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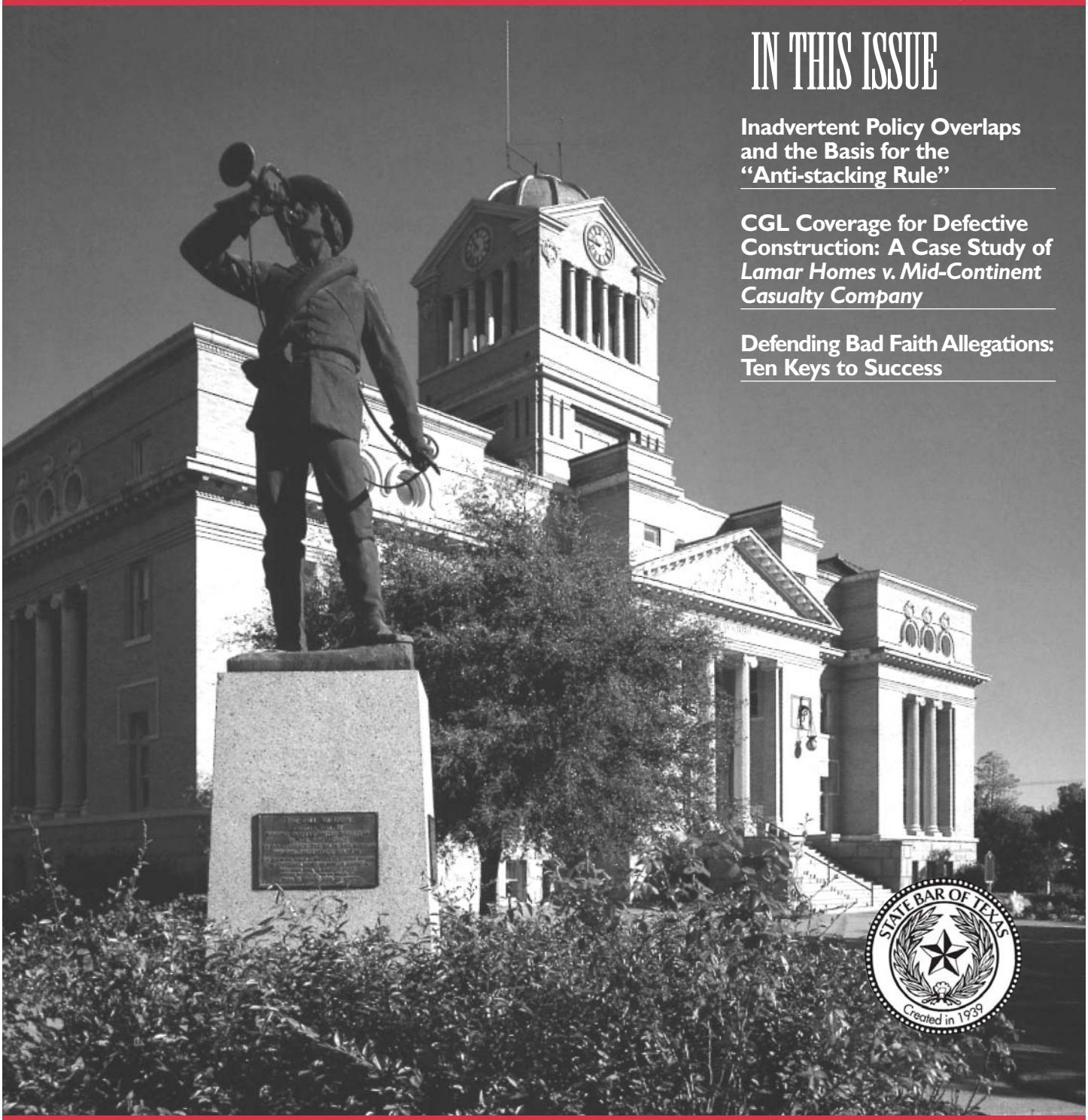

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Official publication of the Insurance Law Section of the State Bar of Texas

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Anyone interested in submitting a manuscript for publication should contact Christopher W. Martin, Editor of ***The Journal of Texas Insurance Law***, at 713-632-1701 or by email at martin@mdjwlaw.com. Manuscripts for publication must be typed double-spaced with endnotes (PC-compatible disks are appreciated). Replies to articles published in the ***Journal*** are welcome.

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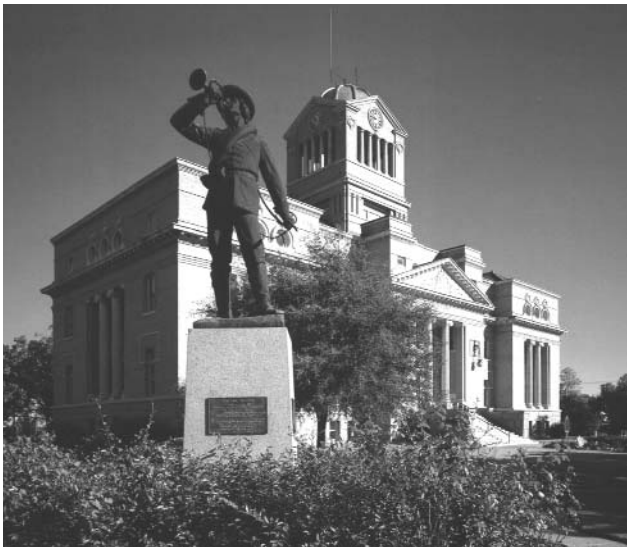
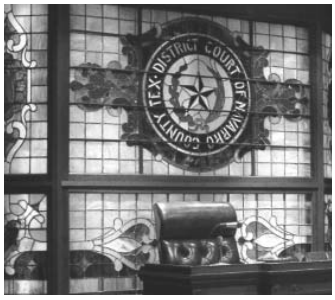


On the Cover:
A statue of a young Confederate trumpeter honors Navarro County's citizens who fought in the Civil War. The Beaux Arts-style courthouse was completed in 1905 at a cost of $150,000. The brick building was built on a base of pink granite from Burnet County and decorated with terra-cotta capitals and cornices.



District court cases in Navarro County are heard in the elegant Corsicana courtroom. A 1964 remodeling utilized elements like stained glass and cast-plaster motifs from the original 1905 interior.

Courtesy of *Texas Highways* magazine

STATE BAR OF TEXAS
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Comments FROM THE CHAIR

BY VERONICA CARMONA CZUCHNA
Jordan & Carmona, P.C.

As we draw to a close of this 2005-2006 Bar year, we continue to await decisions in several significant insurance cases pending before the Texas Supreme Court. Perhaps due to changes on the Court and/or to school finance litigation and legislation, we still are waiting on decisions that, frankly, many of us had anticipated – or, rather, hoped – would be issued by now. The Section intends to present telephone seminars as those significant cases are decided through the coming year. In the meantime, we are planning to webcast a Supreme Court preview of those cases with both policyholder and insurer perspectives. Watch for details in the coming weeks.

One of the cases which was argued only recently to the Court was *Lamar Homes*, which deals with coverage for construction defects and Article 21.55. Lee Shidlofsky argued the case for the policyholder, and now has written an article for this issue of the *Journal* responding to Kipper Burke's article presenting an insurer's perspective on the subject in our last *Journal* issue. The Section strives to balance the interests of both policyholder lawyers and insurance company lawyers, and we invite you, our members, to submit responsive articles presenting counterpoints or "the other perspective."

The Section is pleased to announce that the inaugural recipient of the Ben Love Memorial Insurance Law Section Scholarship is Elisabeth Wilson of SMU Law School. The scholarship was established in memory of Benjamin Love, our friend and colleague, well-respected insurance practitioner, and former Insurance Law Section Council member, who passed away in 2004. At the Section's annual meeting in Austin on June 15th, we presented the scholarship to Ms. Wilson. Irene Love joined us for the presentation of this scholarship in her late husband's honor. Look for photos in the next issue of the *Journal*.

If you have not looked lately, take a minute to see our Section's website, www.txins.org. It provides updates of Section events and other helpful tools.

Veronica Carmona Czuchna
Chair, Insurance Law Section

BY DAVID CLAY WILKERSON

RYMER, MOORE, JACKSON & ECHOLS, P.C.

Inadvertent Policy Overlaps and the Basis for the "Anti-stacking Rule"

Insureds may not "stack" the limits of consecutive liability policies in Texas. "No stacking" is one of the rare certainties in Texas insurance coverage jurisprudence. When asked, any practitioner who has read the Texas Supreme Court's opinion in *Garcia v. American Physician's Ins. Exchange* will respond, without equivocation, that stacking is not permitted. The Northern District of Texas recently handed down its *Erie* guess as to the application of the *Garcia* rule under a unique set of facts in *RLI v. Philadelphia Indemnity Insurance Company, et al.*, --- F.Supp.2d ----, 2006 WL 680472 (N.D. Tex. Mar 15, 2006). This case, and the Northern District court's ruling, raise a more fundamental question -- whether the *Garcia* rule has its basis in equity or in the law of contract.

The parties in *RLI v. Philadelphia* stipulated to all of the following facts. The underlying lawsuit involved allegations of nursing home neglect spanning two policy periods. The allegations were of a single, continuous injury coextensive with the alleged period of residency. The Philadelphia primary policy, with limits of $1,000,000.00 per occurrence, was originally issued to be effective from October 1, 1998 until 12:01 a.m., Standard Time, October 1, 1999. Philadelphia issued the excess policy above its own primary, with the same effective period. Philadelphia declined to renew its coverage, and on August 25, 1999, mailed Notices of Non-Renewal of Insurance. August 25, 1999 was only thirty-seven (37) days from the original expiration date of the Philadelphia policies (October 1, 1999). Believing that thirty-seven days was insufficient notice of non-renewal, Philadelphia issued an endorsement, purporting to extend the expiration date of the Philadelphia policies by twenty-seven (27) days, from October 1, 1999 to October 28, 1999. This (27) day extension effectively provided the insured with sixty (60) days notice of non-renewal, plus three (3) days for mailing.

The insured did not request the twenty-seven (27) day extension of coverage, nor did it pay any additional premium for that extension. The coverage extension was provided by Philadelphia on its own initiative, and for no additional premium, in order to ensure that the insured was provided with sufficient notice of non-renewal and sufficient time to acquire new coverage without creating a "gap" in coverage. The insured never requested that Philadelphia provide any coverage that would overlap in time with any other insurance policy, and Philadelphia never intended to provide any coverage to the insured that would overlap in time with any other insurance policy. Rather, Philadelphia intended to ensure that the insured had sufficient time in which to acquire replacement coverage.

The insured did in fact acquire replacement coverage without any gap by having the insured facility in question added by endorsement to an existing policy with USF, effective October 1, 1999. RLI issued the excess policy above the USF primary policy. The underlying lawsuit was settled at mediation for a total amount of $3,900,000. Of that amount, $500,000 was paid under the Philadelphia primary policy, $500,000 was paid under the USF primary policy, $450,000 was paid under the Philadelphia excess policy, and $2,450,000 was paid under the RLI excess policy.[1]

RLI asserted that $1,000,000 should have been paid under both the Philadelphia and USF primary policies, for a total amount of $2,000,000. RLI based this assertion on the twenty-seven (27) day coverage extension endorsement issued by Philadelphia, which technically overlapped with the beginning of coverage for the insured facility under the USF primary policy. The United States District Court for the Northern District of Texas, Fitzwater, J., agreed.

David Clay Wilkerson practices insurance coverage law with Rymer, Moore, Jackson & Echols, P.C. in Houston, Texas.

Both sides relied on *American Physicians Ins. Exchange v. Garcia*, 876 S.W.2d 842 (Tex. 1994). The court explained that, while *Garcia* did not directly support either side's position, it did inform the court's conclusion. The court's resolution of the stacking question was based on a hypothetical in which a single continuous occurrence triggered three consecutive primary policies, the first and last policies with one million dollar limits and the middle policy with two million dollar limits. Conceding that the hypothetical was not literally equivalent to the facts before it, the court nevertheless found it analogous and explained that under such a hypothetical, the application of *Garcia* was clear that the insured should be entitled to a total limit equal to whatever limit applied at the single point in time when the insured's limits were highest, i.e., two million dollars.

The main argument asserted by Philadelphia and USF was that *Garcia* was fundamentally based on the principle that the insured should receive no more coverage than it bargained for, and that stacking was therefore only appropriate in instances of "co-insurance by design," e.g., concurrent primary and umbrella coverage, while the facts at issue were of an "inadvertent overlap." The Northern District agreed that *Garcia* could reasonably be read to stand for the proposition that the insured should get only the benefit of its bargain, but pointed out that, while the insured received the Philadelphia coverage extension for free, it had paid a premium for the one million dollars in coverage from USF during the overlap period.

Philadelphia argued, in the alternative, that coverage should be pro-rated according to "time on the risk," and the two primaries should contribute equally to the twenty-seven days of two million dollar coverage. The court rejected this approach, pointing out that the Austin Court of Appeals had twice rejected the same argument, once in the context of the duty to defend and once in the context of the duty to indemnify. *See Tex. Prop. & Cas. Ins. Guar. Ass'n v. Southwest Aggregates, Inc.*, 982 S.W.2d 600, 605 (Tex. App. – Austin 1998, no pet.); *CNA Lloyds of Texas v. St. Paul Ins. Co.*, 902 S.W.2d 657, 661 (Tex. App.-- Austin 1995, writ dism'd by agreement). The court discussed the influential decision of the D.C. Circuit Court of Appeals in *Keene Corp. v. Insurance Co. of N. Am.*, 667 F.2d 1034 (D.C. Cir. 1981), cert. denied, 455 U.S. 1007, 102 S.Ct. 1644, 1645, 71 L.Ed.2d 875 (1982), on which the Austin Court of Appeals and the *Garcia* court relied. Both the *Keene* court and the Austin court held that any insurer whose policy is triggered is fully liable to the insured for its full limits as there was nothing in the policies providing for a reduction of the carrier's liability if the injury occurred only in part during the policy period. Each triggered carrier thus is liable for its full policy limits, and its only redress is against other triggered carriers under the right of equitable subrogation. The Northern District court opined that this conclusion was consistent with the holding of *Garcia* in that *Garcia* did not adopt a pro-rata approach, and concluded that the Texas Supreme Court would follow the Austin Court of Appeals in focusing on the contractual obligations created by the policies rather than common law doctrines. The Northern District pointed out that "by contract" the insured had two million dollars in primary coverage during the twenty-seven day overlap, and held that it was entitled to that higher limit. Turning again to the primary carriers' argument that *Garcia* limits the insured to the coverage that it bargained for, the Northern District explained that "[the primary carriers] should not be surprised that they must indemnify [the insured] for $1 million. Each insurer agreed to accept a premium in exchange for the risk of exposure up to $1 million; this is the very nature of insurance coverage.

Is the "no stacking" holding of *Garcia* grounded in equity or in the law of contracts? When viewed through the lens of contract law, the "no stacking" rule appears at odds with the proposition that each carrier triggered by a single continuous occurrence is *fully liable* to the insured for its policy limits. The logical result of this "fully liable rule" is the application of multiple limits to the same occurrence: two hypothetical carriers issuing two consecutive one million dollar policies that are triggered by even part of an occurrence each are fully liable to their mutual insured up to one million dollars each, for a total of two million dollars. Their recourse is to pursue their right of equitable subrogation against one another. If the hypothetical judgment or settlement is less than two million dollars and the paying carrier recovers half from the non-paying carrier, it has, in the final analysis, paid less than its limit. However, if the judgment or settlement is two million dollars or greater, each carrier will pay its full limit for a total benefit to the insured of two million dollars. Where the judgment or payment is greater than two million, each carrier pays its limit and has no recourse, as a practical matter against the other. This result obtains, again, because each triggered carrier, according to the Austin Court of Appeals, and arguably *Garcia*, is fully, not partially, liable to protect the insured. This is what the contracts themselves require.

However, applying the rule against stacking to the above hypothetical significantly alters the result that contract law would seem to dictate. Instead of being fully liable up to the policy limits, under the rule against stacking each carrier can ultimately only be liable for half of the policy limit for which it took a premium, even though "there is nothing in the policies that provides for a reduction of the insurer's liability if an injury occurs only in part during a policy period." *RLI v. Philadelphia*, at *7 (quoting *Keene Corp.* at 1048; and citing *CNA Lloyds*, 902 S.W.2d at 661). Indeed, perhaps there is "nothing in the policies" that provides for such a reduction but there is certainly something that so provides – the rule against stacking.

Is the rule against stacking an equitable instrument, in the nature of equitable subrogation, rather than a strict application of contractual obligations? If so, what precisely are the equities involved? At this point, the best that can be said is that the *Garcia* rule against stacking provides for such a reduction where consecutive policies are triggered, and that it seems to reject the arbitrariness of awarding the insured more coverage than it bargained for based on the timing of the occurrence. The question *Garcia* left unanswered, of course, is if any conceivable instance of concurrent coverage permits stacking, and if not, how and where are the lines to be drawn. The *Garcia* opinion includes only one type of concurrent coverage that can be stacked:

> At no time during the four relevant coverage years did any two policies overlap. Thus, at no time during the four years did Garcia carry liability insurance with a per-occurrence limit greater than $500,000. Garcia did not purchase malpractice insurance for $1.5 million in coverage, as he might have done by purchasing excess or umbrella coverage, [FN23] and therefore he may not claim to benefit from $1.5 million in coverage by stacking temporally distinct policies.

Garcia at 854-855. Likewise, footnote 23 to the *Garcia* opinion references only instances where the insured had specifically bargained for multiple limits by purchasing excess or umbrella coverage:

> See, e.g., *Chicago Ins. Co. v. Pacific Indem. Co.*, 566 F. Supp. 954 (E.D. Pa. 1982) (discussing excess coverage in a dispute between primary and excess malpractice insurers); *Olympic Ins. Co. v. Employers Surplus Lines Ins. Co.*, 126 Cal. App. 3d 593, 178 Cal. Rptr. 908 (1981) (discussing excess coverage when insured had four layers of excess coverage above two primary policies); see also *American Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 485-86 (Tex. 1992) (Hecht, J., concurring, joined by Phillips, C.J., Gonzalez, Cook, and Cornyn, JJ.) (discussing primary insurer's duty to settle when insured has purchased temporally concurrent excess coverage); *Syverud*, supra at 1193-1207 (analyzing duty to settle in context of reinsurance and excess insurance).

Id. at n. 23. The question presented in *RLI v. Philadelphia* was whether an overlap, of any length of time, that was "inadvertent" from the standpoint of the insured, permits stacking of the policies that overlap. The broader questions raised are whether the *Garcia* anti-stacking rule is grounded in contract law or rather is best understood as an equitable doctrine, and if so, precisely what are the equities involved. These questions may go unanswered until the Texas Supreme Court has cause to revisit the anti-stacking rule announced in *Garcia*.

