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COURT GRANTS SUMMARY JUDGMENT FINDING DUTY TO DEFEND INSURED IN LAWSUIT ARISING FROM FAULTY BOAT REPAIRS

Last Monday, the U.S. District Court in Galveston, Texas analyzed an insurer's duty to defend and indemnify an insured under a Commercial General Liability Policy in a lawsuit against the insured for faulty work on a boat that resulted in the need to replace the entire hull. The court found a duty to defend in favor of the insured and denied the insurer's motion on the duty to indemnify, without prejudice pending the development of further evidence in the case. In *Robert Garner; dba Kustom Kolors Boatworks v. Nautilus Insurance Company*, 2017 WL 1134142 (S.D. Tex. March 27, 2017), the insured worked on a boat to repair cracks "in the fiberglass gel coat" and "other interior structural problems." After the boat was put to routine use, it reportedly developed significant cracks and "the entire hull" was not repairable and allegedly had to be replaced because of the work performed by the insured. A lawsuit was filed and Nautilus refused to defend. A judgment was taken in the underlying case against the insured for $48,375 and then this separate lawsuit in the insured's name was filed against Nautilus.

In the subsequent coverage suit, both parties moved for summary judgment on Nautilus's duty to defend and indemnify under the CGL policy. The court noted the distinction between the duty to defend, as based on a strict eight-corners analysis, and the duty to indemnify as based on the actual facts establishing the insured's liability in the underlying litigation. Addressing the duty to defend, the court declined to review extrinsic evidence and found that the allegation of the limited work performed, resulting in the entire hull needing to be replaced and related loss of use, was sufficiently alleged to trigger coverage under the policy. In doing so, the court rejected Nautilus's more restrictive reading of the factual allegations and found the "property damage" allegation was sufficiently alleged so as to trigger a duty to defend. The court then turned to the exclusions relied upon by Nautilus to deny coverage.

The court examined exclusion **j(4)** for damage to "personal property in the care, custody or control of the insured" and discussed Texas law finding that the exclusion only applies to the "particular object of the insured's work" which the insured "totally and physically manipulates." And here, the court noted it was a "close call" but it did not apply the exclusion under the facts alleged. The court next examined **j(6)** precluding coverage for "property damage to…[t]hat particular part of any property that must be restored, repaired or replaced because "your work" was incorrectly performed on it." The court noted the insured "was hired to repair certain parts of the boat's hull, but his work on those parts had a negative impact on the entire hull and required replacement of the hull as a whole." The court then quoted Texas law addressing the exclusion stating in part that if the insurer wanted the exclusion to apply more broadly, it should say "because 'your work' was incorrectly performed on *any part of* it" and, because it is more limited as worded, the exclusion should not apply under the facts alleged. Similarly, the court examined exclusion **l** for damage to "your work" and found that because the damage alleged went beyond the scope of the work performed by the insured, it did not preclude coverage.

Lastly, the court examined exclusion **d**, the "aircraft, auto or watercraft exclusion" which Nautilus also argued precluded coverage for property damage. Nautilus asserted that the loss was one "arising out of the ownership, maintenance, use or entrustment to others of…watercraft" and the insured's work on the boat and repairs were "maintenance." But, turning to an exception to the exclusion, the court disagreed noting that it does not apply to "(1) A watercraft while ashore on premises you own or rent…." The court found significant the lack of allegations implying the work or repair took place anywhere other than the insured's premises. Accordingly, the court found none of the exclusions applied and Nautilus had a duty to defend the underlying lawsuit. The court also denied the insurer's motion on the duty to indemnify, without prejudice, pending the development of further evidence in the case. In doing so, the court noted in part that Nautilus "correctly points out that the analysis of a duty to indemnify is less favorable to the insured."

PROPERTY MANAGER ENTITLED TO DEFENSE: FEDERAL COURT FINDS CONDO OWNER CLAIMS FALL OUTSIDE OF PROPERTY DAMAGE EXCLUSION

Recently, the U.S. District Court for the Southern District of Texas found an insurer had a duty to defend a property management company after determining that some underlying claims did not fit within the applicable policy's property damage exclusion. In *The Landing Council of Co-Owners v. Federal Insurance Company*, 2017 WL 1092310 (S.D. Tex. 2017), a homeowners' association, The Landing Council of Co-Owners, managed and maintained a condominium development known as The Landing in El Lago, Texas. Federal provided primary and excess insurance coverage to the Council. After Hurricane Ike damaged the Landing in 2008, several condominium owners became frustrated with the Council's handling of the property. Eventually, several condominium owners sued the Council alleging the Council had wrongfully demolished condominium units, tried to improperly sell the property and improperly counted votes on whether the condominium contract should be terminated. Arguing that the property damage exclusion applied to all of the owners' claims, Federal denied coverage. In response, the Council sought a declaratory judgment that it was owed a defense under the policy. Both parties filed motions for summary judgment to bring the issue to a head before the Court.

