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The Journal of Texas Insurance Law is published by the Insurance Law Section of the State Bar of Texas. The purpose of the ***Journal*** is to provide Section members with current legal articles and analysis regarding recent developments in all aspects of Texas insurance law, as well as convey news of Section activities and other events pertaining to this area of law.

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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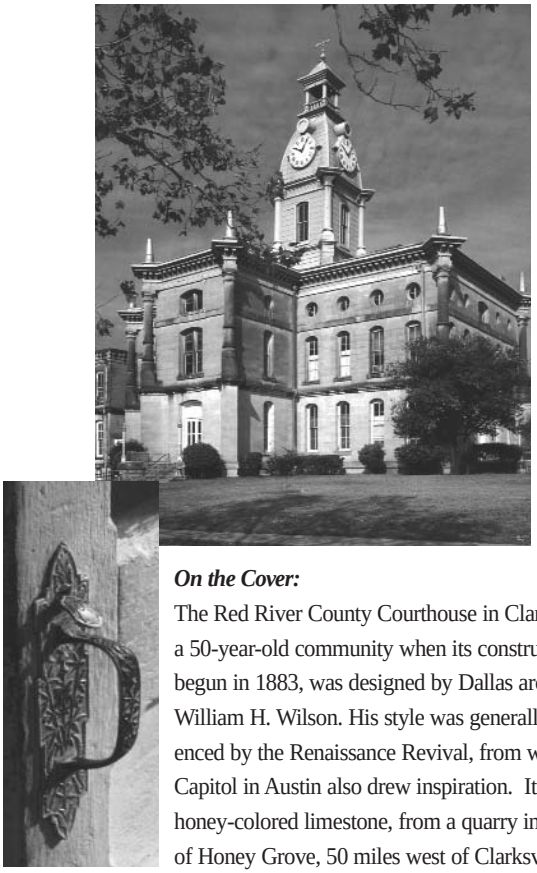

On the Cover:

The Red River County Courthouse in Clarksville, a 50-year-old community when its construction was begun in 1883, was designed by Dallas architect William H. Wilson. His style was generally influenced by the Renaissance Revival, from which the Capitol in Austin also drew inspiration. It is clad in honey-colored limestone, from a quarry in the town of Honey Grove, 50 miles west of Clarksville.

An interesting historical note: by 1845 when Texas became a state and a new constitution was written, new counties were encouraged to encompass about 900 square miles. If a county were kept to a 30-mile-square, the county seat, located within five miles of the geographic center, could be reached in no more than half a day by anyone riding a horse or driving a team.

Courtesy of *Texas Highways* magazine

STATE BAR OF TEXAS
Created in 1939

Comments FROM THE CHAIR

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

As most of you know, the Texas Supreme Court heard oral arguments in February in two cases of great interest to the insurance bar. The first, *Lamar Homes*, was argued on February 14, 2006 and addressed the issues of coverage for construction defects and the applicability of Article 21.55 to the insured's claim for a defense. This issue of the *Journal* includes an article by Kipper Burke on coverage for construction defects. The second case set for submission to the Court is *Frank's Casing*, which was argued on February 15, 2006. *Frank's Casing* was the subject of an informative article in the previous issue of the *Journal*. Both *Lamar Homes* and *Frank's Casing* were the subject of excellent panel discussions at the recent 10th Annual Insurance Law Institute co-sponsored by the Section and UT Law School. We plan to continue to provide you with updates, analyses, and seminars addressing these and other important insurance cases pending at the Texas Supreme Court, including a summary of the oral arguments and the issues raised by the Court during argument.

Please mark your calendars and plan to attend this upcoming event sponsored by the Section. The Section's annual meeting and afternoon CLE program is scheduled on **Thursday, June 15, 2006** during the State Bar convention in Austin. We encourage all members to attend – it is an excellent opportunity to meet and mingle with other members of the Section. The CLE program is first rate, approved for 3 hours of MCLE credit (including 1 hour of ethics), and it is free!

Thank you to those of you who responded to the Section's Member Survey. We received many useful comments and suggestions concerning our CLE offerings, the website, and the *Journal*. We now are considering whether and how to implement some of the suggestions.

Finally, the Section is undertaking a project that relies, in large part, upon you, our members. Drafting a charge in an insurance case is not always as simple as referring to the PJC. Therefore, as an added benefit to our members, we want to compile a database of jury questions, instructions and definitions that have been approved and submitted by state and federal courts in coverage and extra-contractual litigation in Texas. If you have any jury questions that you would like to provide for the database, please email them to me at vcc@jordancarmona.com. Thank you for your contributions.