1. While issues regarding the appropriate amounts payable at the excess layer were submitted to the court, the court's ruling in favor of RLI on the issue of the primary limits made resolution of the excess issues unnecessary.

BY LEE H. SHIDLOFSKY

CGL Coverage for Defective Construction: A Case Study of *Lamar Homes v. Mid-Continent Casualty Company*

I. INTRODUCTION

Over the past few years, an increasing number of opinions have been issued by appellate courts and federal district courts sitting in Texas and across the country addressing commercial general liability ("CGL") coverage for defective construction claims. Although the great majority of the case law purports to interpret standard policy language, the case law is decidedly split.

Most of the focus, at least as of late, has been on the "property damage" and "occurrence" requirements in the insuring agreement as well as on extraneous legal theories like the "business risk" rationale and/or the "economic loss" rule. In fact, oftentimes CGL insurers never raise or otherwise invoke any of the construction-specific exclusions that were designed to specifically delineate the scope of coverage afforded by a CGL policy for construction defect claims. In undertaking this myopic analysis of the CGL policy, insurers (and sometimes courts) ignore the fact that the construction-specific exclusions would be rendered mere surplusage if defective construction claims were found to automatically run afoul of the policy's "property damage" and "occurrence" requirements. Moreover, in failing to read and apply the policy as a whole, insurers deprive insureds of paid-for coverage that is clearly contemplated by the CGL policy.

A prior version of this article, which was published in this publication at 5:1 J. Tex. Ins. L. 37 (Feb. 2004), set forth a fairly typical hypothetical construction defect claim and then analyzed CGL coverage as applied to the hypothetical claim. In this article, however, the focus will be on the *Lamar Homes, Inc. v. Mid-Continent Casualty Company* case that is currently pending before the Supreme Court of Texas via certified questions from the Fifth Circuit Court of Appeals. In particular, this article will explore the legal arguments as raised by both Lamar Homes, Inc. ("Lamar Homes") and Mid-Continent Casualty Company ("Mid-Continent"). At the same time, this article will respond to the arguments set forth by Kipper Burke in the last edition of this publication. See Christopher "Kipper" Burke, *Coverage for Construction Defects under a Commercial General Liability Policy—Clarifying the Confusion*, 7:1 J. Tex. Ins. L. 16 (Spring 2006).[1]

II. FACTUAL BACKGROUND

A. The Underlying Lawsuit

In April 1997, Vincent and Janice DiMare entered into a contract to purchase a home constructed by Lamar Homes. After completion, the DiMares allegedly discovered some physical damage to the stone veneer and sheetrock that was allegedly caused by defects in the design and/or construction of the foundation. In March 2003, the DiMares filed suit against Lamar Homes and its subcontractor claiming that Lamar Homes was negligent and failed to design and/or construct the foundation of the DiMares' residence in a good and workmanlike manner in accordance with implied and express warranties.

The DiMares alleged that defects in the foundation caused: (i) excessive deflection of the foundation; (ii) cracks in the sheetrock; (iii) cracks in the stone veneer; and (iv) binding and ghosting doors. In their petition, the DiMares alleged that an engineer retained by Lamar Homes prepared the foundation design, that another subcontractor poured the foundation, and that the engineer then inspected and approved the foundation at various points during construction. It is clear from the pleadings that Lamar Homes, itself, did not design or construct the foundation. Instead, Lamar Homes relied on the expertise of an engineer and a foundation subcontractor. Yet, given the fact that Lamar Homes was in contractual privity with the DiMares, Lamar Homes was sued for damages.

B. The District Court Case

Lamar Homes timely tendered the DiMares lawsuit (the "Underlying Lawsuit") to Mid-Continent for defense and indemnity pursuant to the terms of the CGL policy. Mid-

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Continent, however, refused to defend Lamar Homes. More specifically, Mid-Continent relied on the following reasons to deny coverage: (i) the "economic loss" rule negates the DiMares' tort claims; (ii) a CGL policy distinguishes between tort liability and liability flowing from a breach of contract or breach of warranty; (iii) property damage to the home flowing from a breach of contract is inherently foreseeable and thus not an "occurrence" under a CGL policy; (iv) damages flowing from defective work in breach of a construction contract are necessarily an uninsured economic loss; (v) upholding coverage for property damage arising out of defective work transforms the CGL policy into a performance bond; and (vi) defective workmanship is an uninsurable business risk. Although some exclusions were mentioned in the denial letter, the focus of Mid-Continent's denial was clearly on the "property damage" and "occurrence" requirements in the CGL policy.

After receiving the denial, Lamar Homes filed suit against Mid-Continent. In response to Mid-Continent's defenses, Lamar Homes argued that: (i) the economic loss rule is a *liability* defense and has no effect whatsoever on the coverage determination under a CGL policy; (ii) nothing in a CGL policy's insuring agreement distinguishes between tort liability and contract/warranty liability; (iii) the use of foreseeability as the test for whether an "occurrence" has been alleged is inherently wrong and would result in illusory coverage; (iv) the policy language specifically provides coverage for damages that the insured becomes legally obligated to pay as damages because of "property damage," including economic losses that arise out of otherwise covered "property damage"; (v) while a performance bond and a CGL policy are undoubtedly different, they are not necessarily mutually exclusive when it comes to physical injury to tangible property; and (vi) the "business risk" rationale espoused by Mid-Continent is embodied in the CGL policy, at least to some extent, in the business risk exclusions and thus the focus should not be on the insuring agreement.

Lamar Homes and Mid-Continent filed cross-motions for summary judgment. The district court ruled in favor of Mid-Continent. Basically, even though the Underlying Lawsuit was still pending, the district court applied the economic loss rule and concluded that the DiMares' tort allegations were not viable. Then, the district court concluded that the remaining breach of contract and breach of warranty claims were an uninsurable business risk that ran afoul of the policy's "occurrence" and "property damage" requirements. More specifically, the district court reasoned that because the gravamen of the Underlying Lawsuit sought relief for a breach of contract resulting in pure economic loss, Mid-Continent was not obligated to provide a defense under the CGL policy. The district court further concluded that this result was mandated by *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617 (Tex. 1986). In so holding, the district court noted that "[t]he purpose of comprehensive liability insurance coverage for a builder is to protect the insured from liability resulting from property damage (or bodily injury) caused by the insured's product, but not for the replacement or repair of that product." Lamar Homes v. Mid-Continent Cas. Co., 335 F. Supp. 2d 754, 759 (W.D. Tex. 2004).

C. The Appeal to the Fifth Circuit and Subsequent Certification to the Supreme Court of Texas

Lamar Homes appealed the district court's judgment to the Fifth Circuit. Shortly before oral argument, the Fifth Circuit certified three questions to the Supreme Court of Texas:

(i) When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege an "accident" or "occurrence" sufficient to trigger the duty to defend or indemnify under a CGL policy?

(ii) When a homebuyer sues his general contractor for construction defects and alleges only damage to or loss of use of the home itself, do such allegations allege "property damage" sufficient to trigger the duty to defend or indemnify under a CGL policy?

(iii) If the answers to certified questions 1 and 2 are answered in the affirmative, does article 21.55 of the Texas Insurance Code apply to a CGL insurer's breach of the duty to defend?

The Supreme Court accepted the certified questions. After additional briefing was filed, the Supreme Court heard oral arguments on February 14, 2006.[2] The remainder of this article will address the first two certified questions.

III. DUTY TO DEFEND, DUTY TO INDEMNIFY, CONTRACT INTERPRETATION PRINCIPLES, AND BURDEN OF PROOF

Before addressing the specific coverage issues raised by *Lamar Homes*, it is important to set out the standards by which insurers must base their coverage decisions. In particular, as with most states, Texas has different rules depending on whether the insurer is analyzing the duty to defend as contrasted with the duty to indemnify. Likewise, Texas courts must follow certain contract interpretation principles in analyzing an insurance policy.

A. The Duty to Defend

Texas courts apply the "eight corners rule" to determine whether an insurer has a duty to defend its insured. *See Nat'l*

Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc., 939 S.W.2d 139, 141 (Tex. 1997); *Northfield Ins. Co. v. Loving Home Care, Inc.*, 363 F.3d 523, 528-35 (5th Cir. 2004). In undertaking the "eight corners" analysis, a court of appeals must compare the allegations in the live pleading to the insurance policy without regard to the truth, falsity, or veracity of the allegations. *See King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 191 (Tex. 2002); *Northfield*, 363 F.3d at 528. Facts ascertained before suit, developed in the process of litigation, or determined by the ultimate outcome of the suit do not affect the duty to defend. *See Trinity Universal Inc. Co. v. Cowan*, 945 S.W2d 819, 829 (Tex. 1997); *Northfield*, 363 F.3d at 528. Thus, in most circumstances, extrinsic evidence cannot be considered to determine the duty to defend.[3] *See Northfield*, 363 F.3d at 531; *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, 267 F. Supp. 2d 601, 621-22 (E.D. Tex. 2003); *Fielder Road Baptist Church v. GuideOne Elite Ins. Co.*, 139 S.W.3d 384, 388 (Tex. App.—Fort Worth 2004, pet. granted); *Tri-Coastal Contractors, Inc. v. Hartford Underwriters Ins.*, 981 S.W.2d 861, 863 (Tex. App.—Houston [1st Dist.] 1998, pet. denied).

Under the "eight corners rule," the allegations in the pleadings are given a "liberal interpretation." *See Merchants Fast Motor Lines*, 939 S.W.2d at 141; *Guar. Nat'l Ins. Co. v. Arock Indus.*, 211 F.3d 239, 243 (5th Cir. 2000). Any doubts must be resolved in favor of the insured. *See Merchants Fast Motor Lines*, 939 S.W.2d at 141; *Harken Exploration Co. v. Sphere Drake Ins. PLC*, 261 F.3d 466, 474 (5th Cir. 2001). Moreover, even if the underlying plaintiff's allegations do not clearly show there is coverage, the insurer, as a general rule, will be obligated to defend if there is, potentially, an action alleged within the coverage of the policy. *See Merchants Fast Motor Lines*, 939 S.W.2d at 141; *Harken*, 261 F.3d at 471. Likewise, if the potential for coverage is found for any portion of a suit, the insurer must defend the entire suit. *See St. Paul Ins. Co. v. Tex. Dep't of Transp.*, 999 S.W.2d 881, 884 (Tex. App.—Austin 1999, pet. denied); *Northfield*, 363 F.3d at 528. Accordingly, alternative allegations of intentional and even malicious conduct will not defeat the duty to defend if combined with allegations that would otherwise trigger a potential for coverage. *See Harken*, 261 F.3d at 474; *Stumph v. Dallas Fire Ins. Co.*, 34 S.W.3d 722, 729 (Tex. App.—Austin 2000, no pet.).

Finally, it is uniformly accepted that the duty to defend is broader than the duty to indemnify. *See Burlington Ins. Co. v. Tex. Krishnas, Inc.*, 143 S.W.3d 226, 229 (Tex. App.–Eastland 2004, no pet.); *E&L Chipping Co. v. Hanover Ins. Co.*, 962 S.W.2d 272, 274 (Tex. App.—Beaumont 1998, no writ); *Northfield*, 363 F.3d at 528. Accordingly, an insurer may have a duty to defend even when the adjudicated facts ultimately result in a finding that the insurer has no duty to indemnify. *See Utica Nat'l Ins. Co. v. Am. Indem. Co.*, 141 S.W.3d 198, 203 (Tex. 2004); *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex. 1997).

…if the potential for coverage is found for any portion of a suit, the insurer must defend the entire suit.

B. The Duty to Indemnify

It is well-settled that the duty to defend and the duty to indemnify are distinct and separate duties. *See Griffin*, 955 S.W.2d at 82; *Cowan*, 945 S.W.2d at 821-22. In contrast to the duty to defend, the duty to indemnify is not based on the third-party claimant's allegations, but rather upon the actual facts that comprise the third party's claim. *See Am. Alliance Ins. Co. v. Frito-Lay, Inc.*, 788 S.W.2d 152, 154 (Tex. App.—Dallas 1990, writ dism'd); *Canutillo Indep. Sch. Dist. v. Nat'l Union Fire Ins. Co.*, 99 F.3d 695, 701 (5th Cir. 1996). In fact, "[a]n insurer is not obligated to pay a liability claim until [the] insured has been adjudicated to be legally responsible." *S. County Mut. Ins. Co. v. Ochoa*, 19 S.W.3d 452, 460 (Tex. App.—Corpus Christi 2000, no pet.). The duty to indemnify is not ripe for determination prior to the resolution of the underlying construction defect claim *unless* the court first determines, based on the eight corners rule, that there is no duty to defend and the same reasons that negate the duty to defend also negate any potential for indemnity. *See Griffin*, 955 S.W.2d at 82.

C. Contract Interpretation Principles

Insurance policies are contracts and are interpreted according to the same principles that govern contract interpretation. *See Balandran v. Safeco Inc. Co.*, 972 S.W.2d 738, 740 (Tex. 1998). The primary goal of contract interpretation is to "ascertain the intent of the parties as expressed in the instrument." *Nat'l Union Fire Ins. Co. v. CBI Indus.*, 907 S.W.2d 517, 520 (Tex. 1995). Moreover, in undertaking contract interpretation analysis, a court must read all parts of the instrument together in order to give meaning to every sentence and to avoid rendering any portion inoperative. *See id.; see also State Farm Life Ins. Co. v. Beaston*, 907 S.W.2d 430, 433 (Tex. 1994) (noting that "courts must be particularly wary of isolating from its surroundings or considering apart from other provisions a single phrase, sentence, or section of a[n insurance] contract").

"Under Texas law, the maxims of contract interpretation regarding insurance policies operate squarely in favor of the insured." *Lubbock County Hosp. Dist. v. Nat'l Union Fire Ins. Co.*, 143 F.3d 239, 242 (5th Cir. 1998). Accordingly, if a contract of insurance is susceptible to more than one reasonable interpretation, the court must adopt the construction most favorable to the insured. *See State Farm Fire & Cas. Co. v. Reed*, 873 S.W.2d 698, 699 (Tex. 1993); *Houston Petroleum Co. v. Highlands Ins. Co.*, 830 S.W.2d 153, 155 (Tex. App.—Houston [1st Dist.] 1990, writ denied). Moreover, the insurance contract interpretation rules dictate that a court "must adopt the construction urged by the insured so long as that construction is not unreasonable, even if the construction urged by the insurer appears to be more reasonable or a more accurate reflection of the parties' intent." *Balandran*, 972 S.W.2d at 741.[4]

D. Burden of Proof

An insured has the initial burden of demonstrating that a claim is potentially within the scope of coverage. *See Northfield*, 363 F.3d at 528. The burden then shifts to an insurer to prove that one of the exclusions, conditions, and/or limitations within the policy constitutes an avoidance or affirmative defense that defeats coverage in its entirety. *See* Tex. Ins. Code Ann. art. 554.002 (previously 21.58(b)) ("The insurer has the burden of proof as to any avoidance or affirmative defense . . . ."); *Northfield*, 363 F.3d at 528; *see also Performance Autoplex II Ltd. v. Mid-Continent Cas. Co.*, 322 F.3d 847, 854 (5th Cir. 2003). In particular, the Texas Insurance Code makes clear that an insurer must plead and prove, by a preponderance of the evidence, that an exclusion or other affirmative defense negates coverage. *See Nobles v. Employees Retirement Sys. of Tex.*, 53 S.W.3d 483, 486 (Tex. App.—Austin 2001, no pet.).

…the Texas Insurance Code makes clear that an insurer must plead and prove, by a preponderance of the evidence, that an exclusion or other affirmative defense negates coverage.

IV. THE CGL POLICY PROVIDES SPECIFIC COVERAGE FOR INADVERTENT CONSTRUCTION DEFECTS THAT RESULT IN PHYSICAL DAMAGE OR LOSS OF USE TO THE WORK ITSELF

The overarching theme of Mid-Continent's denial of coverage is based on the notion that the insuring agreement of a CGL policy, which is comprised of the "property damage" and "occurrence" requirements, does not apply to defective workmanship claims when the damage is to the work itself. It makes no difference, under Mid-Continent's analysis, whether the defective work was performed by the general contractor or by a subcontractor. Mid-Continent's view, however, fails to recognize the scope of coverage afforded under a modern CGL policy and, in particular, ignores the evolution of the CGL policy.

CGL policies are created with a modular structure under which the scope of coverage can be understood only by considering the policy as a whole. Such policies begin with an insuring agreement that grants broad coverage for "property damage"[5] caused by an "occurrence."[6] The policy then narrows and defines the scope of coverage by shifting various identified risks back to the insured by way of specific exclusions. These exclusions, as applied to the construction industry, generally are referred to as the "business risk" exclusions.[7] Notably, the business risk exclusions remove some construction-related damages from the scope of coverage provided by the insuring agreement. These exclusions, in turn, have certain exceptions that preserve coverage for identified risks. One of those risks, as will be discussed in greater detail, is when the "damaged work or the work out of which the damage arises was performed on the [general contractor's] behalf by a subcontractor."[8]

The evolution of these policy exclusions and the exceptions to the exclusions demonstrates that insurers have *broadened* the scope of coverage provided to general contractors for completed operations and, in particular, that CGL insurers intended to provide coverage to general contractors when the allegedly defective work was performed on their behalf by subcontractors.[9] See Phillip L. Bruner & Patrick J. O'Connor, 4 Bruner & O'Connor on Construction Law Ch. 11 (1st ed. 2002) (updated 2005) (hereinafter, Bruner & O'Connor); Patrick J. Wielinski, Insurance for Defective Construction Chs. 11, 16 (2d ed. 2005) (hereinafter, Defective Construction); Clifford J. Shapiro, *Further Reflections—Inadvertent Construction Defects are an "Occurrence" Under Commercial General Liability Policies*, 686 PLI/LIT 73, 82 (2003).

A federal district court applying Texas law correctly recognized that coverage for construction-related damages should therefore be analyzed by way of the construction-specific exclusions and not by focusing on the threshold definitions of "occurrence" and "property damage" within the insuring agreement:

> This court follows the [Grapevine Excavation] decision in the Fifth Circuit, as well as similar cases in other courts holding that construction defect claims arising from negligent work allege an "occurrence," leaving the coverage to be determined by construction-specific exclusions in the policy.

