.

47. Nationwide Mut. Fire Ins. Co. v. Beville, 825 So. 2d 999, 1004 (Fla. Dist. Ct. App. 2002).

48. Rovira v. LaGoDa, Inc., 551 So. 2d 790, 794–95 (La. Ct. App. 1989).

49. Foote v. Sarafyan, 432 So. 2d 877, 882 (La. Ct. App. 1982).

50. Costagliola v. Lawyers Title Ins. Corp., 560 A.2d 1285, 1289 (N.J. Super. Ct. Ch. Div. 1988).

51. Wyman-Gordon Co. v. Liberty Mut. Fire Ins. Co., No. 96-2208A, 2000 WL 34024139, at *6–7 (Mass. Supp. Ct. July 14, 2000).

Griffin v. Allstate Insurance Company,[52] a court of appeals in Washington held an insurer may be responsible for pre-tender defense costs where the insurer is not prejudiced by the late notice.[53]

B. *Federal court opinions regarding pre-tender costs*

Like their state court counterparts, several federal courts have held the prejudice analysis should apply to pre-notice/pre-tender defense costs. In *Peavey v. M/VANPA*, the Fifth Circuit Court of Appeals, applying Louisiana law, held in cases where timely notice is not a condition precedent, an insurer must demonstrate it was sufficiently prejudiced by the insured's late notice.[54] The *Peavey* court also concluded that attorney's fees incurred prior to the notice to the insurer were recoverable where the insurer benefited from and relied on the attorney's efforts prior to notification.[55] In *TPLC, Inc. v. United National Insurance Company*, the Tenth Circuit Court of Appeals, applying Pennsylvania law, concluded pre-notice costs were reimbursable except when the insurer could show prejudice.[56]

Other federal courts have allowed pre-notice costs. For example, a Massachusetts federal court held Massachusetts law did not exclude pre-notice costs absent prejudice.[57] A New York federal court held an insurer was liable for the cost of defense "from the time each case or claim is brought," not from the time each claim is tendered.[58] Further, in Pennsylvania insurers must reimburse the insured for payments the insured made before giving notice to the insurer unless the insurer can prove it was prejudiced because such payments were unnecessary or too high.[59]

A federal court in Tennessee has held pre-tender costs are reimbursable unless the insurer can show prejudice.[60] In that case, the federal district court stated that Tennessee had "adopted the modern trend" and no longer treated notice as a condition precedent to coverage.[61] The *Smith* court then held:

> In a state where the duty to notify "is merely a covenant that, absent a showing of prejudice, does not excuse the insurer from com-

52. Griffin v. Allstate Ins. Co., 29 P.3d 777, 777 (cited with approval by Truck Ins. Exch. v. Vanport Homes, Inc., 58 P.3d 276, 281 n.5 (Wash. 2002)).

53. *Id.* at 781–82.

54. Peavey Co. v. M/V ANPA, 971 F.2d 1168, 1173 (5th Cir. 1992).

55. *Id.* at 1178.

56. TPLC, Inc. v. United Nat'l Ins. Co., 44 F.3d 1484, 1493 (10th Cir. 1995).

57. Liberty Mut. Ins. Co. v. Black & Decker Corp., 383 F. Supp. 2d 200, 207–08 (D. Mass. 2004).

58. Burroughs Wellcome Co. v. Commercial Union Ins. Co., 713 F. Supp. 694, 697 (S.D.N.Y. 1989).

59. Harrisburg Area Cmty. Coll. v. Pac. Employers Ins. Co., 682 F. Supp. 805, 807–12 (M.D. Pa. 1988).

60. Smith & Nephew, Inc. v. Fed. Ins. Co., No. 02-2455 B., 2005 WL 3434819, at *3 (W.D. Tenn. Dec. 12, 2005).

61. *Id.* at *1.