Veronica Carmona Czuchna
Chair, Insurance Law Section

BY FRED A. SIMPSON AND RANDALL L. SMITH

Self Insureds Have No Extra-contractual Duties

INTRODUCTION

Courts generally agree that liability insurers providing first layer ("primary") coverage must compromise and settle claims when opportunities arise. This duty results from the fact that primary insurers typically reserve that settlement right exclusively to themselves. That reservation creates tort duties of care for insurers in addition to the express contractual duties found in written insurance contracts. Usually those same tort duties are owed to "excess" insurers, those who provide coverage above the primary coverage, enforceable under one or more of several different legal theories.[2] In contrast, self-insurers who control the defenses and/or settlements of claims against them owe no similar extracontractual duties to those insurers that provide layers of coverage above the amounts of self-insurance.

Our conclusion is that, although there are no Supreme Court of Texas decisions on the subject, Texas law will follow that of other jurisdictions and excess insurers will have no right of recovery from self insureds for wrongful claims handling. In the process of reaching our conclusion, we review the components of excess insurance programs and show how and why duties are owed by primary insurers to their insureds and to insurers who provide excess coverage above primary insurance policy limits.

THE STATE OF THE LAW ON DUTIES OWED BY SELF-INSUREDS

Few jurisdictions have ruled on whether self-insureds owe any duties to insurers that provide coverage in excess of self insured retentions ("SIRs").[3] However, even if excess insurers may recover from commercial primary insurers who wrongfully fail to settle cases within primary policy limits, it does not necessarily follow that self-insureds owe tort-based duties to settle lawsuits within SIRs. As observed in *Employers Mutual Casualty Co. v. Key Pharmaceuticals, Inc.*,[4]

> The simple fact of the matter is that policyholders, even partially self-insured policyholders, are not primary carriers. Policyholders pay premiums to excess carriers in order to have protection against the risk of litigation (which risks include that of guessing wrong in settlement negotiations); primary carriers do not, and therefore must be careful as to how they balance their own interests with the competing interests of the excess carriers in any given claim instance. We have found no basis in the law, nor have we been pointed to any, for concluding that, apart from the premiums it pays, an insured also assumes a fiduciary duty of care toward its insurer in the context of settlements.[5]

In future cases where courts examine duties of self-insureds to settle, two California cases, styled *Transit Casualty Co. v. Spink Corp.*[6] and *Commercial Union Assurance Companies v. Safeway Stores, Inc.*,[7] will likely be considered. In *Spink*, the intermediate appellate court concluded that duties of good faith and fair dealing mutually apply to self-insureds, just as they do to traditional commercial liability insurers. Therefore, self-insureds must commit their own funds to protect insurers "excess" of self-insured retentions on the same basis that commercial primary insurers must commit their funds to protect both their insureds and excess insurers against excess judgments. The California Supreme Court later overruled *Spink* in *Commercial Union*, holding that self-insureds need not commit their own funds to protect the interests of excess insurers. The court in Commercial Union reasoned that self-insurers and commercial insurers owe mutual duties of good faith and fair dealing based on each other's reasonable expectations. However, those expectations are not symmetrical:

> One of the most important benefits of a maximum limit insurance policy is the assurance that the company will provide the insured with defense and indemnification for the purpose of protecting

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> him from liability. Accordingly, the insured has the legitimate right to expect that the method of settlement within policy limits will be employed in order to give him such protection.
>
> No such expectations can be said to reasonably flow from an excess insurer to its insured. The object of the excess insurance policy is to provide additional resources should the insured's liability surpass a specified sum. The insured owes no duty to defend or indemnify the excess carrier; hence, "the carrier can possess no reasonable expectation that the insured will accept a settlement offer as a means of "protecting" the carrier from exposure. The protection of the insurer's pecuniary interests is simply not the object of the bargain.
>
> In fact, the primary reason excess insurance is purchased is to provide an available pool of money, in the event that the decision is made to take the gamble of litigating.[8]

The California Supreme Court reasoned that, if insurers above the SIR amounts expect protection from self-insureds, those expectations must clearly be shown in appropriate policy language.[9] This type of remedy is not easily obtainable, however, given basic competitive factors and the existing degree of regulation placed on the insurance industry which may require advance approval of insurer policy forms.