Great Am. Ins. Co. v. Calli Homes, 236 F. Supp. 2d 693, 700 (S.D. Tex. 2002) (citing *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 730 (5th Cir. 1999)); *accord Luxury Living, Inc. v. Mid-Continent Cas. Co.*, 2003 WL 22116202 (S.D. Tex. Sept. 8, 2003) (not designated for publication); *Lennar Corp.*, 2006 WL 406609, at *9-*10; *Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833, 843 (Tex. App.—Dallas 2004, pet. filed). The fact that coverage for construction-related damages should be analyzed by way of the construction-specific exclusions rather than the insuring agreement is not a novel concept:

> [The insurance company] cites numerous cases for the general proposition that a policy is not a performance bond and, hence, does not cover claims for insufficient or defective work or the repair and replacement of that work. While this general proposition is true, the rationale for the proposition is not that the allegations of negligent construction or design practices do not fall within the broad coverage for property damage caused by an occurrence, but that, as discussed in the balance of this opinion, the damages resulting from such practices are usually excluded from coverage by the standard exclusions found in such policies.

Erie Ins. Exch. v. Colony Dev. Corp., 736 N.E.2d 941, 947 (Ohio App. 1999); *see also Am. Familty Mut Ins. Co. v. Am. Girl,Inc.*, 673 N.W.2d 65, 74-79 (Wis. 2004).

Mid-Continent's coverage defenses ignore the construction-specific exclusions. A review of the policy, and in particular the "subcontractor exception" to exclusion L, however, demonstrates that none of the construction-specific exclusions negate coverage when a homebuyer sues a general contractor for physical damage (or loss of use) to a completed home when the damaged work or the work out of which the damage arises was performed by a subcontractor.[10] Further, the very presence of the construction-specific exclusions demonstrates the fallacy of Mid-Continent's contention that the insuring agreement (or some sort of business risk/economic loss rationale) operates to negate any and all coverage for defective workmanship claims. *See Am. Family Mut.*, 673 N.W.2d at 78 ("Why would the insurance industry exclude damage to the insured's own work or product if the damage could never be considered to have arisen from a covered 'occurrence' in the first place?").

As will be discussed, Lamar Homes *does not* take the position that all contractual breaches should result in coverage under a CGL policy. Quite to the contrary, as Lamar Homes readily admits, "CGL policies generally do not cover contract claims arising out of the insured's defective work or product, but this is by operation of the CGL's business risk *exclusions*, not because a loss actionable only in contract can never be the result of an 'occurrence' within the meaning of the CGL's policy initial grant of coverage." *See Am. Family Mut.*, 673 N.W.2d at 76 (emphasis added); *see also Colony Dev. Corp.*, 736 N.E.2d at 949; *Lennar Corp.*, 2006 WL 406609, at *10.

A. The Insuring Agreement

The insuring agreement is comprised, at least in part, by the "occurrence" and "property damage" requirements. As noted, CGL insurers with increasing frequency focus on the insuring agreement rather than on the construction-specific exclusions in determining coverage for construction defects.[11] This truncated analysis of the CGL policy is undertaken to avoid a defense obligation because the construction-specific exclusions oftentimes do not apply to negate coverage in its entirety.

1. The "Occurrence" Requirement

The "occurrence" requirement is perhaps the single most often raised defense by CGL insurers in construction-related cases. The term "occurrence" in a CGL policy "means an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Perhaps part of the problem stems from the fact that the term "accident" is undefined. In fact, one commentator noted that the term "'accident' remains a 'blob of jelly' as a legal construct." Marc Meyerson, *The Faulty Workmanship of the Courts*, Insurance Scrawl, http://www.insurancescrawl.com/archives/2005 (citing David Mellinkoff, *The Language of the Law* 377 (1963)).[12]

The Supreme Court of Texas has noted that an "accident" includes damage that is the unexpected, unforeseen or undesigned happening or consequence of an insured's negligent behavior. *See Mass. Bonding & Ins. Co. v. Orkin Exterminating Co.*, 416 S.W.2d 396, 400 (Tex. 1967). In one of the more recent cases on the "occurrence" requirement, the Supreme Court of Texas provided the following guidance:

> An injury caused by voluntary and intentional conduct is not an accident just because "the result or injury may have been unexpected, unforeseen and unintended." On the other hand, the mere

> fact that "an actor intended to engage in the conduct that gave rise to the injury" does not mean that the injury was not accidental. Rather, both the actor's intent and the reasonably foreseeable effect of his conduct bear on the determination of whether an occurrence is accidental. "[A]n effect that 'cannot be reasonably anticipated from the use of [the means that produced it], an effect which the actor did not intend to produce and which he cannot be charged with the design of producing, is produced by accidental means.'"

Mid-Century Ins. Co. of Tex. v. Lindsey, 997 S.W.2d 153, 155 (Tex. 1999). Thus, according to the Supreme Court in Lindsey, two factors are considered in making the determination of whether a particular act or omission, or series of acts and omissions, constitutes an accident: (i) whether the actor intended to cause damage to others (i.e., a subjective inquiry); and (ii) the reasonably foreseeable effect of the actor's conduct (i.e., an objective inquiry). *See id.*

Mid-Continent, and other CGL carriers that take a narrow view of coverage, improperly focus on the second prong of the *Lindsey* test and, in particular, on the "reasonably foreseeable effect" language. The problem with such a focus, however, is that one must look at the reasonably foreseeable effect of the actor's *intended* conduct. Notably, the fact that the consequences of a particular act and/or omission may be foreseeable in the tort sense does not mean that the consequences are not accidental for purposes of determining coverage. Foreseeability, it must be remembered, is a required element to prove negligence. Thus, if a purely objective standard along foreseeability lines is followed, even a finding of negligence would negate coverage. Under Mid-Continent's view, therefore, CGL policies would provide coverage only for *unforeseeable* consequences—that is, only in those situations where the law would impose no tort liability and where there would be no need for liability coverage in the first place.

At the outset, one must wonder why anyone would purchase insurance for *unforeseeable* consequences. Generally speaking, meteorite insurance is not popular in the marketplace. In addition, if only *unforeseeable* consequences are covered by a policy, one also has to wonder why insurance companies employ actuaries. Simply put, the foreseeability of a loss and the economic consequences from that loss are at the heart of the underwriting process. It also must be questioned how far Mid-Continent's foreseeabiltiy theory will apply? Auto policies also are triggered by "accidents." If an insured driver runs a red light and causes a collision or is speeding and collides with another vehicle, are those collisions no longer accidents? Certainly, in a purely objective sense, it is foreseeable that if you run a red light or speed over the posted limit that a collision may occur. The reason that auto insurers routinely pay such losses, however, is that the driver (although violating the law and likely the recipient of a citation) neither expected nor intended to cause the collision. Why should the undefined term *accident* mean anything different in the context of a CGL policy?

Although Mid-Continent claims to be applying the *Lindsey* test as written, subsequent authority from the Supreme Court of Texas has cast strong doubt on Mid-Continent's interpretation of the "occurrence" requirement. More specifically, in *King v. Dallas Fire Insurance Company*, 85 S.W.3d 185 (Tex. 2002), the Supreme Court restricted a "reasonably foreseeable" or "reasonably anticipated" inquiry to situations when an insured seeks coverage for its intentional conduct. *Id.* at 190. Moreover, the *King* case makes clear that courts must focus on the unexpected or unintended results from the standpoint of the insured. In doing so, the Court specifically warned against reading the "occurrence" definition so narrowly as to "obviate the need for many other standard exclusions often contained in CGL policies." *Id.* at 193. Despite this warning, Mid-Continent's coverage position vis-a-vis the insuring agreement renders the business risk exclusions mere surplusage.[13]

Mid-Continent, in turn, argues that it should not be enough for an insured to simply say, "I didn't mean it." Lamar Homes agrees with Mid-Continent on this point and never argued otherwise. Moreover, Lamar Homes never argued that the mere allegation of negligence is sufficient to trigger coverage or the potential for coverage. Rather, a synthesis of *Lindsey* and *King* as well as prior precedent from the Supreme Court of Texas demonstrates that the "accident"/"occurrence" analysis boils down to a two-part test:

> STEP 1: Did the insured's conduct rise to the level of an intentional tort?
>
> If "yes," then no "occurrence" exists regardless of whether the insured subjectively expected or intended the injury.
>
> If "no," then proceed to step 2.
>
> STEP 2: Would the resulting "property damage" have been the natural or probable result had the insured acted in a non-negligent manner?
>
> If "yes," then the conduct is not an "occurrence" even though the claims against the insured may be grounded in negligence.
>
> If "no," then the conduct constitutes an "occurrence."

Step one addresses intentional torts. The Supreme Court of Texas has made it clear that intent to injure is presumed in the context of intentional torts. *See Argonaut Ins. Co. v. Maupin*, 500 S.W.2d 633, 635 (Tex. 1973). Accordingly, for this step, it makes no difference whether the insured actually intended to cause the damage. *See id.*

Step two addresses negligence-based or inadvertent conduct and focuses on the expected or intended nature of the resulting damage. The term "accident" includes the "negligent acts of the insured causing damage which is undesigned and unexpected." *See Orkin*, 416 S.W.3d at 400. Thus, "[i]f intentionally performed acts are not intended to cause harm, but do so because of negligent *performance*, a duty to defend arises." *CU Lloyd's of Tex. v. Main Street Homes*, 79 S.W.3d 687, 693 (Tex. App.—Austin 2002, no pet.). Stated otherwise, "if the act is deliberately taken, performed negligently, and the effect is not the intended or expected result had the deliberate act been performed non-negligently, there is an accident." *Harken Exploration Co. v. Sphere Drake Ins. PLC*, 261 F.3d 466, 473 (5th Cir. 2001).

Recognizing that an objective test along foreseeability lines would render liability coverage illusory, the second step focuses on whether the resulting damage was inevitable regardless of how the insured acted. The perfect example is *Martin Marietta Materials Sw., Ltd. v. St. Paul Guardian Ins. Co.*, 145 F. Supp. 2d 794 (N.D. Tex. 2001). The *Martin Marietta* case involved a lawsuit by downstream users arising out of the insured's impounding of Big Sandy Creek. The court found that the purposeful diversion of water would result in an inevitable reduction of downstream waters regardless of whether the insured's acts and/or omissions constituted negligence. *See Mt. Hawley Ins. Co. v. Steve Roberts Custom Builders, Inc.*, 215 F. Supp. 2d 783, 790 n.2 (E.D. Tex. 2002) (discussing *Martin Marietta* and contrasting it with a construction defect case); *see also Lennar Corp.*, 2006 WL 406609, at *8 n.18 ("We do not examine whether the damage was expected from the improper, i.e., negligent performance of the contract . . . . Instead, we examine whether the damage was expected if the work was performed properly, i.e., non-negligently.").

Boiled down to its essence, Mid-Continent contends that no "occurrence" exists in the context of damage to the work itself because the performance of a construction contract by an insured is a voluntary and intentional act. Essentially, according to Mid-Continent, by virtue of the construction contract between the general contractor and the owner, a general contractor presumptively expects or intends any property damage to its work—regardless of the general contractor's actual expectation or intent. In this sense, Mid-Continent treats construction defects like intentional torts. While it is beyond dispute that the construction of a home is a deliberate or volitional act (i.e., homes do not build themselves), that fact does not result in the conclusion that allegations of damage to the home itself run afoul of the "occurrence" requirement. In fact, if such a narrow interpretation of the "occurrence" requirement is correct, then insurance covers everything except for what happens.

Fortunately, the Supreme Court of Texas has at least implicitly rejected such a narrow view of the "occurrence" requirement. *See Trinity Universal Life Ins. Co. v. Cowan*, 945 S.W.2d 819, 828 (Tex. 1997). In *Cowan*, the Court offered the illustration of a hunter who intentionally fires a gun believing his target to be a deer, when in fact it was a person. *See id.* The Supreme Court reasoned that the adoption of the insurer's "occurrence" argument "would render insurance coverage illusory for many of the things for which insureds commonly purchase insurance." *Id.*[14]

While it is beyond dispute that the construction of a home is a deliberate or volitional act (i.e., homes do not build themselves), that fact does not result in the conclusion that allegations of damage to the home itself run afoul of the "occurrence" requirement.

Other courts likewise have followed this rationale as applied to construction defect claims against general contractors arising out of the work of subcontractors. *See Home Owners Mgmt.*, 2005 WL 2452859, at *6 ("The Twomeys never alleged that Holmes-Redding intended to cause foundation damage to the home. Instead, the Twomeys claimed that Holmes-Redding negligently caused the foundation damage. An allegation of negligence constitutes an accidental 'occurrence' under the policy and is sufficient to trigger Mid-Continent's duty to defend."); *Archon Investments*, 174 S.W.3d at 340 ("If intentionally performed acts are not intended to cause harm, but do so because of negligent performance, a duty to defend arises."); *Lennar Corp.*, 2006 WL 406609, at *10 ("Accordingly, we agree with the cases cited by Lennar because the courts recognized tha the 'occurrence' requirement can encompass damage to the insured's own work, and coverage then depends upon the exclusions."); *Mid-Continent Cas. Co. v. JHP Dev., Inc.*, 2005 WL 1123759, at *4 (W.D. Tex. Apr. 21, 2005) ("After examining the policy's definition of 'occurrence' and the lack of allegations that JHP intentionally caused the damage, the Court concludes that there was an 'occurrence' under the CGL policy."); *Gehan Homes*, 146 S.W.3d at 843 ("In this case, the intentional act of performing the contract was allegedly performed negligently. The purport-

ed damage was an unexpected and undesigned consequence of Gehan's alleged negligence."); *Luxury Living*, 2003 WL 22116202, at *16 ("[T]he court finds that the underlying lawsuit against Luxury contains general allegations of negligence, rendering the damages to the Wards' residence an 'accident' thus constituting an 'occurrence' within the scope of the Policy."); *Calli Homes*, 236 F. Supp. 2d at 698 ("[A]lthough the work was voluntarily and intentionally performed, it was undertaken with the intent to perform properly and the consequences of inadvertent construction defects are 'accidental.'"); *Steve Roberts Custom Builders*, 215 F. Supp. 2d at 791 ("The focus should not be on whether the damage should have been expected when SRCB performed its duties negligently; rather the court should focus on the intended or expected results when SRCB performed those duties non-negligently."); *Main Street Homes*, 79 S.W.3d 687 at 693 ("[I]f intentionally performed acts are not intended to cause harm but do so because of negligent *performance*, a duty to defend arises."); *First Texas Homes*, 2001 WL 238112, at *3 ("The paramount consideration for coverage purposes is whether the resulting damage was unexpected or unintended.").

Generally speaking, and consistent with the two-part test set out above, courts have recognized that two lines of "occurrence" cases exist in Texas: one for intentional torts (i.e., the *Maupin* line) and one for non-intentional actions (i.e., the *Orkin* line). *See Home Owners Mgmt.*, 2005 WL 2452859, at *4-5; *Gehan Homes*, 146 S.W.3d at 839; *Luxury Living*, 2003 WL 22116202, at *13-15; *Calli Homes*, 236 F. Supp. 2d at 699; *Steve Roberts Custom Builders*, 215 F. Supp. 2d at 788; *Main Street Homes*, 79 S.W.3d at 693; *Grapevine Excavation*, 197 F.3d at 723-25. Under the *Maupin* line for intentional torts, as previously noted, no "occurrence" exists regardless of whether the insured subjectively expected or intended the injury. *See Harken*, 261 F.3d at 472. Under the *Orkin* line for non-intentional conduct, an "occurrence" exists even if the act is deliberate as long the damages were neither expected nor intended. *See id.*

Ignoring this distinction, Mid-Continent instead focuses solely on the general contractor's contractual undertaking. In so doing, Mid-Continent takes the position that damage to the work itself cannot be an "occurrence" as a matter of law. Again, Mid-Continent's argument fails to take into account the actual definition of "occurrence." Notably, the definition of "occurrence" does not depend on the character of the property that is damaged. See Wielinski, Defective Construction, at 55-58. It is the *exclusions* rather than the insuring agreement that "render the existence of third-party property damage a critical element of most defective work claims."[15] *Id*. Thus, for purposes of defining whether there has been an "occurrence," it is immaterial whether the damage is to the home itself versus third-party property.

Although the case law is decidedly split, as is evident from the Appendix to this article, the better reasoned authorities have rejected a damage-to-third-party-property requirement in favor of reading the policy as a whole. One court, for example, correctly rejected Mid-Continent's attempt to amend the defintition of "occurrence" to add a requirement of damage to third-party property:

> Mid-Continent attempts to distinguish Grapevine Excavation and its progeny by arguing that the damage alleged in this case was to a home designed and constructed by First Texas, not to the work of a third party. The Court disagrees. When a third party's work is damaged, it "is presumed to have been unexpected and, therefore, constitutes an accident or an occurrence." Grapevine Excavation, 197 F.3d at 725. The paramount consideration for coverage purposes is whether the resulting damage was unexpected or unintended.

* * *

Thus, the relevant inquiry is not whether the insured damaged his own work, but whether the resulting injury or damage was unexpected or unintended. *First Texas Homes*, 2001 WL 238112, at *3.

Other courts similarly have concluded that damage to the work itself constitutes an "occurrence" so long as the damage was unexpected or unintended from the standpoint of the insured. *See, e.g., Archon Investments*, 174 S.W.3d at 341-42 ("Although property damage to Archon's work is excluded from coverage under the terms of the policy, that exclusion does not apply if the damage to property occurred after the house was completed and sold if the work out of which the damage arose was performed on Archon's behalf by a subcontractor."); *Lennar Corp.*, 2006 WL 406609, at *12 ("In sum, reading the standard CGL policy as a whole, we hold that negligently created, or inadvertent, defective construction resulting in damage to the insured's own work that is unintended and unexpected can constitute an 'occurrence.'");[16] *JHP Dev.*, 2005 WL 1123759, at *4 ("Apparently, it is Mid-Continent's position that if there were other builders on site at the property and JHP unintentionally damaged their work, there would be coverage. However, that is not how the term 'occurrence' has been defined in the agreement."); *Gehan Homes*, 146 S.W.3d at 843 ("The insurers also argue that since the claim is damage to the house, the subject of the contract, there is no occurrence. We recognize that some courts have based their decision on that basis. However, several courts have held that negligence that results in damage to the subject matter of the contract, the house, constitutes an 'occurrence,' because the relevant

inquiry is not whether the insured damaged his own work, but whether the resulting damage was unexpected or unintended. We agree with this latter analysis."). Other courts, while not directly addressing the issue, likewise have found coverage even when the damages were restricted to the homes themselves. *See, e.g., Home Owners Mgmt.*, 2005 WL 2452859, at *6 (finding coverage for a general contractor even though the damages were to the home itself); *Luxury Living*, 2003 WL 22116202, at *16 (same); *Calli Homes*, 236 F. Supp. 2d at 702 (same); *Main Street Homes*, 79 S.W.3d at 687 (same). No logical basis exists within the "occurrence" definition for distinguishing between damage to the work itself versus damage to some third-party property:

> The logical basis for the distinction between damage to the work itself (not caused by an occurrence) and damage to collateral property (caused by an occurrence) is less than clear. Both types of property damage are caused by the same thing—negligent or defective work. One type of damage is no more accidental than the other. Rather, as evidenced by our original opinion, the basis for the distinction is not found in the definition of an occurrence but by application of the standard "work performed" and "work product" exclusions found in a Commercial general liability policy.