> plying with its duty to defend, the logic of such a holding becomes significantly attenuated, for it creates a time gap between the insurer's right to control the defense and its duty to provide one." If the Court were to adopt such reasoning, upon the filing of the underlying complaint, the insurer would have a right to control the defense but no duty to defend until notice was provided . . . Because notice is not a condition precedent to coverage absent prejudice . . . the Court finds that pre-tender notice costs are not per se excluded, but subject to prejudice analysis.[62]

Based on its analysis, the *Smith* court approved the award of reasonable pre-tender fees and expenses.[63]

C. *Application*

Because of the Supreme Court of Texas's holding in *PAJ* that notice provisions are covenants and not conditions precedents, it is likely Texas courts will apply the *PAJ* holding to pre-notice defense costs in the same way the *Smith* court applied the prejudice analysis from the Tennessee Supreme Court in *Alcazar*. Where an insurer cannot establish it was prejudiced by late notice of a claim, all costs, including pre-tender defense costs, should be recoverable.[64]

VI. PRE-*PAJ* ARGUMENTS AND CASES SUPPORTING DENIAL OF PRE-TENDER COSTS

There is no Texas Supreme Court precedents regarding recovery of pre-tender defense costs and the few Texas court cases that discuss the issue were decided before *PAJ*. Insurers often offer two justifications for denying pre-notice defense costs. The first justification is the duty to defend does not arise until the insurer receives notice; the second justification is pre-tender defense costs are excluded under the voluntary payment provisions of the typical policy.[65]

A. *Texas cases regarding pre-tender costs decided before PAJ*

The three cases often cited by Texas insurers to deny pre-tender defense costs are *E&L Chipping Company v. Hanover Insurance Company; Nagel v. Kentucky;* and *LaFarge Corporation v. Hartford Casualty Insurance Company*. Each of these cases is distinguishable from a post-*PAJ* demand for pre-tender defense costs.

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62. *Id.* at *3 (citing Sherwood Brands, Inc. v. Hartford Accident & Indem. Co., 698 A.2d 1078, 1084 (Md. 1997)) (citations omitted).

63. *Id.*

64. *See id.*

65. *See* Klein, *supra* note 3, at 1106.

In *E&L Chipping Company, Inc. v. Hanover Insurance Company*, the Beaumont Court of Appeals treated notice as a condition precedent.[66] That court found:

> An insured generally is not entitled to reimbursement of the defense costs it voluntarily incurred before notifying the insurer of the suit. Because an insurer's duty to defend is triggered by notice, the insurer has no duty to reimburse the insured for defense costs incurred before the insured gave the insurer notice of the lawsuit.[67]

The holding that notice provisions are a condition precedent under *E&L Chipping* is no longer good law after the Texas Supreme Court's holding in *PAJ* that notice provisions are covenants.[68]

In *Nagel v. Kentucky Central Insurance Company*, the Austin Court of Appeals held the doctrine of quantum meruit[69] did not require reimbursement for pre-notice defense costs.[70] *Nagel* is a correct proposition of law because quantum meruit is an equitable theory of recovery based on an implied contractual agreement;[71] however, quantum meruit did not apply because *Nagel* involved an actual contract.[72] Thus, any discussion of pre-notice defense costs in *Nagel* is *obiter dictum*[73] and gives no valid guidance for the recovery of pre-tender defense costs.

Another oft-cited case is *LaFarge Corporation v. Hartford Casualty Insurance Company*, in which the Fifth Circuit, applying Texas law, held pre-tender costs were *per se* excluded from recovery where a "voluntary payment" provision of a policy precluded liability for such costs.[74] In reaching this conclusion, the court noted an insurer's duty to defend an action did not attach until notice alleging a potentially covered claim was tendered to the insurer.[75] Because there was no duty on the insurer to defend until notice was provided, the Fifth Circuit reasoned the insurer could not be held liable for defense costs

66. E & L Chipping Co. v. Hanover Ins. Co., 962 S.W.2d 272, 278 (Tex. App.—Beaumont 1998, no pet.).

67. *Id.*

68. *See* PAJ, Inc. v. Hanover Ins. Co., 243 S.W.3d 630, 636–37 (Tex. 2008).

69. Vortt Exploration Co. v. Chevron U.S.A., 787 S.W.2d 942, 944 (Tex. 1990).

70. Nagel v. Ky. Cent. Ins. Co., 894 S.W.2d 19, 21 (Tex. App.—Austin 1994, writ denied).

71. *See Vortt Exploration*, 787 S.W.2d at 944 (holding quantum meruit is available only if no express contract exists).