Applying the eight corners rule, the Court analyzed whether any of the factual allegations from the petitions in the owners' lawsuits triggered a duty to defend under Federal's policy. The applicable policy contained a property damage exclusion excluding coverage for any claims "based upon, arising from, or in consequence of any . . . damage to or destruction of any tangible property." Under

Texas law, the phrase "arising from" requires only a causal connection or relation—not direct or proximate cause. Accordingly, Federal argued that "but for" the damage from Hurricane Ike there would have been no demolition of condos, no attempt to market the property, or no vote on whether to terminate the condominium contracts. In other words, the Court only needed to find a minimal causal connection between the underlying claims and the property damage to for the exclusion to apply. The Council instead insisted that the proper analysis merely required the Court to ask whether the underlying claims could have arisen even if no hurricane damage had occurred. The Federal District Judge adopted the Council's interpretation of the policy exclusion and found that two of the underlying claims could have arisen *even if* Hurricane Ike had never weaved its destructive path through El Lago, Texas. Specifically, the Court found that the property damage exclusion did not apply to the owners' claim that the Council did not have authority to sell the property because its decision-making authority or lack thereof was a separate issue not solely related to the hurricane damage. Similarly, the Court noted the allegation that the Council had improperly counted votes on whether to terminate the condominium contracts could have arisen independently from any hurricane damage. Thus, the Federal Court granted the Council's motion for summary judgment and found Federal had a duty to defend the underlying lawsuits by the condominium owners.

FEDERAL COURT EXAMINES EFFECT OF PROPERTY SALE ON PENDING PROPERTY DAMAGE CLAIM

Recently, a Federal District Court in Dallas undertook a close examination of what really happens to a claim for property damage when the policyholders sell their home, holding the insured may sell the property during claim handling without losing its right to assert a claim, but must still prove it incurred a direct financial loss considering the sale. In *Johnson v. Safeco Ins. Co. of Indiana*, 3:15-CV-1939-B, 2017 WL 879211 (N.D. Tex. Mar. 6, 2017), the Johnsons experienced water damage to their home when a washer overflowed. They considered repairing the damage and making improvements to the home, but decided to sell the home instead. They sold the home to a developer and never disclosed the water damage to the buyer. Three days before the closing, they made a claim with Safeco for the water damage. They continued to occupy the home for several months after closing, but eventually vacated it and the developer demolished it. During Safeco's handling of the claim, the Johnsons did not disclose the home had been sold and actively concealed the fact from the Safeco adjusters.

Safeco initially paid the Johnsons for the minor repairs they had completed. The Johnsons were dissatisfied with the payment and invoked appraisal but, before the appraisal was complete, Safeco learned of the sale and cancelled the appraisal. The Johnsons sued Safeco alleging their claim had been grossly underpaid. Safeco moved for summary judgment on all claims, contending: (a) the Johnsons had no insurable interest in the home due to the sale and (b) the Johnsons had suffered no pecuniary loss due to the sale.

The court quickly concluded the policy terms and basic Texas insurance law only require the policyholder to have an insurable interest at the time the policy was issued and such an interest continued to exist at the time of the loss. A later sale of the property will not change that interest. The court stated: "Plaintiffs undisputedly owned the house when the Policy was issued and when the washing machine overflowed and caused damage. Plaintiffs have therefore met their burden of proving an insurable interest – apparent foot dragging in filing their claim with Safeco does not change that."

The stickier question was whether the Johnsons had suffered any pecuniary loss after selling the home with no apparent diminution in value. The positions of the parties were starkly stated: the Johnsons contended the correct measure of loss was the cost of repair and they were entitled to the actual cash value of the repair costs at the time of the loss regardless of whether any repairs were ever made. Safeco, in contrast, contended the insureds' recovery was limited under both Texas law and the policy terms to the direct financial loss they incurred and they had incurred none due to the sale.

The court agreed with the Johnsons that a policyholder is not required to make repairs in order to recover actual cash value benefits. Under Texas law, the insured has the option of collecting the money and retaining the property in its damaged state. But the court also agreed with Safeco that basic principles of Texas insurance law limit a policyholder's recovery to the amount of the actual loss, and that there is no pecuniary loss when the loss has been made good by a related transaction. Thus, the court concluded the policy's loss settlement provision is not a "blanket entitlement to recovery absent repair," but rather is limited to the direct financial loss suffered by the policyholder.