Erie Ins. Exch. v. Colony Dev. Corp., 736 N.E.2d 950, 952 n.1 (Ohio App. 2000); *see also Lennar Corp.*, 2006 WL 406609, at *8 n.18 ("However, we do not see how damage to the insured's own work is any more expected than damage to the work or property of a third-party if the faulty construction was inadvertent").

Moreover, the "subcontractor exception" language to exclusion L clearly signifies that the CGL policy contemplates coverage for physical damages to the work itself. In fact, there would be no need for the "your work" or "your product" exclusions if the insuring agreement already "excluded" damage to the work or product itself.[17]

In sum, plugging the facts of the Underlying Lawsuit into the "occurrence" framework makes it even clearer that the "occurrence" requirement has been satisfied—if the construction of the home (i.e., the deliberate act) had been performed "non-negligently" (i.e., properly)—the intended or expected result is a home that is free of cracks in the stone veneer and sheetrock. Moreover, since the foundation work was designed by an engineer, performed by a subcontractor, and then inspected and approved by the engineer, how could it be said that the damages were expected or intended from the standpoint of Lamar Homes?

2. The "Property Damage" Requirement

The policy covers "property damage" caused by an "occurrence," and defines "property damage," in part, as "physical injury to tangible property." Similar to the argument raised in connection with the "occurrence" requirement, Mid-Continent contends that the Underlying Lawsuit fails to allege "property damage" because damage to the home itself constitutes a mere economic loss. That contention, however, does not comport with the definition of "property damage" in the policy. More specifically, the definition of "property damage" *does not* state "physical injury to tangible property *of others*" or "physical injury to tangible property *of third parties*" or "physical injury to *work beyond the scope of the contractual undertaking*." Rather, by its explicit terms, the "property damage" definition only requires that there be physical injury to tangible property.

One federal court expressly rejected the narrow interpretation of the "property damage" definition that Mid-Continent advocates in Lamar Homes:

> The definition of property damage in the policies does not limit the coverage to property that is not in the possession of or work product of the insured. F&D correctly points out that if the work product of the insured could never come within the definition of property damage, then the exclusions set forth in the policy to limit such damages would be without meaning.

Fid. & Deposit Co. v. Hartford Cas. Ins. Co., 189 F. Supp. 2d 1212, 1220 (D. Kan. 2002).

Other courts likewise have rejected the contention that property damage must be to property owned by a third party:

> Travelers claims that the trial court erred by concluding that Diamaco met its threshold burden of establishing that the "property damage" here was within the insuring clause of the policies. . . . Travelers argues that Diamaco's claim was not eligible for coverage as "property damage" because there was no damage to the property of others, only to the property of the insured. We reject this argument. . . . Had Travelers intended to exclude from its insuring clause the property of the insured in this case, it could easily have done so . . . .

Diamaco, Inc. v. Aetna Cas. & Sur. Co., 983 P.2d 707, 709-11 (Wash. App. 1999). As one commentator has noted:

> Either there is physical injury to tangible property or there is not. Nothing more is required to reach

> a finding that "property damage" exists. . . There is no policy requirement that physical injury occur to a particular class, i.e., other people's property, in order for "property damage" to exist.

Bruner & O'Connor, at § 11:34 at p. 114. Another commentator similarly concluded:

> One of the myths that has emerged from caselaw interpreting the CGL policy surrounds the concept of "third-party" property damage. Specifically, this myth holds that an insured seeking coverage for a defective work claim must demonstrate damage to a third-party's property, as opposed to the insured's own work. Otherwise, there can be no covered "occurrence" of "property damage," as those terms are defined in the policy.

In reality, this "requirement" has no support in the definitions of those terms. As can be seen, nowhere in the definition of "property damage" is there any hint of a third-party property damage requirement; rather, it is the exclusions directed at limiting coverage for property damage involving the insured's own defective work that render the existence of third-party property damage an important element of most defective work claims. Wielinski, Defective Construction, at 117-18.

…it is one thing to allege that an insured misrepresented the existence of pre-existing damage caused by others; it is quite another to allege that the insured caused the damage.

Texas courts have recognized this fact and, for the most part, rejected the view that the damage must extend beyond the home itself. *See Home Owners Mgmt.*, 2005 WL 2452859, at *7 (holding that damages awarded by arbitrator to homebuyers to compensate them for repairs necessitated by a faulty foundation constituted "property damage" under a CGL policy); *Lennar Corp.*, 2006 WL 406609, at *15 (holding that costs to repair water damage caused by defective EIFS constituted "property damage" within the meaning of a CGL policy); *JHP Dev.*, 2005 WL 1123759, at *4-5 (rejecting breach of contract/economic loss analysis and concluding that allegations of damage to the work was all that was necessary to satisfy "property damage" definition); *Gehan Homes*, 146 S.W.3d at 844 (same); *Luxury Living*, 2003 WL 22116202, at *16 (same); *First Tex. Homes*, 2001 WL 238112, at *2 (same).

The case law Mid-Continent relied on in making its "property damage" arguments is misplaced and simply stands for the unremarkable proposition that *purely* economic losses tied to misrepresentations or failures to disclose do not constitute "property damage." For example, Mid-Continent cites to *State Farm Lloyds v. Kessler*, 932 S.W.2d 732 (Tex. App.—Fort Worth 1996, writ denied) (economic damages due to misrepresentation by seller of home about pre-existing property damage); *Terra International, Inc. v. Commonwealth Lloyds Insurance Company*, 829 S.W.2d 270 (Tex. App.—Dallas 1992, writ denied) (fraudulent misrepresentations as to property located in flood control district); *Great American Lloyds Insurance Company v. Mittlestadt*, 109 S.W.3d 784 (Tex. App.—Fort Worth 2003, no pet.) (inability to sell home due to encroachment on pipeline easement); and *Lay v. Aetna Insurance Company*, 599 S.W.2d 684 (Tex. App.—Austin 1980, writ ref'd n.r.e.)(economic loss from negligent failure to locate an oil well). Those cases are distinguishable from a construction defect case on the basis that they did not involve physical injury to tangible property that allegedly was caused by the insured or its subcontractors' accidental conduct. Rather, those cases involve negligent or fraudulent misrepresentations or failures to disclose pre-existing damage or damage to intangible property. Cases of this sort have been properly rejected in the context of a suit against a general contractor for faulty workmanship. See JHP Dev., 2005 WL 1123759, at *5. Simply put, it is one thing to allege that an insured misrepresented the existence of pre-existing damage caused by others; it is quite another to allege that the insured caused the damage.

Even so, in an effort to avoid the actual policy language, Mid-Continent simply seeks to recast physical damage to tangible property as "economic loss." While it is true that *purely* economic losses are not covered (i.e., economic losses not tied to any "property damage"), the same is not true for consequential economic losses that arise from or relate to "property damage" (i.e., physical injury to tangible property and/or loss of use). *See Lennar Corp.*, 2006 WL 406609, at *12-16 (rejecting insurer's attempt to recast physical injury to tangible property as an uncovered mere economic loss); *JHP Dev.*, 2005 WL 1123759, at *4-5 (same); *Gehan Homes*, 146 S.W.3d at 844 (same); *Luxury Living*, 2003 WL 22116202, at *16 (same).

CGL policies unambiguously cover consequential economic damages. The proof is in the policy itself. In particular, the policy's insuring agreement states: "We will pay those sums that the insured becomes legally obligated to pay as damages *because of* . . . 'property damage.'" The words "because of" indicate that all that matters is that the legal liability have as its source, or arise from, physical injury to or loss of use of tangible property. Accordingly, once "property damage" has been established, the policy then covers economic losses that

flow because of the "property damage." *See Riley Stoker Corp. v. Fid. & Guar. Ins. Underwriters, Inc.*, 26 F.3d 581 (5th Cir. 1994) (finding coverage for consequential economic losses arising from loss of use of plant's electric generators); *Home Assurance Co. v. Libbey-Owens-Ford Co.*, 786 F.2d 22 (1st Cir. 1986) (finding coverage for consequential losses stemming from physical injury to windows even though there was no coverage for the repair and replacement of the windows themselves); *see also* Donald S. Malecki & Arthur L. Flitner, Commercial General Liability 8-9 (7th ed. 2001) ("In light of [the 'because of'] wording, all damages flowing as a consequence of bodily injury or property damage would be encompassed by the insurer's promise, subject to any applicable exclusion or condition. This includes purely economic damages, as long as they result from otherwise covered bodily injury or property damage."); Wielinski, Defective Construction, at 121-23; Allan D. Windt, Insurance Claims & Disputes, Representation of Insurance Companies and Insureds § 11:1, at p. 285 (4th ed. 2001 & Supp. 2005) (hereinafter Insurance Claims & Disputes).

The DiMares alleged, *inter alia*, cracks in the stone veneer and sheetrock. While the DiMares may have sought economic damages in the form of money against Lamar Homes, it is difficult to discern how such damages do not meet the "property damage" requirement.

3. The Proper Role of the "Property Damage" and "Occurrence" Requirements

One of the "sky is falling" arguments raised by Mid-Continent in its briefing and at oral argument is that a finding in favor of coverage will result in home builders being covered for all of their punch-list and/or warranty work. This argument is completely without merit. At the outset, Lamar Homes never contended that all construction defects were covered under a CGL policy. In fact, it is Mid-Continent—not Lamar Homes—that ignored the existence of the various construction-related exclusions that were designed to delineate the precise scope of coverage for construction-related defects. Those exclusions would bar coverage for many "punch-list" or "warranty" items. For example, exclusions J5[18] and J6[19] exclude many types of damages that take place during the course of construction, and no subcontractor exception applies to those exclusions. Additionally, by its own terms, exclusion L eliminates coverage for damages to the insured's completed work that are caused by the insured's own faulty work.

Even aside from the exclusions, the "property damage" and "occurrence" requirements do have a role in the initial coverage analysis. If, for example, a contract called for painting the interior of a house white but the painting subcontractor painted the interior red, there would be no coverage under the CGL policy because the "property damage" definition would not be satisfied (i.e., the wrong paint color does not constitute "physical injury to tangible property" as required by the CGL policy). Likewise, if a contractor installed all of the windows backwards and discovered the defect prior to any resulting damage, there would be no coverage for the same reason since the mere faulty installation, in and of itself, does not constitute physical injury to the home. If, however, the improperly installed windows caused water intrusion and that water intrusion physically damaged the home, then the requisite physical injury to tangible property requirement of the "property damage" definition has been satisfied.

The "occurrence" analysis is similar. If the contractor did not intend to install the windows backwards, but rather did so because of a misreading of the specifications, that conduct would be considered accidental and the resulting water damage would be deemed to be accidental as well. If, however, the contractor purposefully installed the windows backwards because doing so would take half the time and would thus be a cost savings to the contractor, then it is questionable whether the "accident" component of the "occurrence" requirement has been satisfied.[20]

It must be noted that the accident is not the faulty workmanship itself—rather, the accident is the unexpected or unintended damage that results from the faulty workmanship. *See, e.g., General Acrylics, Inc. v. Maryland Cas. Co.*, 2006 WL 898163 (D. Ariz. Apr. 5, 2006). In other words, CGL policies do not cover the accident of faulty workmanship; instead, CGL policies cover an accident caused by faulty workmanship. In *Lamar Homes*, for example, the allegedly poorly designed or constructed foundation, in and of itself, would not trigger coverage. The resulting physical damage to the DiMares' home, however, constitutes physical damage to tangible property that was unexpected or unintended from the standpoint of Lamar Homes. Likewise, the mere repair or replacement of defective EIFS installed on a house does not trigger coverage. But, damages caused by water intrusion behind the defective EIFS triggers coverage under a CGL policy. *See Lennar Corp.*, 2006 WL 406609, at *15-*16.

Certainly, case law exists that rejects Lamar Home's view of coverage. As one court correctly noted, however, most of the case law that supposedly supports the insurer's position falls into one of three categories: (i) case law that addresses situations in which no property damage was caused, such as mere unfinished work; (ii) case law that involves claims to replace or repair defective material that causes no property damage; or (iii) case law that construed and applied policy exclusions rather than the insuring agreement. *See Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 104 P.3d 997, 1002 (Kan. App. 2005). Another court noted that some of these

supposedly pro-insurer decisions have resulted in some "regrettably overbroad generalizations about CGL policies…" Am. Family Mut., 673 N.W.2d at 76. A closer look at the case law that purportedly supports Mid-Continent's view demonstrates that some of the cases fall into the three categories described in the Lee Builders case. Other cases relied on by Mid-Continent simply follow the aforementioned "regrettably overbroad generalizations" without analyzing the policy as a whole.

B. The Exclusions

Coverage for defective construction claims, in most cases, should be decided by analyzing the exclusions in the CGL policy. While the term "business risk exclusions" encompasses exclusions J5, J6, K, L, M, and N, the three main exclusions for purposes of determining the scope of coverage for physical injury to tangible property are exclusions J5, J6, and L.

This section of the article will demonstrate that these three exclusions do not negate coverage in *Lamar Homes*. As a practical matter, this fact went uncontested at the Fifth Circuit and Supreme Court. For that matter, Mid-Continent did not raise *any* of the business risk exclusions on appeal. Even so, in order to demonstrate the fallacy of Mid-Continent's arguments vis-a-vis the insuring agreement, a brief discussion of exclusions J(5), J(6) and L is warranted.[21] Notably, the fact that none of the construction-specific exclusions negate coverage is the very reason Mid-Continent tried so hard to avoid any discussion of the exclusions. In fact, in its briefing, Mid-Continent argued that any discussion of the exclusions was irrelevant.

1. Exclusion J(5)—the "Operations" Exclusion

The first coverage-specific exclusion is J(5). This exclusion eliminates coverage for "that particular part of real property on which you or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations." Exclusion J(5), by its terms, applies even when a subcontractor performs the work. Even so, also by its express terms, exclusion J(5) applies only to damages that occur while operations are being performed. See Lennar Corp., 2006 WL 406609, at *22 ("Giving the exclusion its plain meaning, the use of the present tense indicates the exclusion applies only to 'property damage' arising while Lennar is currently working on a project."); JHP Dev., 2005 WL 1123759, at *7 ("There is no evidence that JHP was working or performing operations at the time the damage occurred."); Luxury Living, 2003 WL 22116202, at *17 (noting that exclusion J(5) could not apply because the underlying plaintiff claimed damage to the home after its closing); Main Street Homes, 79 S.W.3d at 695 ("Since the underlying petitions indicate that Main Street had completed construction and sold the homes to the home buyers before the alleged damage resulted, the exclusion does not preclude Lloyd's duty to defend Main Street.").

In Lamar Homes, it was undisputed that the damage to the home was discovered after its sale to the DiMares. As such, exclusion J(5) is inapplicable.

2. Exclusion J(6)—"Faulty Workmanship" Exclusion

The second construction-specific exclusion is J(6). It excludes coverage for "that particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it." The term "your work" is defined as "[w]ork or operations performed by you or on your behalf; and [m]aterials, parts or equipment furnished in connection with such work or operations." The exclusion goes on to state, however, that it "does not apply to 'property damage' included in the 'products-completed operations hazard.'" The policy defines the "products-completed operations hazard" to include all property damage arising out of the insured's work—except "work that has not been completed or abandoned." As a result, exclusion J(6) only applies to work that has not been completed or abandoned.

Thus, damage that occurs to a completed home or building does not fall within the scope of exclusion J(6). *See Luxury Living*, 2003 WL 22116202, at *18 ("[T]he property damage to the Wards' home is, by definition, part of the 'products-completed operations hazard,' as Luxury no longer owns or rents the Wards' residence and the work done on the house has long been completed."); *Main Street Homes*, 79 S.W.3d at 696-97 (holding that exclusion j(6) was inapplicable because the house had been completed and sold to the claimant prior to the claimed damage). No dispute exists that the damage in *Lamar Homes* fell within the "products-completed operations hazard" since it occurred after the home already was sold to the DiMares. Moreover, even had the damages occurred during the course of construction, the exclusion does not apply if the defective work causes damage to other work of the insured that was otherwise not defective. *See JHP Dev.*, 2005 WL 1123759, at *8.

3. Exclusion L—"Your Work" Exclusion

The third construction-specific exclusion, in contrast to exclusions J(5) and J(6), does apply to damages that fall within the "products-completed operations hazard." Exclusion L negates coverage as follows:

> l. Damage to Your Work
>
> "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."

> This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor. (emphasis added).
>
> By its own terms, exclusion L eliminates coverage with respect to work that is both: (i) performed by the named insured; and (ii) damaged by work performed by the named insured. Absent both elements, the exclusion simply does not apply.

Notably, the so-called "subcontractor exception" to the "your work" exclusion (i.e., the italicized language above) represents a major extension of coverage for defective workmanship that causes "property damage." The only damage that remains excluded after application of the exception is damage to the named insured contractor's own work arising out of that work. Damage to a subcontractor's work is covered (whether it arises out of the insured contractor's work or any subcontractor's work), as is damage to the insured contractor's work arising out of a subcontractor's work. Thus, if a general contractor becomes liable for damage to work performed by a subcontractor—or for damage to the general contractor's own work arising out of a subcontractor's work—the exclusion by its express terms does not negate coverage. *See Archon Investments*, 174 S.W.3d at 342. ("[W]e conclude, based on a plain reading of the entire policy, including the subcontractor exception, that Braden's pleadings allege a claim potentially within the scope of coverage of the CGL policy."); *Lennar Corp.*, 2006 WL 406609, at *10 ("More significantly, coverage for some 'business risks' is *not* eliminated when the damaged work, or the work out of which the damage arose, was performed by subcontractors."); *Main Street Homes*, 79 S.W.3d at 697-98 ("Both the . . . petitions allege that the property damage was caused by the subcontractors who designed and constructed the foundations . . . A plain reading of this exclusion in light of the underlying pleadings demonstrates that the subcontractor exception applies and the exclusion does not preclude Lloyd's duty to defend."); *First Texas Homes*, 2001 WL 238112, at *3-*4 (finding the exclusion inapplicable in a defective foundation case against the general contractor because "someone other than First Texas may be responsible for the damages…").

Notably, the so-called "subcontractor exception" to the "your work" exclusion represents a major extension of coverage for defective workmanship that causes "property damage."