VARIOUS FORMS OF LIABILITY INSURANCE COVERAGE

Loosely stated, primary insurers provide lawsuit defenses and initial (first-dollar) indemnification within stated policy limits.[10] On the other hand, excess insurers offer an inexpensive means to purchase higher policy limits at lower costs under contracts that require insureds to maintain their primary insurance coverage within those lower limits where losses have greater frequency.[11]

The U.S. insurance industry provides two types of higher coverage levels that are generally referred to as "excess" liability insurance. One type is "umbrella" insurance, the other is pure "excess" liability insurance.[12] These coverages are not the same, despite their generic reference as "excess" liability insurance. Only inquiry can show which is which.

THE NATURE OF UMBRELLA POLICIES

Umbrella policies are hybrid policy forms, having features of both primary and "follow form" excess policies.[13]

Umbrella policies differ from other excess policies in that umbrella policies fill gaps in coverage both vertically (by providing excess coverage) and horizontally (with additional primary coverage for a larger range of hazards).[14]

The insurance industry sells umbrella coverages in two different formats: complete policy forms, or (less frequently) very simple certificates of umbrella insurance containing language such as:

> Coverage shall follow all terms and conditions of policy number _____, issued by _____ (insurer), including all renewals and rewrites thereof.
>
> This policy is subject to all agreements, limitations, and conditions as contained in or as may be added to the underlying insurance.[15]

Umbrella policies generally provide a broad range of insurance to fill unanticipated gaps in coverage. As one court explained:

> [an umbrella] arrangement contrasts with the method of providing Excess Liability insurance along traditional lines. Under the excess approach, it is up to the insured . . . to choose those exposures against which excess protection is desired. The obvious disadvantage lies in the possibility of a wrong guess about the critical exposures. Under the Umbrella Liability contract, the principal guesswork is in the [underwriter's] rating [of the overall risk].[16]

Umbrella policies provide expanded coverage in two ways,[17] (1) more dollars of coverage when primary policy limits are exhausted, and (2) plugs for unexpected gaps in primary coverages (except where gaps result from insolvencies of primary insurers).[18] When insureds lack coverage in either of those two situations, umbrella policies might "drop down" and provide first-dollar coverage for amounts that exceed any retained limits.[19] Umbrella policies therefore differ from "following form" excess policies which generally provide the same coverages as underlying policies (usually not containing drop-down provisions, however).

PRINCIPLES OF UMBRELLA COVERAGE

Umbrella policies may cover a greater range of hazards than primary policies and provide defense dollars as well.[20] For example, assume a tort plaintiff asserts the following causes of action against an insured: fraud; conversion; slander; and invasion of privacy, in a situation where the insured's primary policy provides:

> If a claim is made or a suit is brought against an insured for damages because of **bodily injury** or **property damage** caused by an **occurrence** to which this coverage applies, we will: Pay up to our limit of liability for the damages for which the insured is legally liable.

Assume further that the same insured's umbrella policy states:

> We will indemnify any insured for **ultimate net loss** in excess of the **retained limit** which the insured shall become legally obligated to pay as damages because of **personal injury** or **property damage**.

However, the umbrella policy defines "personal injury" more broadly than just "bodily injury" by adding words such as: "bodily injury, sickness, disease, disability or shock; mental anguish or mental injury; false arrest, detention or imprisonment, wrongful eviction, malicious prosecution or humiliation; libel, slander, defamation of character or invasion of privacy." The umbrella policy's defense clause is as follows:

> When a claim is made which we cover, and which is not covered in the insured's underlying policies we will: defend any suit against any insured, even if it is groundless or fraudulent. And we will investigate, negotiate and settle on behalf of the insured any claim or suit as we deem expedient.

Because the primary policy excludes all claims of bodily injury and property damage that appear in this example, but the umbrella policy covers two of the claims (slander and invasion of privacy), the defense clause of the umbrella policy is triggered.

EXAMPLE OF UMBRELLA COVERAGE

Umbrella policies are not always the top layers of coverage structures designed by or for insureds. In multi-layered insurance programs, brokers might sandwich umbrella policies between primary insurance and/or layers of excess insurance. Such was the case in *Westchester Fire Insurance v. Heddington Insurance, Ltd.*,[21] where Texaco contracted with GM's Saturn Corporation ("Saturn") to supply antifreeze for use in Saturn automobiles.[22] Texaco filled antifreeze orders with a product manufactured by "Lubripac," a general partnership between Texaco Refining and Marketing ("TRMI") (2/3 owner) and Rosewood Lubricants ("Rosewood") (1/3 owner). Lubripac purchased $1 Million of primary insurance from Travelers and a $10 Million umbrella policy from Westchester (successor to International Insurance Co.)[23]