This legal conclusion created a rather thorny fact issue which prevented Safeco from winning summary judgment. The court concluded the parties must dig into the sale of the home and determine whether the Johnsons actually suffered a direct financial loss, examining the totality of the transaction. This included the need to determine answers to questions such as whether the property sold for less than fair market value, the effect of the Johnsons' rent-free occupancy of the home for the several months between sale and demolition, whether the buyer knew of the water damage and whether it impacted its offer, and several other similar issues. Although the court did not state it explicitly, proving a direct financial loss would appear to be the policyholders' burden under Texas law.

Editor's Note: Although this ruling appears on the surface to be a loss for the carrier in this case, in some respects it is a win for the insurance industry as a whole, because it makes clear that a policyholder cannot sell the property (particularly at a profit) during claim handling and expect the court to disregard that fact. It also implies that the sale of the property is a material fact, and thus active concealment of it may fall within the scope of the policy's fraud and concealment clause. Thus, it is in a policyholder's best interest to promptly and fully disclose a sale or contemplated sale and allow the insurer ample opportunity to inspect the property and complete its investigation before surrendering possession of the property.

HOUSTON COURT OF APPEALS EXAMINES EFFECT OF BUYING PROPERTY ON PROPERTY DAMAGE CLAIM

While the Dallas federal court was looking at the effect of a sale, a Houston appellate court recently examined the reverse situation – what happens to coverage when a former mortgagee forecloses on the property and buys it at foreclosure? In *Westview Drive Investments v. Landmark American Ins. Co.*, 2017 WL 830510 (Tex. App. – Houston [14th Dist.] February 28, 2017), the 14th Court of Appeals in Houston upheld the policy's anti-assignment clause, holding an insurer was not required to grant full named-insured status to a buyer of the property who was not actually been added to the policy as a named insured.

Westview was listed on the policy as a mortgagee, but it assumed ownership of the property after foreclosure. Before Westview could be added to the policy as named insured, the property burned. Landmark refused to acknowledge Westview as a named insured on the property and made only the payments it would be entitled to as mortgagee – physical damage to the structure only and ***not*** business income, accounts receivable, or business personal property. The trial court granted partial summary judgment in favor of the insurer, holding Westview was only entitled to mortgagee coverage. The case was tried and the jury found Landmark had not breached the policy. After trial, this appeal followed.

The court first observed that upon buying the property, Westview did not automatically acquire the same rights as the prior owner, particularly noting the policy expressly prevents transfer of the insured's rights in the policy without consent. The court then held Westview was not entitled to an equitable lien on the prior owner's rights in the insurance policy because the former owner's obligations had been extinguished by the foreclosure and sale. Westview's final bid for full coverage was under Texas Insurance Code Section 862.055, which it alleged allows a mortgagee to recover fully on a fire insurance policy if the named insured cannot do so. The court rejected this argument, finding it only *protects*, and does not *expand*, the mortgagee's interest. The court affirmed the summary judgment in favor of Landmark. After affirming this issue, the court went on to affirm the jury's finding that in paying mortgagee benefits only, Landmark had not breached the policy or engaged in any unfair or deceptive acts.

WRONGFUL FORECLOSURE NOT COVERED UNDER COVERAGE A OR COVERAGE B OF LIABILITY POLICY

The Fort Worth Court of Appeals recently affirmed summary judgment in favor of State Farm in a case involving an alleged wrongful foreclosure. In *Eugene and Mary McClain v. State Farm Fire & Cas. Co.*, 02-16-00315-CV, 2017 WL 817152 (Tex. App.—Fort Worth Mar. 2, 2017, no. pet. h.), State Farm's insureds, the McClains, sold a home to the Ramirezes for $60,500 and executed a promissory note which specified monthly payments over 18 years. Eight years into the transaction, the McClains accelerated the note and foreclosed on the property, ultimately buying it back at the foreclosure sale for $42,000. The Ramirezes sued the McClains, setting forth a detailed timeline of the parties' dealings and alleging the McClains made verbal demands, slurs, and engaged in unfair debt collection practices including intimidation and threats as part of their wrongful foreclosure process. The Ramirezes continued to occupy the property for at least four months after the foreclosure sale and repurchase by the McClains.

The McClains sought a defense under their umbrella policy issued by State Farm. State Farm refused to defend them, and the McClains defended themselves, ultimately going on to win the case. In the process, the McClains incurred $36,000 in defense costs and they sued State Farm for these costs, alleging State Farm should have defended the suit. State Farm won summary judgment in the state district court, and this appeal followed.