Noted commentators, writing during the time the "subcontractor exception" was added to the CGL policy, recognized the effect of the provision:

> There is, however, an exception to exclusion "L" of substantial importance to insured contractors, which provides that "[t]his exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor." *This exception should allow for coverage, for example, if an insured general contractor is sued by an owner for property damage to a completed residence, caused by faulty plumbing or electrical work done by a subcontractor.* The coverage in that circumstance should extend to all "work" damaged, whether it was done by the contractor or by any subcontractor, since the "work out of which the damage arises was performed . . . by a subcontractor." The only property damage to completed work which is excluded by exclusion "L" is damage to the insured contractor's work, *which arises out of* the insured contractor's work.

James D. Hendrick and James P. Wiezel, *The New Commercial General Liability Forms—An Introduction and Critique*, 36 Fed'n Ins. Corp. Couns. Q. 317, 360 (1986) (emphasis added in part). The emphasized example used by Messrs. Hendrick and Wiezel is exactly the type of situation presented in *Lamar Homes*.

Other authoritative commentators agree:

> If the policy's exclusion for damage to the insured's work contains a proviso stating that the exclusion is inapplicable if the work was performed on the insured's behalf by a subcontractor, it would not be justifiable to deny coverage to the insured, based upon the absence of an occurrence, for damages owed because of property damage to the insured's work caused by the subcontractor's work. Reading the policy as a whole, it is clear that the intent of the policy was to cover the risk to the insured created by the insured's use of a subcontractor. Moreover, if coverage were never available for damage to the insured's work because of a subcontractor's mistake, on the theory that there was no occurrence even under those circumstances, the foregoing subcontractor proviso to the exclusion for damage to the insured's work would be meaningless, and if possible, policies should not be interpreted to render policy provisions meaningless.

Windt, Insurance Claims & Disputes, at § 11.3. In other words, by incorporating the subcontractor exception into the "your work" exclusion, the insurance industry specifically contemplated coverage for property damage caused by a subcontractor's defective workmanship. See, e.g., Limbach Co. v. Zurich Am. Ins. Co., 396 F.3d 358, 362-63 (4th Cir. 2005); Lennar Corp., 2006 WL 406609, at *10-*14; Am. Family Mut., 673 N.W.2d at 82.

Mid-Continent attempts to circumvent the "subcontractor exception" by focusing on the insuring agreement's threshold requirements of "occurrence" and "property damage." As noted by Windt, and contrary to well-settled contract interpretation rules, that focus renders the "subcontractor exception" as well as the other construction-specific exclusions mere surplusage. *See King*, 85 S.W.3d at 193; *Archon Investments*, 174 S.W.3d at 342; *Gehan Homes*, 146 S.W.3d at 843.[22] The Underlying Lawsuit establishes that the home was constructed by subcontractors. Accordingly, exclusion L does not apply.[23]

V. NEITHER THE "BUSINESS RISK" RATIONALE NOR THE "ECONOMIC LOSS" RULE TRUMP THE ACTUAL POLICY LANGUAGE.

Recognizing that allegations of defective construction oftentimes do not fall squarely within any of the exclusions so as to negate the potential for coverage and thus the duty to defend, CGL insurers focus on the so-called "business risk" rationale and/or the "economic loss" rule to support their denials of coverage. These defenses, however, have very little to do with the actual policy language.

A. The "Business Risk" Rationale

The "business risk" rationale, boiled down to its essence, is that defective construction is a business risk within the control of the contractor and thus is not covered by a CGL policy. According to Mid-Continent, damages to the work itself caused by the faulty workmanship of a subcontractor constitute an uninsurable business risk vis-a-vis the general contractor.[24] The better reasoned authorities construing modern CGL policies recognize that the application of any so-called "business risk" rationale cannot supplant the actual terms of the CGL policy itself. *See J.S.U.B., Inc. v. United States Ins. Co.*, 906 So. 2d 303, 308 (Fla. App. 2005); *Lee Builders*, 104 P.3d at 1003; *Wanzek Constr. Inc. v. Employers Ins. of Wausau*, 679 N.W.2d 322, 326-28 (Minn. 2004); Am. Family Mut., 673 N.W.2d at 83-84; *Kvaerner Metals v. Commercial Union Ins. Co.*, 825 A.2d 641, 648-58 (Pa. 2003); *Kalchthaler v. Keller Constr. Co.*, 591 N.W.2d 169, 172-76 (Wis. App. 1999); *O'Shaughnessy v. Smuckler Corp*, 543 N.W.2d 99, 102-05 (Minn. App. 1996); *High Country Assocs. v. N.H. Ins. Co.*, 648 A.2d 474, 477-78 (N.H. 1994).

As a subset to its business risk rationale, Mid-Continent contends that a CGL policy is not a performance bond. While that statement undoubtedly is true, it does not necessarily follow that defective workmanship resulting in physical damage to the home itself runs contrary to the "property damage" and "occurrence" requirements in a CGL policy. While a performance bond and a CGL policy are two distinct things, the scope of protection provided by each is not necessarily mutually exclusive.[25]

In fact, as previously noted, a CGL policy is a contract. It broadly grants coverage for property damage caused by accidents and then limits the broad grant of coverage by way of specific exclusions. To the extent that the coverages afforded by a CGL policy overlap to any extent with the protections provided by a performance bond, and sometimes they do, that is the fault of the drafter of the CGL policy and not the insured. *See Kalchthaler*, 591 N.W.2d at 174 ("We have not made the policy close to a performance bond for general contractors, the insurance industry has."); *Fid. & Deposit Co. of Maryland v. Hartford Cas. Ins. Co.*, 189 F. Supp. 2d 1212, 1218 (D. Kan. 2002) ("This court is also not persuaded by Hartford's argument that if the structural damage caused by the faulty workmanship constitutes an 'occurrence,' then the CGL and umbrella policies will be transformed into a performance bond."); *Lee Builders*, 104 P.3d at 1003 ("We reject this [performance bond] argument on the same basis that it has been rejected by federal courts in Kansas, specifically that a performance bond does not insure the contractor, it runs to the benefit of the third-party owner only."); *Colony Dev. Corp.*, 736 N.E.2d at 947 (holding that the "performance bond" analogy is relevant to application of the business risk exclusions as opposed to the insuring agreement); *Lennar Corp.*, 2006 WL 406609, at *11 ("Finally, we reject the carriers' argument that allowing defective construction to constitute an "occurrence" will transform the CGL policy into a performance bond."); *see also* Bruner & O'Connor, at § 11.29; Scott C. Turner, Insurance Coverage for Construction Disputes § 3.10 (2d ed. 2003) (Supp. 2005); Wielinski, Defective Construction, at 291-98.

More specifically, courts and commentators point to the express "subcontractor exception" to exclusion L as specific evidence that the "business risk" rationale must give way to the literal policy language. One court, for example, noted:

> For whatever reason, the industry chose to add the new exception to the business risk exclusion in 1986. We may not ignore that language when interpreting case law decided before and after the addition. To do so would render the new language superfluous. We realize that under our holding a general contractor who contracts out all the work to subcontractors, remaining on the job

> in a merely supervisory capacity, can ensure complete coverage for faulty workmanship. However, it is not our holding that creates this result: it is the addition of the new language to the policy. *We have not made the policy closer to a performance bond for general contractors, the insurance industry has.*

Kalchthaler, 591 N.W.2d at 174 (citation omitted) (emphasis added). The Minnesota Court of Appeals reached the exact conclusion:

> Here, we are faced not with an omission, but an affirmative statement on the part of those who drafted the policy language, asserting that the exclusion does not apply to damages arising out of the work of a subcontractor. It would be willful and perverse for this court simply to ignore the exception that has now been added to the exclusion.
>
> We cannot conclude that the exception to exclusion (l) has no meaning or effect. The CGL policy already covers damage to the property of others. The exception to the exclusion, which addresses "'property damage' to 'your work,'" must therefore apply to damages to the insured's own work that arise out of the work of a subcontractor. Thus, we conclude that the exception at issue was intended to narrow the Business Risk Doctrine.

O'Shaughnessy, 543 N.W.2d at 104-05 (emphasis added). Texas courts, dating back to 1988, support this view as well:

> Under the more restrictive language of the endorsement, the insured is protected by the endorsement's completed operation coverage when the insured is legally liable for property damage to the work of the subcontractor, to the work of the insured or other subcontractors arising from the work of a subcontractor of the insured. In other words, although appellant would have no insurance coverage for damage to its work or arising out of its work, appellant was covered for damage to its work arising out of a subcontractor's work. By contrast, absent the endorsement, under exclusions (k) and (o), any property damage to work completed by appellant or on behalf of appellant by its subcontractors would be excluded.

Mid-United Contractors, Inc. v. Providence Lloyds Ins. Co., 754 S.W.2d 824, 827 (Tex. App.—Fort Worth 1988, writ denied) (discussing a predecessor version of exclusion L that was available by endorsement to broaden coverage over what was contained within the 1973 CGL policy). And, in 2006, Texas courts still recognize this fact:

> Instead, the subcontractor exception demonstrates insurers intended to cover some defective construction resulting in damage to the insured's work.

Lennar Corp., 2006 WL 406609, at *10. Further, as one commentator poignantly noted:

> The [insurance] industry has now taken to arguing that whenever a claim of defective construction is alleged against an insured, the claim is automatically barred from coverage as not constituting an "occurrence." The position is nothing more than a rehash of the "business risk" doctrine, whose success depends entirely on courts' ignoring the actual language of the CGL policy.

Prior to the district court's opinion in Lamar Homes, *at least one federal district court had rejected a similar attempt by Mid-Continent to apply the economic loss rule.*

James Duffy O'Connor, *What Every Construction Lawyer Should Know About CGL Coverage For Defective Construction*, 21-WTR CONSTR. LAW 15, 17 (2001). Mr. O'Connor's words ring true here, and he is not alone. See Jotham D. Pierce, Jr., *Allocating Risk Through Insurance and Surety Bonds*, 425 PLI/REAL 193, 198-99 (1998) (noting that even courts that have regarded themselves as primary upholders of the "business risk" theory, denying coverage when possible, now recognize that the insurance industry *intended* to narrow the theory through the subcontractor exception).[26]

The fallibility of the business risk rationale is best illustrated by a mistake made by the district court and Mid-Continent in *Lamar Homes*. In particular, Mid-Continent argued and the district court held that "if an insurance policy were to be interpreted as providing coverage for construction deficiencies, the effect would be to 'enable a contractor to receive initial payment for the work from the homeowner, then receive subsequent payment from his insurance company to repair and correct the deficiencies in his own work.'" *Lamar Homes*, 335 F.

Supp. 2d at 759 (quoting *Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706, 714 (N.D. Tex. 2003) (in turn quoting *T.C. Bateson Constr. Co. v. Lumbermens Mut. Cas. Co.*, 784 S.W.2d 692, 694-95 (Tex. App.—Houston [14th Dist.] 1989, writ denied)). The court of appeals that issued *T.C. Bateson*, however, recently noted that the principle quoted by Mid-Continent and the district court was based "solely on the 'business risk' exclusions, particularly the 'your work' exclusion…" *Lennar Corp.*, 2006 WL 406609, at *9. The *Lennar Corp.* court went on to note that the version of the CGL policy at issue in *T.C. Bateson* did not have the subcontractor exception. Id. This point highlights the fact that the so-called "business risk" rationale is embodied, at least to some extent, in the carefully crafted business risk exclusions and thus, generally speaking, coverage should be won or lost by analyzing the applicability of the exclusions to the facts of a particular construction defect lawsuit.

B. The "Economic Loss" Rule Does Not Negate Coverage

Mid-Continent, in what could be described as a companion argument to its "business risk" rationale, contends that the economic loss rule negates coverage under a CGL policy. Mid-Continent's argument requires two steps: (i) the court's application of the economic loss rule to negate tort claims pending in an underlying lawsuit; and (ii) the court's conclusion that a CGL policy does not apply to the remaining breach of contract/warranty claims. As a practical matter, this is exactly the two steps undertaken by the district court in *Lamar Homes*.

When determining whether the construction defect claim meets the "property damage" and "occurrence" definitions, the actual definitions used in the insurance policy control the analysis.

Numerous problems exist in undertaking this Texas two-step. First, it confuses a *liability* defense with a *coverage* defense. Second, any application of the economic loss rule when the underlying lawsuit still has tort claims pending in a different court would be nothing more than an advisory opinion that could lead to inconsistent rulings. Third, even if the economic loss rule somehow applies, nothing in the CGL policy (let alone the "occurrence" and "property damage" definitions) speaks in terms of contract/warranty versus tort distinction. Fourth, Mid-Continent's "contort" analysis puts too much emphasis on the label of the cause of action.

In supporting its argument, Mid-Continent improperly contends that *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617 (Tex. 1986) and *Nobility Homes of Texas, Inc. v. Shivers*, 557 S.W.2d 77 (Tex. 1977) establish that the damages alleged in the Underlying Lawsuit were for purely economic losses that are not covered by a CGL policy. The words "insurance coverage," "occurrence," "accident," and "duty to defend" appear nowhere within those opinions. Simply put, neither *Jim Walter Homes* nor *Nobility Homes*, nor the cases that have followed them, have anything at all to do with insurance coverage—let alone with an insurer's duty to defend against allegations of faulty workmanship. In fact, the very first sentence of *Nobility Homes* states that "[t]his is a products liability case. It presents the question of whether a remote manufacturer is liable for the economic loss his product causes a consumer with whom the manufacturer is not in privity." *Nobility Homes*, 557 S.W.2d at 77 (emphasis added). Similarly, the very first sentence of *Jim Walter Homes* states: "This case involves whether there is an independent tort to support an award of exemplary damages." *Jim Walter Homes*, 711 S.W.2d at 617. These cases address *liability* issues—not coverage issues.

Mid-Continent also argues that no persuasive reason exists to analyze construction defect claims one way when insurance is not involved and another way when insurance is involved. In particular, Mid-Continent argues that the nature of the claim involved and the damages incurred do not change. While Mid-Continent is correct in this regard, it fails to recognize that liability and coverage have never been measured by the same yardstick. When determining whether the construction defect claim meets the "property damage" and "occurrence" definitions, the actual definitions used in the insurance policy control the analysis. It can hardly be argued that cracks in sheetrock and stone veneer do not constitute physical injury to tangible property. Stated otherwise, regardless of the label attached to the cause of action, the "physical injury to tangible property" requirement in the "property damage" definition has been satisfied. Neither *Jim Walter Homes* nor *Nobility Homes* changes this plain reading of the CGL policy.

Prior to the district court's opinion in *Lamar Homes*, at least one federal district court had rejected a similar attempt by Mid-Continent to apply the economic loss rule. *See Luxury Living*, 2003 WL 22116202, at *16 ("Thus, under controlling authority, Mid-Continent's assertion that the Wards' allegations do not fall within the scope of a commercial general liability policy and should be considered a business risk/economic loss to be borne by Luxury must be rejected."). Subsequent to the district court's opinion in *Lamar Homes*, two Texas appellate courts rejected its application of the economic loss rule. In *Archon Investments*, for example, the court noted as follows:

> Application of the economic loss doctrine of Jim Walter Homes would require us to extend the economic loss doctrine beyond the area of exemplary damages in an adjudicated case into the area of an insurance company's duty to defend on the pleadings (as the federal court did in Lamar Homes) and to subsume under Braden's breach of warranty claims both the torts that Braden has alleged Archon committed and the alleged torts of Archon's subcontractors, while ignoring the character of those claims. We decline to extend Jim Walter Homes as Great American requests.

174 S.W.3d at 341.[27] Likewise, in *Lennar Corp.*, the court rejected the district court's application of the economic loss rule by noting that "the [Supreme Court] has not applied the economic loss doctrine to determine whether an insured's action constitutes an accident under a CGL policy." *Lennar Corp*., 2006 WL 406609, at * 8.

Courts from other jurisdictions similarly have rejected application of the economic loss doctrine to determine insurance coverage. The best example is the *American Family Mutual* case from the Wisconsin Supreme Court:

> The economic loss doctrine is a remedies principle. It determines how a loss can be recovered—in tort or in contract/warranty law. It does not determine whether an insurance policy covers a claim, which depends instead upon the policy language.

Am. Family Mut., 673 N.W.2d at 75; *see also Ferrell v. West Bend Mut. Ins. Co*., 393 F.3d 786, 794-95 (8th Cir. 2005) (relying on Am. Family Mut. to reject application of the economic loss doctrine to determine insurance coverage); *Commercial Union Ins. Co. v. Roxborough Vill. Joint Venture,* 944 F. Supp. 827, 832 (D. Colo. 1996) (noting that the application of the economic loss doctrine in an insurance coverage case is improper).[28]

The case law cited by Mid-Continent illustrates its misapplication of the economic loss rule. *See Nobility Homes of Tex., Inc. v. Shivers,* 557 S.W.2d 77 (Tex. 1977) (UCC implied warranty of merchantability as applied to manufactured mobile homes); *Mid-Continent Aircraft Corp. v. Curry County Spraying Serv., Inc.*, 572 S.W.2d 308 (Tex. 1978) (rebuilt airplane bought "as is" with no implied warranties of merchantability and fitness); *Two Rivers Co. v. Curtiss Breeding Serv*., 624 F.2d 1242 (5th Cir. 1980) (loss of reputation of cattle herd as a result of genetically abnormal bull semen); *Alcan Aluminum Corp. v. BASF Corp.*, 133 F. Supp. 2d 482 (N.D. Tex. 2001) (economic loss rule applied to manufacturer of urethane foam system); *Rocky Mountain Helicopters, Inc. v. Bell Helicopter Co.*, 491 F. Supp. 611 (N.D. Tex 1979) (interpreting express or implied warranties applicable to helicopter crash). Notably, none of the economic loss rule cases cited by Mid-Continent has anything to do with insurance coverage. Rather, Mid-Continent simply cited to a string of cases that applied the economic loss rule to limit recovery in products liability cases. Mid-Continent fails to recognize that the product liability theories that form the basis of the economic loss rule have no application to the terms of an insurance contract. In particular, the definition of "your [Lamar Homes'] product" in the Mid-Continent policy extends to "any goods or products, *other than real property*, manufactured, sold, handled, distributed or disposed of by . . . You [Lamar Homes]." A house or commercial building is not a "product" and certainly qualifies as real property. *See, e.g., Main Street Homes,* 79 S.W.3d at 697 (rejecting argument by insurer that a completed home was the insured's product); *Mid-United Contractors,* 754 S.W.2d at 826-27 (rejecting contention of insurer that construction project is the insured's "product").