72. *Nagel*, 894 S.W.2d at 21–22.

73. *See* Edwards v. Kaye, 9 S.W.3d 310, 314 (Tex. App.—Houston [14th Dist.] 1999, pet. denied) (holding "[d]ictum is an observation or remark made concerning some rule, principle, or application of law suggested in a particular case, which observation or remark is not necessary to the determination of the case. . . . [and] is not binding as precedent under stare decisis") (citation omitted); *see also* Nichols v. Catalano, 216 S.W.3d 413, 416 (Tex. App.—San Antonio 2006, no pet.); *In re* Mann, 162 S.W.3d 429, 434 (Tex. App.—Fort Worth 2005, no pet.).

74. Lafarge Corp. v. Hartford Cas. Ins. Co., 61 F.3d 389, 399 (5th Cir. 1995).

75. *Id.* at 400; *see also* Members Ins. Co. v. Branscum, 803 S.W.2d 462, 467 (Tex. App.—Dallas 1991, no writ).

incurred before the insurer's duty attaches.[76] The court rejected the plaintiff's argument that pre-tender costs were recoverable absent a showing of prejudice and held prejudice was not required in consideration of pre-tender costs.[77] After *PAJ*, the *LaFarge* holding is no longer good law because *PAJ* expressly held the failure to provide timely notice is a covenant, not a condition precedent, and as such will not defeat coverage absent a finding of prejudice.[78]

B. *Insurer's argument that the duty to defend does not arise until notice*

The first justification insurers use to deny pre-notice defense costs is that the duty to defend does not arise until the insurer receives notice. This argument fails to account for the genesis of when the duty attaches and is based on the belief that notice is a condition precedent.

The argument supporting the first justification is "predicated upon the notion that [the insurer's] defense obligation is circumscribed by the insured's separate obligation to give notice, although the standard form insuring agreement does not so provide."[79] This argument also "confuse[s] events which give rise to the duty to defend . . . and events which give rise to an insurer's breach of that duty . . . . The duty to defend pre-exists any obligation on the part of the insured as to notice . . . [and] arises when the underlying claim is brought and thus pre-exists the insured's obligation to notify its insurer of th[e] suit."[80] Moreover, this justification is not responsive to the issue before the insurer, which is whether the typical CGL policy requires the insurer to pay for all defense costs of the suit, including pre-notice defense costs. Finally, this argument is based on the assumption that notice is a condition precedent to the insurer's obligation to perform.[81] As a result, this argument is no longer valid in Texas because the Supreme Court of Texas now treats such notice provisions as covenants rather than conditions.[82]

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76. *Lafarge*, 61 F.3d at 400.

77. *Id.* at 400 n.19.

78. *See* PAJ, Inc. v. Hanover Ins. Co., 243 S.W.3d 630, 636–37 (Tex. 2008).

79. Klein, *supra* note 3, at 1106; *see also PAJ*, 243 S.W.3d at 636 ("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." (citing Matador Petroleum Corp. v. St. Paul Surplus Lines Ins. Co., 174 F.3d 653, 658 (5th Cir. 1999)).

80. *See* Aetna Casualty & Surety Co. v. Dow Chem. Co., 44 F. Supp. 2d 847, 857 (E.D. Mich. 1997); *see also* Smith & Nephew, Inc. v. Fed. Ins. Co., No. 02-2455 B., 2005 WL 3434819, at *2 (W.D. Tenn. Dec. 12, 2005).

81. *See Lafarge*, 61 F.3d at 399–400; *see also* Klein, *supra* note 3, at 1106.

82. *See PAJ*, 243 S.W.3d at 636–37.

C. *Insurer's argument that pre-tender costs are voluntary payments*

The second justification insurers use to deny pre-notice defense costs is that such costs are excluded under the voluntary payment provisions of the typical policy. The second justification, however, neither applies to defense costs nor withstands the required prejudice analysis.

