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****** SPECIAL REPORT **** SPECIAL REPORT **** SPECIAL REPORT ******

SUPREME COURT OF TEXAS FINDS DUTY TO DEFEND CONSTRUCTION DEFECT ALLEGATIONS UNDER CGL POLICIES – PROMPT PAYMENT PENALTIES ALSO APPLY

In a surprising and sharply divided opinion, last Friday the Supreme Court of Texas answered three certified questions from the Fifth Circuit Court of Appeals and concluded that a general contractor sued for construction defects involving only damage to or loss of use of a home built by the insured contractor was an "accident" and "occurrence" resulting in "property damage" and was sufficiently pled so as to trigger the insurer's duty to defend. In *Lamar Homes Inc. v. Mid-Continent Casualty Co.*, 2007 WL 2459193 (Tex. August 31, 2007), the court refused to address the duty to indemnify observing; "that duty is not triggered by allegations but rather by proof at trial." But, the court concluded that Texas Prompt Payment of Claims Act, formerly Article 21.55 (now Chapter 542), applied to the duty to defend and is triggered when the insured submits a legal bill to the insurer for payment.

The majority opinion focused on the meaning of an "occurrence" and "accident" under the policy and determined that allegations of "*unintended* construction defects" could trigger the duty to defend. Because "accident" is not defined in the policy, the court applied the generally understood meaning of the term as a "fortuitous, unexpected, and unintended event." The majority also found that "a deliberate act, performed negligently, is an accident if the effect is not the intended or expected result; that is, the result would have been different had the deliberate act been performed correctly." In this case the allegations focused on negligent design and defective foundation construction that caused sheetrock and stone veneer to crack. These allegations were also found to constitute "physical injury" to "tangible property" within the meaning of "property damage."

The court examined exclusions j(5) and j(6) excluding ongoing operations and work incorrectly performed but then focused on the subcontractor exception for the "damage to your work" exclusion and the impact of the 1976 ISO Broad Form Property Damage endorsement and related changes made in the 1986 ISO policy form as supporting the court's findings. In response to the assertion that the damages sought here were not for "property damage" but "broken promises and breached duties connected with the sale" or "economic loss rather than property damage," the court abruptly dismissed these arguments stating that the "economic-loss rule, however, is not a useful tool for determining

insurance coverage." The court agreed with a previous ruling from the Fifth Circuit "that 'claims for damage caused by an insured's defective performance or faulty workmanship' may constitute an 'occurrence' when 'property damage' results from the unexpected, unforeseen or undersigned happening or consequence' of the insured's negligent behavior." Thus, the duty to defend was triggered. The complete decision can be found here.

Editors Note: This landmark decision appears to create many more questions than it provides answers. As noted in the dissenting opinion, the majority decision is both wrong and unfortunate. Many carriers will have significant claims problems going forward because of the inference that under similar facts the policy *may* also provide a duty to indemnify. Even more troubling is the application of Texas Insurance Code Chapter 542 – Texas' Prompt Payment of Claims Act with its 18% per annum penalty -- to the duty to defend, a decision that will have far reaching implications for CGL and other liability insurers in many contexts other than construction defect claims. The strict application of Texas' "eight-corners rule" to the duty to defend, combined with the risk of an 18% penalty for claim denials, leaves liability insurers with few choices - either settle, defend, file a DJ action, or risk the penalty regardless of whether a duty to indemnify ever develops. Insurers with Texas claims may be tempted to reopen certain claims following this decision, but any carrier should be extremely mindful of the numerous strategic claim issues implicated by this decision including the varying statutes of limitations periods that may apply to contractual and extra-contractual claims. As numerous questions are raised about both construction defect coverages in Texas and, more importantly, the applicability of Texas Prompt Payment statute to liability claims in general, we will continue to monitor the legal arguments being made and the receptiveness of Texas' courts to such arguments in the weeks and months to come.