In addition, asking a court in a coverage case to apply the economic loss rule to negate tort-based allegations in a pending underlying lawsuit results in an advisory opinion that may conflict with the trial judge's view in the underlying lawsuit.[29] Likewise, as the duty to defend standards make clear, it is improper for a coverage court to delve into the veracity of the underlying tort claims.[30] *See Archon Investments*, 174 S.W.3d at 341-42 (rejecting a CGL insurer's invitation to attack the veracity of the tort allegations at the duty to defend stage); *Gehan Homes,* 146 S.W.3d at 842-43 (same). Even if it were true that the only viable claims asserted against Lamar sounded in contract/warranty, that fact is not dispositive of the coverage analysis for several reasons.

First, nothing in the definitions of "property damage" or "occurrence" sets forth any sort of "contort" distinction, with coverage provided for tort claims but not contract claims. *See Essex Builders Group, Inc. v. Amerisure Ins. Co.*, 2005 WL 3981766 (M.D. Fla. Sept. 21, 2005) (noting that the determination of coverage was dependent on whether there had been an occurrence of property damage as opposed to whether the claims sounded in tort or contract); *Am. Family Mut. Ins. Co. v. Am. Girl, Inc.*, 673 N.W.2d 65, 77-78 (Wis. 2004); *Vandenberg v. Superior Court,* 982 P.2d 229, 245 (Cal. 1999); *Broadmoor Anderson v. Nat'l Union Fire Ins. Co.*, 912 So. 2d 400, 405 (La. App. 2005); Bruner & O'Connor, at § 11.36; Wielinski, Defective Construction, at 19-31. In fact, the words "negligence," "contract," or "warranty" do not appear in these definitions nor in any other portion of the insuring agreement. Certainly, if Mid-Continent had intended to exclude coverage for breach of contract or breach of warranty claims, it could easily have done so through an explicit exclusion. Or, Mid-

Continent could have inserted the following language into the insuring agreement: "We will pay those sums that the insured becomes legally obligated to pay as damages [in tort] because of… 'property damage' to which this insurance applies."

Second, any contention that breach of contract allegations run afoul of the coverages afforded by a CGL policy creates a false dichotomy between "noncovered breach of contract" damages and "covered tort liability." *See* Scott C. Turner, Insurance Coverage for Construction Disputes § 6.8 (2d ed. 2003) ("Liability for breach of contract should qualify under the 'legally obligated' qualification of the insurance clause absent disqualification under some other term or provision of the policy. That is, the legal theory under which the claim against the insured is pursued, namely breach of contract, should have little or no relevance in the determination of coverage…"). Commentary from within the insurance industry supports this view as well. In particular, the Associate General Counsel of Kemper Insurance Companies, noted that the "legally obligated to pay" clause that still exists in the insuring agreement of a CGL policy "is intentionally broad enough to include the insured's obligation to pay damages for breach fo contract as well as for tort." *See* George H. Tinker, *Comprehensive General Liability Insurance—Perspective and Overview*, 25 Fed. Ins. Coun. Q. 217, 265 (1975).

Third, since the same act may constitute both a breach of contract and a tort, drawing a coverage line between the two is a distinction without a difference. *See Ins. Co. of N. Am. v. McCarthy Brothers, Co*., 123 F. Supp. 2d 373, 377 (S.D. Tex. 2000) ("In Texas, the underlying liability facts, rather than the legal theory of liability, trigger the duty to indemnify."); *E&R Rubalcava Constr., Inc. v. Burlington Ins. Co*., 147 F. Supp. 2d 523, 527 (N.D. Tex. 2000) (noting that the breach of contract claims asserted against the insured were, in effect, claims of negligence); *Stumph v. Dallas Fire Ins. Co.*, 34 S.W.2d 722 (Tex. App.—Austin 2000, no. pet.) (noting that coverage would not be precluded if the contractor's breach of contract or warranty resulted from an accident within the meaning assigned to it in the insurance policy); *see also Vandenberg v. Centennial Ins. Co.*, 982 P.2d 229, 243-46 (Cal. 1999) (overruling a long line of California case law that had supported the contract versus tort distinction for purposes of determining insurance coverage); *Broadmoor Anderson v. Nat'l Union Fire Ins. Co*., 912 So. 2d 400, 405 (La. App. 2005) ("This policy language for the CGL grant of coverage does not make any express distinction between tort or contractual liability. While the term 'accident' may imply a tortious event, T-Z's deficient conduct, unexpected and with lack of foresight, can also be considered accidental."); *Am. Family Mut*., 673 N.W.2d at 78 ("If, as American Family contends, losses actionable in contract are never CGL 'occurrences' for purposes of the initial coverage grant, then the business risk exclusions are entirely unnecessary."); *Amerisure Mut. Ins. Co. v. Paric Corp*., 2005 WL 2708873 (E.D. Mo. Oct. 21, 2005) ("The ESA defendants have asserted negligence claims against defendant Paric in two of the underlying actions where a subcontractor installed the EIFS. In the remaining action, defendant Paric apparently installed the EIFS itself and no negligence claim was asserted against defendant Paric. However, the Court does not find that these differences rule out the possibility of plaintiff's coverage in any of the underlying actions.") . In fact, aside from the availability of attorneys' fees under a breach of contract theory, it is quite possible that the measure of recovery under tort versus contract would be the same or very similar.

Fourth, both the Supreme Court of Texas and the Fifth Circuit have recognized that intentional and negligent types of tortious acts occur in the performance of a contract. *See Grapevine Excavation*, 197 F.3d at 729-30. Thus, the mere fact that construction duties originally flowed from a contract does not alter the coverage analysis in any manner.

Mid-Continent further relies, in part, on *Hartick v. Great American Lloyd's Insurance Company*, 62 S.W.3d 270 (Tex. App.—Houston [1st Dist] 2001, no pet.) to bolster its argument that a *breach of warranty* claim is not covered by a CGL policy. In addition to the fact that the court that issued *Hartrick* retreated somewhat from its narrow stance in *Archon Investments, Inc. v. Great American Lloyds Insurance Company*, 174 S.W.3d 334 (Tex. App.—Houston [1st Dist.] 2005, pet. filed) (a panel that included the author of *Hartrick*), the holding that a breach of warranty cannot constitute an "occurrence" is questionable for the same reasons as set forth above in connection with breach of contract. Simply put, the insuring agreement of a CGL policy makes no distinction based on the particular cause of action pled. Moreover, when adopting the implied warranty cause of action, the Supreme Court of Texas noted that service providers such as home builders could absorb the cost of fulfilling such warranties through insurance. *See Melody Home Mfg. Co. v. Barnes*, 741 S.W.2d 349, 353 (Tex. 1987). Additionally, the Supreme Court of Texas has not articulated a distinction between a claim of negligence sounding in tort and a claim for breach of implied warranty that would justify an across-the-board coverage difference between the two. *See Humber v. Morton*, 426 S.W.2d 554, 556 (Tex. 1968) ("[T]he notion of implied warranty arising from sales is considered to be a tort rather than a contract concept"); *Coulson & Cae, Inc. v. Lake L.B.J. Mun. Util. Dist.*, 734 S.W.2d 649, 651 (Tex. 1987) (noting that no real difference exists between claim for breach of implied warranty and negligence). Assuming this to be the case, why should any discernable difference exist vis-a-vis the coverage analysis?

Notably, Mid-Continent's whole "contort" distinction places inappropriate emphasis on the label of the cause of

action rather than on the substance of the claim. In this regard, Mid-Continent takes inconsistent positions. On the one hand, Mid-Continent contends that the negligence claim can simply be ignored and that courts should focus instead on the origin of the damages. On the other hand, after applying its economic loss defense, Mid-Continent argues that CGL policies do not cover breach of contract or breach of warranty claims. Contrary to Mid-Continent's argument, the label of the cause of action—whether it is negligence, contract, or warranty—simply does not control the coverage analysis. That being said, Lamar Homes does not contest the viability of the economic loss rule as applied in underlying construction defect claims. Rather, Lamar Homes simply points out that many types of damage arising out of defective work still satisfy the definitions of "property damage" and "occurrence" even if the damage is not actionable in tort.

Moreover, if an owner can only assert claims of breach of contract and/or breach of warranty against a general contractor for damage to the work itself, and if such claims can never give rise to an "occurrence" in the first place, then the business risk exclusions in the policy would be rendered mere surplusage. In other words, no need would exist for the "your work" exclusion because any construction defect claim for property damage to the work itself, to which the exclusion would apply, would already run afoul of the policy's "occurrence" requirement.[31] Of course, if Mid-Continent is correct, it and other like-minded CGL insurers are guilty of a classic bait-and-switch.

It simply makes no sense to insure a roofing subcontractor or a framing subcontractor for water damage to the interior of a home or building, while at the same time denying coverage to the general contractor for the same damages.

VI. AN INTERESTING TWIST

Mid-Continent's conduct vis-a-vis other parties to the Underlying Lawsuit further highlights the fallacy of Mid-Continent's legal contentions. Mid-Continent, in addition to insuring Lamar Homes (the general contractor), also insured the foundation subcontractor. Mid-Continent, in fact, defended and indemnified the foundation subcontractor against the allegations in the Underlying Lawsuit.

In this sense, Mid-Continent's actions in defending and indemnifying the foundation subcontractor are completely consistent with its view that coverage must be analyzed in connection with the insured's contractual undertaking. In particular, under Mid-Continent's theory, the cracks in the sheetrock and stone veneer would constitute "property damage" caused by an "occurrence" as to the foundation subcontractor since those damages were to property other than to the foundation that was the subject matter of the subcontractor's contract. In stark contrast, as to Lamar Homes (the general contractor), those ***same*** cracks in the ***same*** sheetrock and stone veneer no longer are considered "property damage" caused by an "occurrence" because Lamar Homes contracted for the construction of the entire house. In other words, under this view, the subcontractor that performs the allegedly faulty work that causes damage should be provided with a defense and indemnity whereas the general contractor that gets sued for the exact same damages because of its contractual privity with the owner should be deprived of a defense and indemnity.

In a recently filed post-submission brief, Mid-Continent attempts to shy away from this reality by objecting to the fact that anything related to the foundation subcontractor is outside of the appellate record. Putting aside the fact that the Supreme Court is deciding certified questions as opposed to the actual coverage in *Lamar Homes*, Mid-Continent's attempted side-step of the issue is disingenuous at best. In particular, while stopping short of denying that it defended and indemnified the foundation subcontractor, Mid-Continent suggested that its decision relative to a "*different* insured on *different* pleadings with a *different* policy should not control the outcome" of the certified questions. Post Submission Brief of Appellee Mid-Continent Cas. Co., at p. 5 (emphasis added). Despite Mid-Continent's implications to the contrary, it was the *same* pleadings and the *same* policy language.

Moreover, during oral argument, Mid-Continent argued that it is foreseeable that if you put a bad roof on a building that it can cause damage. Likewise, Mid-Continent argued that it is foreseeable that if you put windows in backwards that they will leak and cause damage. Yet, consistent with its theory that coverage must be determined by the insured's contractual undertaking, Mid-Continent and other CGL insurers would cover the roofing subcontractor and the framing subcontractor for damages that extend beyond their work (i.e., water damage to the interior of the project). At the same time, Mid-Continent would deny coverage to the general contractor for the same damages because the entire home or building is within the scope of its contract.

Simply put, the scope of the insured's contractual undertaking in the construction contract cannot serve as the basis of whether resulting damage is accidental from the standpoint of the insured. It simply makes no sense to insure a roofing sub-

contractor or a framing subcontractor for water damage to the interior of a home or building, while at the same time denying coverage to the general contractor for the same damages. In the context of *Lamar Homes*, and despite Mid-Continent's record objection, it makes no sense to cover the foundation subcontractor for the physical damage to the home, while at the same time denying coverage to the general contractor for the same damages.[32]

VII. AN EMERGING MIDDLE- GROUND APPROACH

Lamar Homes contends that physical damage to the work itself can be "property damage" caused by an "occurrence" so long as the damage is unexpected or unintended from the standpoint of the insured. Moreover, at least in the completed operations context, Lamar Homes contends that such a loss is not excluded because of the explicit subcontractor exception language to exclusion L (at least before the adoption of CG 22 94). Mid-Continent, on the other hand, argues that physical damage to the work itself is inherently foreseeable due to the general contractor's contractual undertaking and thus is not an "occurrence." Similarly, Mid-Continent argues that damage to the work itself is a mere economic loss that does not satisfy the definition of "property damage." As for the subcontractor exception language, Mid-Continent argues that exceptions to exclusions cannot create coverage if none exists.

Recently, there has been an emergence of a new middle-ground approach.

As one can see, the arguments by the two parties in *Lamar Homes* are at polar opposites.[33] Recently, there has been an emergence of a new middle-ground approach. In *Okatie Hotel Group, LLC v. Amerisure Ins. Co.*, 2006 WL 91577 (D. S.C. Jan. 13, 2006), for example, a federal district judge was faced with analyzing a recent Supreme Court decision from South Carolina. The Supreme Court decision had reversed a widely-cited appellate court decision that had supported Lamar Homes' view of coverage. *See L-J, Inc. v. Bituminous Fire & Marine Ins. Co.*, 621 S.E.2d 33 (S.C. 2005) (opinion on reh'g). The South Carolina Supreme Court's opinion, which was at least initially perceived as a major blow to insureds, held that damage to the insured's work product is not accidental and thus not an occurrence. *Id*. at 36.

The *Okatie* court, however, was troubled by the fact that the *L-J* court cited with approval to cases that seemingly stood for the opposite proposition. In particular, in *L-J*, the South Carolina Supreme Court noted that it found the New Hampshire Supreme Court's analysis in *High Country Associates v. New Hampshire Insurance Company*, 648 A.2d 474 (N.H. 1994), helpful "in distinguishing a claim for faulty workmanship versus a claim for damage to the work product caused by the negligence of a third party." *L-J*, 621 S.E.2d at 36. In the *High Country* case, the New Hampshire Supreme Court found coverage for a general contractor for damage to a building caused by the exposure to water seeping into the negligently constructed walls. In particular, the *High Country* court concluded that the claimant had "alleged negligent construction that resulted in an occurrence, rather then an occurrence of alleged negligent construction." 648 A.2d at 478.

Ultimately, based on *L-J's* approval of *High Country*, the *Okatie* court concluded that *L-J* merely stood for the proposition that no "occurrence" exists if the damage is restricted to the defect itself. According to the *Okatie* court, the *L-J* court found no coverage because the negligent acts in connection with the construction of the roadway system resulted only in damage to the roadway system. *Okatie*, 2006 WL 91577, at *6. The Okatie court then proceeded to distinguish *L-J* based on the facts before it. In *Okatie*, the general contractor contracted to construct a 66-room Fairfield Inn Marriott. It was alleged that, following completion, the hotel was exposed to leaks and moisture infiltration. In other words, there was "property damage beyond damage to the work product and/or the improper performance of the task itself." *Id*. The *Okatie* court was not concerned with the fact that the entire hotel was the work product of the general contractor. Rather, the *Okatie* court only was concerned with whether the damage extended beyond the defect itself to otherwise non-defective work.

More recently, and also in the face of a seemingly bad decision from a state supreme court, the Fourth Circuit adopted this middle-ground approach. *See French v. Assurance Co. of Am.*, 2006 WL 1099471 (4th Cir. Apr. 27, 2006). James and Kathleen French contracted with Jeffco Development Corporation for the construction of a single-family home. Pursuant to the construction contract, and through the use of a subcontractor, the exterior of the home was clad with a synthetic stucco system known as EIFS. Following completion of the home, the Frenches discovered extensive moisture and water damage to the otherwise non-defective structure and walls of their home resulting from the defective EIFS cladding. The parties made the same arguments as those before the Court in *Lamar Homes*. The

Fourth Circuit, however, adopted the middle-ground:

> We hold that… a standard 1986 commercial general liability policy form published by ISO does not provide liability coverage to a general contractor to correct defective workmanship performed by a subcontractor. We also hold that… the same policy form provides liability coverage for the cost to remedy unexpected and unintended property damage to the contractor's otherwise nondefective work-product caused by the subcontractor's defective workmanship.

French, 2006 WL 1099471, at *11.

In other words, the court held that damage to the defective EIFS itself is not an "occurrence" whereas the physical damage *caused* by the defective EIFS to otherwise nondefective parts of the home is an "occurrence" *See id*. at *8. In reaching this holding, the Fourth Circuit specifically recognized that the coverage distinctions espoused by Mid-Continent in the *Lamar Homes* case are without merit:

> At oral argument, counsel for Insurance Defendants candidly and correctly acknowledged that had a portion of the defective EIFS exterior on the Frenches' home fallen outwardly onto an automobile or inwardly onto a painting hanging on an interior wall or on furniture in the home, the 1986 ISO CGL Policies would have provided Jeffco liability coverage for damages to the automobile, the painting, and the furniture. In this same vein, it is illogical to contend that had the defective EIFS exterior on the Frenches' home failed and caused damage to the flooring inside the home or to the structural members of the house, neither of which was defective at completion of construction and certification of occupancy, coverage would not have been provided under the 1986 ISO CGL Policies.

Id. at *10.

Lamar Homes does not advocate this middle- ground approach because it still reads something into the CGL policy that simply is not there (i.e., a requirement of damage beyond the work itself). Even so, if the Supreme Court of Texas were to adopt the middle-ground approach, it would require affirmative answers to the first two certified questions. In particular, as applied to *Lamar Homes*, the allegations of cracks to the stone veneer and sheetrock are certainly damages that extend beyond the alleged defects in the foundation. Moreover, as the fact patterns of *Okatie* and *French* demonstrate, negative answers to the first two certified questions in *Lamar Homes* would effectively eliminate coverage for risks that clearly fall within the coverages afforded by the CGL policy.

VIII. CONCLUSION

Decades ago, the Supreme Court of Texas stated that a court "must presume that the objective of the insurance contract is to insure, and [courts] should not construe the policy to defeat that objective unless the language requires it." *Goswick v. Employers' Cas. Co*., 440 S.W.2d 287, 289 (Tex. 1969). What the Supreme Court of Texas said in *Goswick* is equally true today as it was in 1969. Nothing in the "occurrence" and "property damage" definitions supports the conclusion that allegations of defective construction against a general contractor that results in inadvertent damage to the work itself do not fall within the insuring agreement of the CGL policy. Quite to the contrary, the presence of carefully crafted construction-specific exclusions and the exceptions to those exclusions establish that the CGL policy was in fact intended to cover such claims in certain circumstances.