The typical voluntary payments policy provision, when "properly construed, does not apply to defense costs at all; rather, the provision is directed toward settlements to which the insurer has not consented."[83] As noted by the Maryland Supreme Court:

> The relevant question as to pre-notice expenses, to be tested against the covenant not to incur unconsented to expenses, is whether the insurer has been prejudiced [;] . . . was it reasonable, under the circumstances, for the insured to have incurred the expense; was the expense reasonable; did the expense materially exceed that which the insurer would likely have incurred in any event had the notice been given earlier?[84]

In situations where the insurer pays for post-tender expenses and fees, the insurer will be hard-pressed to argue the costs are unreasonable. Furthermore, the insurer will have a difficult time arguing it was prejudiced by reasonable expenses incurred by the insured prior to tender when the insurer relies on the defense that was provided.[85]

D. *Application*

Even though *PAJ* and its progeny are silent with regard to the obligation for pre-tender costs, the logical conclusion from the holdings is that pre-tender defense costs are also subject to a prejudice analysis. This is because the Supreme Court of Texas concluded notice is a covenant to coverage.[86] Such treatment is important because a party's breach of a covenant excuses the non-breaching party's performance only when the breach is material to the contract as a whole.[87] On the other hand, breach of a condition precedent excuses performance altogether.[88] With *PAJ*, *Prodigy*, and *XL Specialty*, the Supreme Court of Texas abrogated prior Texas precedents holding notice provisions are conditions that excuse performance irrespective of prejudice. As a result, an insurer's reliance upon *E&L Chipping Company v. Hanover Insurance Company*; *Nagel v. Kentucky*; and *LaFarge Corporation v. Hartford Casualty Insurance Company* is no longer legitimate.

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83. Klein, *supra* note 3, at 1106.

84. Sherwood Brands, Inc. v. Hartford Accident & Indem. Co., 698 A.2d 1078, 1086 (Md. 1997).

85. Peavey Co. v. M/V ANPA, 971 F.3d 1168, 1173 (5th Cir. 1992).

86. *See PAJ*, 243 S.W.3d at 636.

87. *See* Hernandez v. Gulf Group Lloyds, 875 S.W.2d 691, 692 (Tex. 1994).

88. Hohenberg Bros. Co. v. George E. Gibbons & Co., 537 S.W.2d 1, 3 (Tex. 1976).

VII. CONCLUSION

Although the Supreme Court of Texas did not specifically answer the question of whether pre-tender defense costs are recoverable, the decision to interpret timely notice provisions as covenants rather than conditions opens the door in Texas for the recovery of pre-tender costs.

Applying a prejudice analysis to the scenario described in Section I, the subcontractor should recover pre-tender defense costs because the insurer was not prejudiced by the delay. In that scenario, the subcontractor was not aware of its right to a defense, indemnity, or additional insured status until November 1, 2009.[89] At that time, the subcontractor received the contract between the operator and driller, and promptly tendered its demand for defense, indemnity, and treatment as an additional insured.[90] In the intervening eight months, the subcontractor paid for its own defense, completed written discovery, hired experts, and participated in depositions, all while the driller's insurer benefited from and relied on these defense efforts.

The defense by private counsel accomplished all that a defense by the insurer would have accomplished because the insurer would have to complete all of the same tasks as if it had conducted the defense from the inception of the suit.[91] Consequently, it will be challenging for the insurer to establish that it was prejudiced by the timing of the tender. In such a case, the subcontractor should be entitled to all attorney's fees and costs expended from the inception of the suit to the date of tender.[92]

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89. *See, e.g.*, Allstate Ins. Co. v. Darter, 361 S.W.2d 254, 255 (Tex. Civ. App.—Fort Worth 1962, no writ).

90. *See, e.g.*, Cent. Sur. & Ins. Corp. v. Anderson, 446 S.W.2d 897, 902 (Tex. Civ. App.—Fort Worth 1969, no writ).

91. *See* Costagliola v. Lawyers Title Ins. Corp., 560 A.2d 1285, 1289–90 (N.J. Super. Ct. Ch. Div. 1988); *see also* Klein, *supra* note 3, at 1104 ("Where an insured defends itself effectively and efficiently in the period prior to notice, the insurer benefits from the insured's efforts-indeed, had it received notice earlier, the insurer may well have taken the very same measures.").

92. *See* Peavey Co. v. M/V ANPA, 971 F.3d 1168, 1173 (5th Cir. 1992); *see also* Klein, *supra* note 3, at 1104.