The Ft. Worth Court of Appeals examined potential coverage for the Ramirezes' allegations under the Texas eight-corners rule, looking to both Coverage A (bodily injury) and Coverage B (personal injury). The McClains argued the suit should have been defended under Coverage B because some of the allegations fell within the "wrongful eviction/wrongful entry" aspect of "personal injury" under Coverage B. Notably, this part of the definition requires the insured to be acting as an owner, landlord, or lessor. The McClains relied heavily on the lack of specific dates in the petition, arguing some of the alleged acts could have taken place after the foreclosure, at which time the McClains became the owners of the property. The court acknowledged that under the rule of liberal construction, when the dates of the critical allegations cannot be determined, and they can reasonably be inferred to have occurred at a time that would create a duty to defend, then the court must find a duty to defend. But here, the petition set out a very clear timeline of when the events in question occurred, ending with the foreclosure, and thus prevented a reasonable inference that any of the wrongful acts alleged took place while the McClains were acting as owners of the property. Therefore, there was no duty to defend under Coverage B.

The McClains also argued that the Ramirezes' allegation they had suffered mental anguish should bring the suit within Coverage A. The court again disagreed noting the definition of "bodily injury" expressly includes mental anguish ***caused by the bodily injury***, but does not create coverage for a "stand-alone" claim for mental anguish.

Editor's Note: Although the opinion is unpublished, this is a potentially significant ruling because it helps to establish the boundaries of liberal construction when no dates of specific wrongful acts are expressly alleged in a petition being examined under a liability policy. The court took a common-sense approach and concluded that if there are enough clues in the petition to infer that event A must have occurred before event B, and that timeline is determinative of coverage, then the petition is not ambiguous in that regard. The lesson learned is that when a petition includes a detailed recounting of events in chronological order, express dates may not be necessary to make certain coverage determinations. And, the argument that "the petition is silent as to key dates; therefore, you must find in favor of coverage" may fall flat.

FEDERAL COURT ISSUES POST-REMAND RULINGS ON IMPAIRED PROPERTY EXCLUSION IN U.S. METALS CASE

After the Fifth Circuit issued its landmark opinion construing the "impaired property" exclusion in July 2016 in *U.S. Metals*,[1] it remanded the suit for further proceedings giving the original district court the opportunity to apply the Fifth Circuit's ruling. The district court recently issued its follow-up opinion, in which it made a determination of exactly what damages in the underlying suit the insurer must pay. *U.S. Metals, Inc. v. Liberty Insurance Corp.* 4:12-CV-0379, 2017 WL 830398 (S.D. Tex. Feb. 27, 2017).

Liberty Mutual argued the Fifth Circuit only mentioned the "insulation and gaskets" in the key sentence of its coverage holding, while U.S. Metals argued the court's holding should be applied more broadly to mean that all property which was damaged or destroyed in the process of removing the faulty flanges should be covered. Applying a careful analysis of the Fifth Circuit's wording, its statements in earlier portions of the opinion, and the coverage concepts at issue, the district court agreed with U.S. Metals and held the insurer must also indemnify U.S. Metals for the temperature coatings and welds that were also destroyed in the process of removing the faulty flanges.

In light of the Fifth Circuit's coverage ruling, the district court also re-examined U.S. Metals' claim for defense costs and associated

Insurance Code Chapter 542 penalties.[2] Here, the court made two troubling conclusions. ***First***, relying on the fact that Liberty Mutual knew its insured was going to be sued, the court held Liberty Mutual owed for defense costs incurred by U.S. Metals before the suit had even been tendered to Liberty Mutual. This conclusion arguably contradicts well-developed Texas law which holds that tender of the suit is an essential condition precedent which must be fulfilled *before* any duty to defend can be triggered, even if the carrier has actual knowledge of the suit.[3] ***Second***, the court held that because neither party presented any evidence segregating defense costs from costs incurred by the same attorneys to pursue coverage issues, Liberty Mutual owed all the defense costs, even though it was undisputed that U.S. Metals' attorneys had spent some of their time also serving as coverage counsel. By placing the burden on Liberty Mutual to segregate the covered versus non-covered defense costs, the court arguably disregarded clearly established Texas law placing that burden solely on the insured.

The district court, did however, grant summary judgment for Liberty Mutual on all extra-contractual claims.

See our previous coverage of this case on July 15, 2013, September 30, 2014,and December 8, 2015.

1 *U.S. Metals, Inc. v. Liberty Mut. Group, Inc.*, 654 Fed. Appx. 664 (5th Cir. 2016).

2Although Chapter 542 only applies to first party claims, current Texas law holds that an insured's claim for defense costs under a liability policy is a first-party claim. See *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 16 (Tex. 2007).

3 See *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Crocker*, 246 S.W.3d 603 (Tex. 2008).