Mid-Continent's arguments against coverage in the *Lamar Homes* case, and others cases that came before it, are nothing more than a revisionist approach to CGL coverage for defective construction. Moreover, by presenting its arguments in isolation from the actual policy language, Mid-Continent attempts to avoid or circumvent the effect of carefully drafted policy exclusions. Those exclusions, in fact, place express limits on the general notion that a CGL policy does not cover a general contractor's risk of defective work by its subcontractors in the context of completed operations. Accordingly, the success of Mid-Continent's arguments rest on a truncated analysis of the CGL policy.

Although the courts in Texas and across the nation have issued diverging opinions, the better reasoned authorities support coverage in cases such as *Lamar Homes*. Only time will tell if the Supreme Court of Texas agrees with Lamar Homes, Mid-Continent, the emerging middle-ground, or some other approach to these thorny issues.

Key Texas Decisions Regarding Construction Defect Coverage

Favorable to Insureds	Favorable to Insurers
Lennar Corp. v. Great Am. Ins. Co., 2006 WL 406609 (Tex. App.—Houston [14th Dist.] Feb. 23, 2006, pet. filed.) (not designated for publication) (duty to indemnify)	***Grimes Construction, Inc. v. Great American Lloyds Insurance Co.,*** 2006 WL 563286 (Tex. App.—Fort Worth March 9, 2006, pet. filed)
Home Owners Mgmt. Enters. v. Mid-Continent Cas. Co., 2005 WL 2452859 (N.D. Tex. Oct. 3, 2005)	***Courtland Custom Homes, Inc. v. Mid-Continent Cas. Co.,*** 395 F. Supp. 2d 478 (S.D. Tex 2005)
Archon Invs., Inc. v. Great American Lloyds Ins. Co., 174 S.W.3d 334 (Tex. App.—Houston [1st Dist.] 2005, pet. filed)	***Lamar Homes, Inc. v. Mid-Continent Cas. Co.,*** 335 F. Supp. 2d 754 (W.D. Tex. 2004)
Mid-Continent Cas. Co. v. JHP Dev., Inc., 2005 WL 1123759 (W.D. Tex. Apr. 21, 2005)	***Vesta Fire Ins. Co. v. Nutmeg Ins. Co.,*** No A-00-CA-468-SS (W.D. Tex., Sept. 29, 2003)
Gehan Homes, Ltd. v. Employers Mut. Cas. Co., 146 S.W.3d 833 (Tex. App.—Dallas 2004, pet. filed)	***Mid-Arc, Inc. v. Mid-Continent Cas. Co.,*** 2004 WL 1125588 (W.D. Tex. Feb. 25, 2004)
Luxury Living, Inc. v. Mid-Continent Cas. Co., 2003 WL 22116202 (S.D. Tex. Sept. 10, 2003)	***Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.,*** 244 F. Supp. 2d 706 (N.D. Tex. 2003)
Great Am. Ins. Co. v. Calli Homes, 236 F. Supp. 2d 693 (S.D. Tex. 2002)	***Acceptance Ins. Co. v. Newport Classic Homes, Inc.,*** 2001 WL 1478791 (N.D. Tex. 2001)
CU Lloyd's of Texas v. Main Street Homes, Inc., 79 S.W.3d 687 (Tex. App.—Austin 2002, no pet.)	***Hartrick v. Great Am. Lloyds Ins. Co.,*** 62 S.W.3d 270 (Tex. App.—Houston [1st Dist.] 2001, no pet.) (duty to indemnify)
First Texas Homes, Inc. v. Mid-Continent Cas. Co., 2001 WL 238112 (N.D. Tex. Mar. 7, 2001), aff'd, 2002 WL 334705 (5th Cir. 2002)	***Devoe v. Great Am. Ins. Co.,*** 50 S.W.3d 567 (Tex. App.—Austin 2001, no pet.)

1. Since Mr. Burke routinely represents Mid-Continent, the references in this article to "Mid-Continent argues" or "Mid-Continent contends" are meant to apply to Mr. Burke's article as well.

2. The *Lamar Homes* case has attracted a lot of attention both in Texas and across the country. Notably, as of the publication date this article, at least eight amicus briefs had been filed. All of the briefing can be found at the Supreme Court's website at http://www.supreme.courts.state.tx.us/ebriefs/files/20050832.htm. In addition, a recording of the oral argument can be heard at http://www.supreme.courts.state.tx.us/oralarguments/audio_2005.asp.

3. The issue of whether extrinsic evidence may be used in the duty to defend analysis is in a state of flux. In *Northfield*, the Fifth Circuit made an *Erie* guess "that the current Texas Supreme Court would not recognize any exception to the strict eight corners rule." 363 F.3d at 531. Five months later, the Fifth Circuit completely ignored its earlier opinion in *Northfield* and concluded that extrinsic evidence may be used in limited circumstances. *See Primrose Operating Co. v. Nat'l Am. Ins. Co.*, 382 F.3d 546, 552 (5th Cir. 2004). Adding to the confusion was the fact that the same judge authored both opinions. In between the issuance of the two contrasting Fifth Circuit opinions, the Fort Worth Court of Appeals issued an opinion that stands for the proposition that extrinsic evidence is permitted in the duty to defend analysis in only "very limited circumstances" involving "fundamental coverage issues." *Fielder Road Baptist Church v. Guide one Elite Ins. Co.*, 139 S.W.3d 384, 388 (Tex. App.—Fort Worth 2004, pet. granted). The *Fielder Road Baptist Church* case is pending before the Supreme Court on petition for review. The outcome of the case could have a dramatic effect on the number of cases defended by CGL insurers.

4. Neither Lamar Homes nor Mid-Continent argued that the CGL policy was ambiguous. Even so, Lamar Homes set forth the contract interpretation principles and noted that two reasonable interpretations created an ambiguity to be construed in Lamar Homes' favor. Mid-Continent argued that the contra-insurer rule only applied to exclusions and thus could not apply to interpretation of the insuring agreement. Although the contra-insurer rule applies with even greater force to the application of exclusionary language, the rule is not limited to exclusions. Notwithstanding this fact, even if Mid-Continent was correct that the contra-insurer rule applies only to exclusions, it is abundantly clear that Mid-Continent treats the "property damage" and "occurrence" requirements as exclusions to coverage.

5. "Property damage" is defined in the Mid-Continent policy, in pertinent part, as "physical injury to tangible property, including all resulting loss of

use of that property" and "loss of use of tangible property that is not physically injured."

6. "Occurrence" is defined in the Mid-Continent policy as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

7. The most commonly applied business risk exclusions are: **J5** (the "operations" exlusion), **J6** (the "faulty workmanship" exclusion), **K** (the "your product" exclusion), **L** (the "your work" exclusion), **M** (the "impaired property" exclusion), and **N** (the "sistership/recall" exclusion).

8. This language comes directly from the exception to exclusion L. Exclusion L, the "your work" exclusion, applies to completed operations (i.e., a completed home or building that has been turned over to the owner). The "your work" exclusion negates coverage as follows:

> l. Damage to Your Work
>
> "Property damage" to "your work" arising out of it or any part of it and included in the "products-completed operations hazard."

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

9. CGL insurers often focus on case law that addresses earlier versions of the CGL policy. For example, many CGL insurers rely heavily on *T.C. Bateson Constr. Co. v. Lumbermans Mut. Cas. Co*., 784 S.W.2d 692, 694-95 (Tex. App.—Houston [14th Dist.] 1989, writ denied), which, in turn, relies on *Weedo v. Stone-E-Brick, Inc.*, 405 A.2d 788 (N.J. 1979). *Weedo* is perhaps the most widely cited opinion by CGL insurers. Likewise, CGL insurers oftentimes rely on *McCord, Condron & McDonald, Inc. v. Twin City Fire Ins. Co.*, 607 S.W.2d 956 (Tex. Civ. App.— Ft. Worth 1980, writ ref'd n.r.e.) as well as *Eulich v. Home Indem. Co.*, 503 S.W.2d 846 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.). The courts in *T.C. Bateson, Weedo, McCord*, and *Eulich* construed exclusions in the 1973 version of the CGL policy in reaching their "no coverage" conclusions. The CGL policy has undergone significant changes since 1973 and thus the case law interpreting predecessor versions simply has little, if any, application to the modern CGL policy. *See Lennar Corp. v. Great Am. Ins. Co.*, 2006 WL 406609 (Tex. App.—Houston [14th Dist.] Feb. 23, 2006, pet. filed) (op. on reh'g) (not designated for publication). Moreover, case law construing *exclusions* is not relevant in determining whether the insuring agreement has been satisfied by allegations of defective construction. *See id*.

10. Mid-Continent and/or its sister company Great American have lost on this very fact pattern on numerous occasions. State court cases involving Mid-Continent or Great American: *Archon Investments, Inc. v. Great Am. Lloyds Ins. Co.*, 174 S.W.3d 334 (Tex. App.—Houston [1st Dist.] 2005, pet. filed); *Lennar Corp. v. Great Am. Ins. Co*., 2006 WL 406609 (Tex. App.—Houston [14th Dist.] Feb. 23, 2006, pet. filed) (op. on reh'g) (not designated for publication); *Gehan Homes, Ltd. v. Employers Mut. Cas. Co.*, 146 S.W.3d 833 (Tex. App.—Dallas 2004, pet. filed). Federal court cases involving Mid-Continent or Great American: *Home Owners Mgmt. Enters. v. Mid-Continent Cas. Co*., 2005 WL 2452859 (N.D. Tex. Oct. 3, 2005); *Luxury Living, Inc. v. Mid-Continent Cas. Co.*, 2003 WL 22116202 (S.D. Tex. Sept. 10, 2003) (not designated for publication); *Great Am. Ins. Co. v. Calli Homes*, 236 F. Supp. 2d 693 (S.D. Tex. 2002); *First Tex. Homes, Inc. v. Mid-Continent Cas. Co.*, 2001 WL 238112 (N.D. Tex. Mar. 7, 2001), *aff'd*, 2002 WL 334705 (5th Cir. 2002) (not designated for publication). For the most recent pronouncement against these cases, see *Grimes Constr., Inc. v. Great Am. Lloyds Ins. Co.*, 2006 WL 563286 (Tex. App.—Fort Worth Mar. 9, 2006, pet. filed). A chart that includes all of the Texas case law that falls within this fact pattern is included in the Appendix to this article.

11. This article is not intended to be an indictment of all CGL carriers. Many CGL carriers properly analyze the policy as a whole and apply it as written. That being said, certain insurers like Mid-Continent Casualty Company and Great American Lloyds Insurance Company have taken a particularly narrow view of CGL coverage.

12. Dictionary definitions of "accident" demonstrate that the term refers to "an event which proceeds from an unknown cause, or is an unusual effect of a known cause, and therefore not expected" (Webster's New Universal Unabridged Dictionary, 2d ed.) or "an unforeseen and unplanned event or circumstance; an unfortunate event resulting especially from carelessness or ignorance" (Merriam Webster's Collegiate Dictionary, 10th ed.). Thus, as illustrated by the quoted definitions, a relationship exists between an effect and the cause of that effect. *See* Jack P. Gibson & Maureen McLendon, Commercial Liability Insurance § V (IRMI 1997 and Supp. 2002) (hereinafter Gibson). A point that is often overlooked, however, is that nothing in the definition of an "occurrence" requires that an accident be something that happens for no reason. *See id*. Rather, "[e]very event has some precedent cause; identifying that cause does not necessarily deprive the event of its 'accidental' nature." *Id*.

13. In *King*, the Supreme Court relied heavily on the Appleman on Insurance treatise and its discussion of the "occurrence" requirement. The Appleman treatise, which also was cited by Mid-Continent in its briefing, squarely rejects the use of foreseeability or any sort of "natural or probable consequence" test in determining whether the "occurrence" definition has been satisfied. *See* Eric Mills Holmes, Appleman on Insurance 2d, §§ 117.1 -117.5, 118.1-118.2 (2000). The Appleman treatise, consistent with the holding in *King*, recognizes that an objective test along foreseeability lines would essentially negate coverage in most circumstances. *See id*.

14. Of course, this same logic applies to a vice president shooting a lawyer believing that lawyer to be a quail.

15. In Mr. Wielinski's treatise, he provides an example that is directly on point:

> Consider an example where a claim is made against the home builder for a defective foundation. The foundation was poured by a subcontractor and is causing widespread cracking throughout the home. Under the "third-party property damage" gloss on the definition of "occurrence," there is no coverage because the entire home is the work of the home builder. On the other hand, where the unexpected and unintended nature of the property damage is recognized as an occurrence, and the exclusions are then applied, the home builder will be entitled to coverage for the property damage to the home arising out of its subcontractor's defective work based on the subcontractor exception to the your work exclusion.

Wielinski, Defective Construction, at p. 58.

16. Even the dissenting/concurring opinion in *Lennar Corp*. recognized that, under the Supreme Court of Texas standards for determining an "occurrence," damage to the work itself could in fact constitute an "occurrence." *See Lennar Corp. v. Great Am. Ins. Co.*, 2006 WL 909937 (Tex. App.—Houston [14th Dist.] Apr. 11, 2006, pet. filed) (Edelman, J., dissenting). While Justice Edelman disagreed with framing the controlling issue as whether defective construction resulting in damage to the insured's own work can be an "occurrence," that is precisely the nature of the certified questions in *Lamar Homes*.

17. Since exclusion L applies only to "your work," the "subcontractor exception" by necessity preserves coverage for property damage to the home itself. *See Kalchthaler v. Keller Constr. Co.*, 591 N.W.2d 169, 174 (Wis. App. 1999); *O'Shaughnessy v. Smuckler Corp.*, 543 N.W.2d 99, 104-05 (Minn. App. 1996). In fact, since the CGL policy already covers damage to third-party property, the subcontractor exception would be unnecessary. *See O'Shaughnessy*, 543 N.W.2d at 104-05 ("The CGL policy already covers damage to the property of others. The exception to the exclusion, which addresses 'property damage' to 'your work,' must therefore apply to damages to the insured's own work that arise out of the work of a subcontractor.").

18. Exclusion J5 bars coverage for "[t]hat particular part of real property on which you [Lamar] or any contractors or subcontractors working directly or indirectly on your behalf are performing operations, if the 'property damage' arises out of those operations."

19. Exclusion J6 bars coverage for "[t]hat particular part of any property that must be restored, repaired or replaced because 'your work' was incorrectly performed on it."

20. Intentionally substituting inferior building materials, stealing from the construction account, and walking off the job before the construction is complete are all examples of conduct that would result, and properly so, in a finding of no "occurrence" even if the claimant attempted to couch the allegations in terms of negligence. *See, e.g., Jim Johnson Homes, Inc. v. Mid-Continent Cas. Co.*, 244 F. Supp. 2d 706 (N.D. Tex. 2003); *Devoe v. Great Am. Ins. Co.*, 50 S.W.3d 567 (Tex. App.—Austin 2001, no pet.). While *Jim Johnson Homes* and *Devoe* are oftentimes cited as supporting Mid-Continent's position, the factual background of those cases support a finding of no "occurrence." In fact, in *Lennar Corp.*, the court noted that "we would likely agree with the result in *Jim Johnson Homes* based on its recited facts although we disagree with the court's suggestion that no damage arising from defective construction can result from an occurrence." *Lennar Corp.*, 2006 WL 406609, at *11 n.28.

21. A prior version of this article, published at 5:1 J. Tex. Ins. L. 37 (Feb. 2004), undertook a more complete analysis of the various business risk exclusions.

22. Contrary to Mid-Continents's assertion, Lamar Homes *does not* contend that the "subcontractor exception" creates coverage when none exists. To the contrary, Lamar contends that the "occurrence" and "property damage" requirements in the insuring agreement are satisfied when a general contractor is alleged to have caused unexpected or unintended damage. *See, e.g., Am. Family Mut.*, 673 N.W.2d at 83-84 (rejecting argument by CGL insurer that the insured was attempting to create coverage via the "subcontractor exception"); *Lennar Corp.*, 2006 WL 406609, at 11 n.26. Lamar Homes simply points to the "subcontractor exception" language in exclusion L, as well as to the other construction-specific exclusions, to demonstrate the fallacy of Mid-Continent's blanket contention that allegations of defective workmanship somehow are *excluded* from coverage as a threshold matter by the "occurrence" and "property damage" requirements.

23. The "your work" exclusion would have applied to negate coverage had the foundation been constructed by employees of Lamar Homes as opposed to by subcontractors. Again, however, the insurance industry purposefully chose to insure general contractors for the faulty work of their subcontractors.

24. Mid-Continent fails to understand that although a general contractor may be responsible for the construction of a project, the general contractor cannot control every risk associated with it. As a general contractor's liability policy insures against risks beyond its control, it naturally flows that such risks can arise from a subcontractor's work. In fact, due to the complexities of construction, numerous instances exist when the general contractor knows little, if anything, about the exigencies of the subcontractor's work. To state that a general contractor should not be able to obtain liability insurance against a subcontractor's work because of "business risk" does not reflect the commercial reality of the insured general contractor. *See Fireguard Sprinkler Sys., Inc. v. Scottsdale Ins. Co.*, 864 F.2d 648, 653-54 (9th Cir. 1988).

25. Mid-Continent also argued that if Lamar Homes' interpretation is accepted, general contractors will have little incentive to hire competent subcontractors, utilize proper materials and workmanship, or adhere to design and construction requirements. Not only is such an argument insulting to the very contractors that Mid-Continent seeks to insure, but it also is inaccurate. Lawyers, doctors, and other professionals have insurance that covers the consequences of our faulty work. It is hard to imagine a doctor leaving a sponge in a patient or a lawyer letting a statute of limitations run simply because insurance will take care of the consequences. Moreover, the insurance industry—through the underwriting process—is in the best position to handle any such issues. If a general contractor has a loss or repeated losses because of the hiring of incompetent subcontractors or failing to utilize proper materials and workmanship, the insurer can raise the premiums or non-renew the account.

26. Interestingly, Mid-Continent and certain other CGL insurers have recently endorsed their policies to eliminate the subcontractor exception language to exclusion L. While Mid-Continent at oral argument argued that the new endorsement (CG 22 94) is being used to correct the misinterpretation of the subcontractor exception by certain courts, the expansive amount of case law and commentary discussing the evolution of the CGL policy proves otherwise. In particular, Mid-Continent's excuse for the adoption of CG 22 94 flies in the face of industry publications and other commentary that demonstrate that the insurance industry had made a purposeful decision to include coverage for general contractors for the defective workmanship of their subcontractors that caused damage to the project. *See Fireguard Sprinkler Sys.*, 864 F.2d at 651-54; *Am. Family Mut.*, 673 N.W.2d at 82-83; *Kvaerner Metals*, 825 A.2d at 656; Appeleman on Insurance 2d, § 132.9; Couch on Insurance 3d, § 129:18.

27. In so doing, the *Archon* court properly noted that the Supreme Court of Texas has recognized that "'[t]he contractual relationship of the parties may create duties under both contract and tort law' and that '[t]he acts of a party may breach duties in tort or contract alone or simultaneously in both.'" *Archon Investments*, 174 S.W.3d at 341 (quoting *Jim Walter Homes v. Reed*, 711 S.W.2d 617, 618 (Tex. 1986)).

28. Commentators also agree with the view that the economic loss rule does not apply to insurance coverage. See 2 Jeffrey W. Stempel, Law of Insurance Contract Disputes § 14A.02[d],14A.03[c]-[d], 14A.05[b] (2d ed. 1999 & Supp. 2005); Bruner & O'Connor, at § 11.32; Wielinski, Defective Construction, at 130-33.

29. By way of example, the DiMares lawsuit in state court had pending tort claims against Lamar Homes at the time that Judge Yeakel ruled that the economic loss rule applied. Although the DiMare's lawsuit was settled prior to any ruling by the trial court as to the application of the economic loss rule, it is possible that the trial judge would have disagreed with Judge Yeakel vis-a-vis the viability of the tort claims. The potential for conflicting opinions—regardless of which judge is correct—demonstrates why coverage courts should not be permitted to rule on liability defenses while the underlying lawsuit is still pending.

30. Under Texas law, a determination on the ultimate issue of negligence need not be made in order to invoke an insurer's duty to defend. Rather, an underlying lawsuit must only allege facts for which a potential for coverage exists. *See Steve Roberts Custom Builders*, 215 F. Supp. 2d at 788; *Main Street Homes*, 79 S.W.3d at 694-95.

31. Mid-Continent sets forth some hypotheticals that it claims demonstrate that the business risk exclusions would not be rendered mere surplusage if its interpretation of "occurrence" is accepted. Similar hypotheticals were set forth in Mr. Burke's article as well. While Mid-Continent and Mr. Burke should be applauded for their creativity, a closer look at the hypotheticals demonstrates their weaknesses. In particular, the hypotheticals are dependent on an insured general contractor causing damage to an adjacent structure that was previously completed by the same insured under a separate contract. For example, in its briefing, Mid-Continent sets forth an example of a builder that constructs several homes in a single neighborhood. According to Mid-Continent, if the builder completes one home and then bumps it with a forklift as he is working on the home next door, this would constitute an "occurrence" and then coverage would depend on whether the forklift operator was an employee of the general contractor or a subcontractor via exclusion L. Again, while creative, the history and evolution of the "subcontractor exception" language undeniably demonstrates that the drafters of the CGL policy were not concerned with any sort of rampant problem of general contractors damaging their own previously finished work on adjacent lots. Moreover, as evident from the actions of other CGL carriers, the drafting and evolution of the business risk exclusions and the exceptions to those exclusions were not so narrowly focused. Mid-Continent, to its credit, did set forth one example that has nothing to do with damage to a previously completed work on an adjacent lot. The example is a general contractor that comes to do warranty work on a completed home, drops a cigarette, and burns down the house. According to Mid-Continent, although the damage to the home would be a covered "occurrence," exclusion L would negate coverage provided that the cigarette was dropped by an employee of the insured general contractor as opposed to a subcontractor. While it is true that the damage caused by the dropping of a cigarette would be an "occurrence," exclusion L would not apply regardless of the application of the subcontractor exception because the dropping of the cigarette has nothing at all to do with the general contractor's work and thus the hypothetical falls outside the ambit of the "your work" exclusion.

32. In the same post-submission brief, Mid-Continent—for the first time—noted that "[p]erhaps there also is no 'accident' when a subcontractor's poor workmanship damages only some greater part of the structure he is building." Post Submission Brief of Appellee Mid-Continent Cas. Co., at p. 6. This statement by Mid-Continent completely undercuts its whole contractual undertaking theory. Moreover, it goes against decades of case law and commentary that supports the finding of coverage for a subcontractor's work that damages other parts of a project. *See, e.g., Grapevine Excavation*, 197 F.3d at 722-26 (finding coverage for the faulty workmanship of a subcontractor that damaged property other than the work the subcontracted had contracted to do); *E&R Rubalcava*, 147 F. Supp. 2d at 527. Further, it completely emasculates the carefully crafted business risk exclusions—such as J(5) and J(6)—that are limited to only "that particular part" of property upon which the insured is performing operations.

33. The *Lennar Corp.* case from the Houston Court of Appeals and the recent *Grimes Construction* case from the Fort Worth Court of Appeals are good examples of the competing interpretations of the CGL policy. The author of this article wrote an amicus brief on behalf of the Texas Association of Builders in support of Lennar Corp. that contained the precise arguments set forth in this article. Those arguments, as evident in the majority opinion, were largely accepted. In contrast, Kipper Burke was the lead counsel for Great American in *Grimes Construction*. The holding in *Grimes Construction* is completely consistent with Mr. Burke's interpretation of the CGL policy as set forth in his prior article. The *Lamar Homes* case shapes up to be a battle of these competing interpretations.

BY JAMES B. STIFF, Ph.D

Defending Bad Faith Allegations: Ten Keys to Success

Jurors in bad faith cases are often confronted with ambiguity about what was said versus what was written, ambiguity about the meaning and intent of representations that were made, and ambiguity surrounding the veracity of conflicting witness testimony. This paper focuses on the challenges jurors face as they attempt to resolve these ambiguities and provides strategic recommendations for framing the discussion of the case issues during deliberations.

TELL THE TRUTH

The old adage "It goes without saying…" does not apply here. It is important to explicitly instruct every witness that believability is the key to success in a bad faith trial. During the past 15 years, we have worked on three bad faith cases that resulted in a large verdict against a client. In each of those cases, a key company witness was caught lying during his trial testimony. Jurors decide bad faith cases based on whom they believe. If jurors conclude that a critical witness is lying, little else matters.

Witnesses must not only be truthful, they must *appear* to be truthful. There are two primary dimensions of credibility, perceived trustworthiness and perceived competence or expertise. In bad faith cases, perceived trustworthiness is generally more important than perceived competence. Too often, fact witnesses are reluctant to admit errors in judgment, discuss performance shortfalls, or acknowledge that remedial actions have been taken because they fear it will undermine their perceived competence. However, in the process of preserving their perceived competence, witnesses often undermine their trustworthiness and become their own worst enemy.

Loyal company employees often assume too much responsibility for ensuring a successful trial outcome and such pressure often impairs their trial testimony. It is important to talk with fact witnesses about their concerns and to ensure that the company has provided ample support, both logistically and in terms of career development, so that witnesses can focus on the difficult task of providing accurate, effective testimony.

EMBRACE BAD FACTS

Every bad faith case has bad facts and documents. It is a natural instinct to avoid or minimize these problems. However, it is important to embrace the bad facts and integrate them into your case presentation. Speakers often believe that they are most persuasive when they focus on the positive issues and avoid discussing the problem areas. However, research in Communication and Social Psychology has demonstrated that presentations that introduce and respond to negative information and opposing arguments are more persuasive than presentations that only focus on the positive aspects of an issue.

Bad facts and documents can be ambiguous, especially to naïve jurors. Embracing the problem issues enables you to create an alternative framework for helping jurors understand them. Jurors will be more willing to entertain your interpretation of a document or your client's perspective on a conversation if you embrace the problems and integrate them into your story of the case.

INTRODUCE PROBLEMS EARLY

The case themes developed during *voir dire* and opening statements create the cognitive framework that jurors use to understand and organize the evidence that follows. Once the case themes have been established, jurors look for evidence that conforms with their concept of the case. Evidence that conforms with a juror's view of the case is accepted. However, negative information that is incompatible with a prevailing viewpoint is perceived as new and assigned greater importance.

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When jurors hear about problem issues during the early stages of the case, the information is more easily integrated into jurors' emerging views of the case. However, when lawyers wait to discuss problem issues in a bad faith case, they run the risk of heightening the importance that jurors assign to those issues when they are introduced later in trial. Moreover, when lawyers initially shy away from bad facts and documents, it undermines their ability to authoritatively discuss the meaning of those facts when they are introduced by opposing counsel.

It is never too early to begin talking with jurors about the problems with your case. Indeed, if *voir dire* presents an opportunity to talk about the problem issues, there will be fewer surprises during opening statements. Moreover, fact witnesses should be given the opportunity to introduce and explain problem documents and issues during their direct examination. Jurors look for surprises in cross examination. When negative issues are introduced during direct examination, cross examination on those same issues becomes less newsworthy. If there is no "news" during the cross examination of your fact witness, the testimony is generally a success.

MAKE CONCESSIONS QUICKLY

Witnesses are often reluctant to make concessions. Lawyers sometimes fall into the same trap. When the concession is inevitable, it is important to make it quickly and confidently. The tone of a concession often determines the significance that jurors assign to it. Too often witnesses will argue a point that they will eventually concede and in the process elevate the significance of the issue in the minds of jurors.

Several years ago we were working on a case in which an internal company legal memorandum was heralded by the plaintiff as the "smoking gun" in a bad faith conspiracy. An objective reading of the document should have raised suspicions, even among defendant-oriented jurors. Instead of arguing over the apparent meaning of the document during his trial testimony, the author confidently acknowledged that he had written the document and that he meant what he wrote. At the conclusion of the trial, post-trial interviews were conducted with jurors. None of the jurors assigned any importance to the document and it was never discussed during deliberations. A document that was the centerpiece of the alleged bad faith conspiracy was relegated to a non-event because of the way it was handled during trial.

This is not to suggest that bad documents will always be dismissed by jurors. However, jurors tend to assign importance to issues based on the amount of time they are given during trial. If a lengthy and contentious debate had developed during cross examination over the meaning of the "smoking gun" document, it would have been a more important issue in jurors' minds.

It is essential to work with fact witnesses so they understand the issues that will be defended and those that will be conceded. The strategic decision to concede an issue should be made by the trial team in advance of trial. Witnesses must understand when they should maintain a firm and unwavering defense of a position and when they should concede a point quickly and confidently.

TAKE THE OFFENSIVE

In bad faith cases it is important to be on the offensive. Case presentations that are organized around responding to the plaintiff's allegations place defendant-oriented jurors in a defensive posture during deliberations. Jurors who begin deliberations in a defensive posture are less persuasive advocates than those who can assume an offensive position that challenges the plaintiff.

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An offensive strategy also increases the complexity for plaintiff-oriented jurors as it creates an obligation to defend the actions of the plaintiff while arguing that the defendant has acted in bad faith.

Consequently, an effective defendant case presentation should emphasize a compelling story that challenges the plaintiff through an alternative theory of the case. The compelling story of the case will include a few critical themes that are woven together as the evidence is presented at trial. The story should provide a framework for understanding what happened and who, if anyone, is responsible.

It is not important, nor necessarily desirable, for the defendant's story of the case to rely on the same documents and testimony emphasized by the plaintiff. Indeed, effective defendant presentations often emphasize documents and testimony that are discounted by the plaintiff. To the extent that the alternative story of the case challenges the plaintiff's judgment, expertise, or trustworthiness, it can also serve to undermine the motivation plaintiff jurors need to become persuasive advocates during deliberations.

EXPLAIN THE PLAINTIFF'S MOTIVATION

If the defendant's story of the case is correct, then jurors will need an explanation of why the plaintiff filed the lawsuit. In most bad faith cases, jurors presume that the plaintiff was justified in filing the lawsuit, even if bad faith cannot ultimately be proven. Indeed, plaintiff jurors often base their verdict preferences on a generalized belief that the plaintiff was misled or harmed by a less than honest defendant. If jurors are to accept the defendant's alternative story of the case, then they will need to understand what motivated the plaintiff to file the lawsuit. Without such an explanation, defendant jurors will have a difficult time arguing why the lawsuit was filed if the plaintiff's story of the case is incorrect.

DEFINE THE DISCUSSION OF DAMAGES

It is important to define the discussion of damages. In much the same way as political candidates strive to define the issues for discussion, trial lawyers and expert witnesses must establish an alternative framework for examining what damages, if any, were suffered by the plaintiff.

An effective damages presentation may focus attention on causality issues or it might emphasize what the plaintiff gained, rather that what the plaintiff lost. Regardless of the approach, the alternative presentation must establish the framework for evaluating a claim of damages.

In most cases, defendants also benefit from establishing an alternative damage number. If this alternative estimate can be combined with an argument that someone else is responsible for the damages, it establishes a cognitive anchor to offset the plaintiff's request for damages without acknowledging your client's liability for the damages.

After the alternative damage model has been presented, attention should be focused on refuting the plaintiff's request for damages. It is important to provide a point by point refutation of the plaintiff's damage model, but this refutation generally should not be the centerpiece of the defendants' damages presentation.

The alternative damages presentation is sometimes an effective tool for undermining the plaintiff's allegations of bad faith. If plaintiff-oriented jurors begin to question whether the plaintiff has suffered any tangible damages that were caused by the defendant, it becomes more difficult for them to argue that a defendant has acted in bad faith. Consequently, it can be advantageous to devote a considerable amount of time during opening statements to the alternative theory of damages. If the plaintiff reserves a detailed damages discussion for the closing argument, the defendant has the opportunity to strike first during opening statements and establish the framework for understanding this issue.

TELL THE COMPANY STORY

The most effective way to undermine the motivation to punish a corporate defendant is to tell a positive story about the company. In bad faith cases, if jurors come to trust the company, they will be more inclined to conclude that any misrepresentation was not intentional and any error in judgment is not indicative of a systemic problem.

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Consequently, the public relations aspect of the trial requires a special type of witness who is capable of presenting a favorable image of the company while responding to questions about policies and procedures. It is often difficult to find a witness who can fill this role and tell a compelling company story. Nevertheless, identifying a witness who can be the face of the company is critically important in defending a bad faith allegation.

TEACH THE ELEMENTS OF BAD FAITH AND BURDEN OF PROOF

Jurors need instruction on the elements of bad faith and the burden of proof if they are to be effective in promoting this framework for organizing the discussion of bad faith during deliberations. The legal requirements for a finding of bad faith often become the foundation for successful defendant jurors as they argue that the plaintiff has not met its burden of proof. When defendant-oriented jurors understand the legal requirements for a bad faith finding, they are able to present those requirements hurdles or barriers to a plaintiff verdict. Moreover, when there is conflicting testimony about a particular issue and no "objective" evidence or documents to resolve the conflict, defendant jurors will often argue that the plaintiff has failed to prove its claim by clear and convincing evidence.

While these observations may be self-evident to trial lawyers, it is surprising how little attention these issues generally receive during trial. Instead of reserving discussion of these issues for the closing moments of final argument, jurors should understand from the outset that the plaintiff has specific

obligations it must meet in order to prove a bad faith allegation. When jurors conduct an element by element analysis of the bad faith allegation, the prospects for a defense verdict improve dramatically. In contrast, when jurors rely on general impressions that a defendant acted in bad faith, it is difficult to avoid a finding of bad faith.

KEEP IT SIMPLE

A compelling story should reframe the discussion of what happened and how it may have affected the plaintiff. A convoluted story is not compelling. Jurors lose patience when they perceive that witness testimony is unnecessary or inefficient. While it is essential to respond to every major allegation, it is equally important to focus the case presentation on key issues and maintain efficiency throughout the trial. Jurors need to understand the significance of each witness and how that witness' testimony should inform their overall judgment about the case. When jurors lose interest, it typically happens during the second half of the trial.

SUMMARY

These recommendations underscore the importance of presenting a credible story that creates a cognitive framework that jurors can use to understand and integrate the evidence they receive during trial. The case presentation should provide defendant-oriented jurors with the evidence and arguments they need to become effective advocates during deliberations. An aggressive response to the bad faith allegation will motivate defendant jurors, but it is also important to provide them with the tools they need to argue their position during deliberations.

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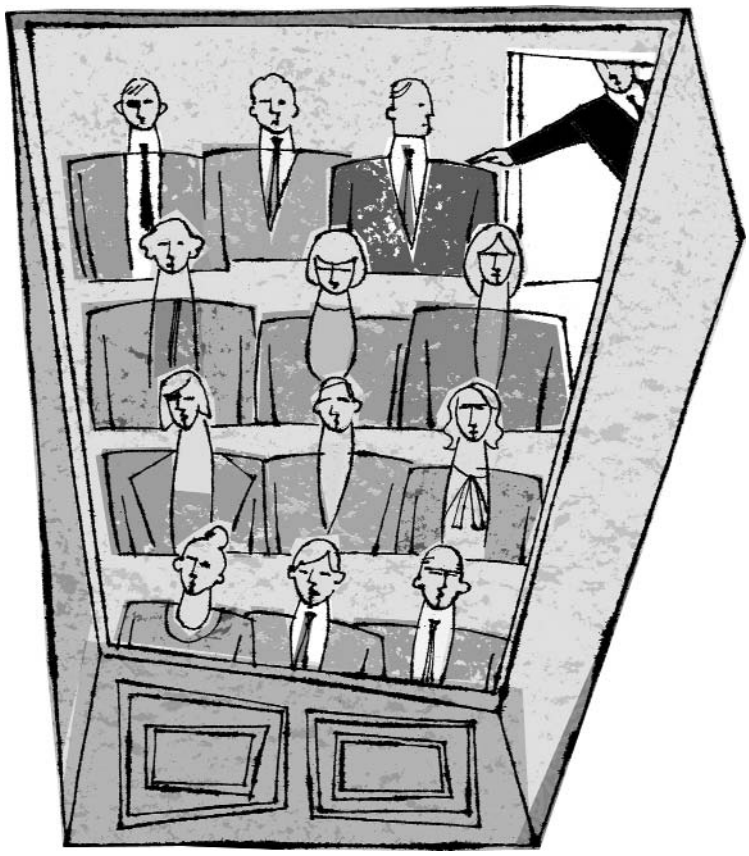

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Comments FROM THE EDITOR

BY CHRISTOPHER W. MARTIN
Martin, Disiere, Jefferson & Wisdom, L.L.P.

The Section bylaws require the election of a new Chair each year. So, this edition marks the transition from our 2005-2006 Chair, Veronica Czuchna, to our new Chair, Rusty McMains. Veronica has done a tremendous job this year as the Chair of the Insurance Law Section. I want to let all of the Section's members know she worked extremely hard over the past twelve months donating many non-billable hours to make the Section better for our members. Although the Section has been led by some exceptionally talented people over the past decade, Veronica established herself as one of our best leaders ever. Veronica, thank you for your tireless efforts, your creative energy, and your commitment to the Section.

This publication is only as good as our members make it. I don't write the articles, I just edit them. If you have an article that you would like to see published, please let me know because we have several spaces available in our remaining publications this year.

Christopher W. Martin,
Martin, Disiere, Jefferson & Wisdom, L.L.P.
Editor-In-Chief

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