Texaco purchased excess products liability insurance from Heddington, Texaco's "captive" insurer under a policy in which Texaco and all its subsidiaries were named insureds. That Heddington policy had limits of $20 Million, excess of $10 Million in underlying limits. Texaco's subsidiary, TRMI, also purchased an excess policy from Heddington with a $20 Million limit of liability, excess of $10 Million, in which TRMI and its subsidiaries were named insureds. Rosewood purchased an excess policy from J.H. Blade, with a $50 Million limit of liability, excess of $11 Million, that listed the Lubripac partnership as an additional insured. Coverage therefore looked like this:

INSURERS

		Travelers	Westchester	Heddington	J.H. Blade
Lubripac	- umbrella		$10 Million		
	- primary	$1 Million			
Texaco	- excess			$20 Million	
	- underlying SIR			$10 Million	
TRMI	- excess			$20 Million	
	- underlying SIR			$10 Million	
Rosewood	- excess				$50 Million

Saturn sued, claiming Lubripac antifreeze damaged Saturn automobiles. When insurers settled with Saturn for $19 Million, Lubripac, TRMI and Rosewood executed an agreement in which each released the other (and their insurers) from all claims.[24] Saturn, General Motors (Saturn's parent), Lubripac, TRMI, and Rosewood all executed a "Release and Indemnification Agreement" that provided for Saturn and TRMI/Lubripac to share any salvage value of damaged automobiles.[25]

Westchester paid $10 Million as part of the settlement and then sued Heddington, Texaco and TRMI, arguing that its umbrella coverage was excess to all other policies and self-insurance retentions, seeking recovery of its $10 Million payment toward the Saturn settlement (and a share of salvage). Westchester claimed that Heddington's policies should apply before Westchester's,[26] rationalizing that umbrella coverage always exceeds other insurance, whether primary, excess, contingent or contributing.[27] This rationalization would shift Westchester's layer of risk to Heddington, leaving Lubripac with uninsured losses of between $1 and $10 Million.[28]

The court rejected Westchester's argument, finding no support in the language of the various policies, the clarity of the overall insuring scheme showing the contrary.[29]

TRUE EXCESS INSURANCE

Excess policies that are truly "excess" (as opposed to umbrella policies) come into play only when underlying policy limits are exhausted.[30] Excess insurers set their premiums with expectations that underlying insurers will absorb the cost of defending their insureds and that claims may never exceed primary limits.[31] The insurance industry currently markets four types of excess liability policy forms:

- Stand alone excess insurance;
- Straight excess insurance;
- Follow form excess insurance;
- Alleged follow form excess insurance.[32]

"**Stand-alone**" excess insurance is considered by insurers to be "self contained" because the language of these policy forms does not refer to the terms, conditions or exclusions of any underlying coverage.[33]

"**Straight**" excess policies sit above primary policies, covering specific risks. For example, an insured might purchase primary CGL coverage, primary commercial auto coverage, and straight excess coverage. However, if insureds face greater auto-related risks than CGL-related risks, brokers might place straight excess policies above only their commercial auto coverages.[34]

In multi-layered insurance programs, insureds look to all their insurers for protection…

"**Follow form**" excess policies bind excess insurers to the terms, conditions and exclusions of certain specified underlying policies.[35] True follow-form excess policies provide exactly the same coverages as the underlying policies they "follow."

"**Alleged follow-form**" excess policies are those which appear to be controlled by terms and conditions of underlying policies, but not if conflicts arise between the terms and conditions of one of these policies and underlying policies they purport to "follow." In those instances, the wording of the excess policy controls.[36] Language from such a policy form shows the priority if conflicts arise:

> Except as otherwise provided herein the insurance afforded by this policy shall follow the terms, conditions and definitions as stated in the policies of underlying insurance, except for limits of liability, any renewal agreement and any obligation to investigate or defend. This coverage only applies to injury or damage covered by the Primary Insurance. The definitions, terms, conditions, limitations and exclusions of the Primary Policies, in effect at the inception date of this policy, apply to this coverage unless they are inconsistent with provisions of this policy or relate to premium, subrogation, other insurance, an obligation to investigate or defend, the amount or limits of insurance, payment of expenses, cancellation or any renewal agreement.[37]

PRIMARY INSURERS' RESPONSIBILITY FOR PROPER DEFENSE.

In multi-layered insurance programs, insureds look to all their insurers for protection, but excess insurers look to primary insurers for protection against judgments in excess of primary insurers' policy limits. This is because primary insurers usually control defenses of lawsuits and settlements of claims. When judgments exceed primary policy limits, excess insurers typically examine the conduct of primary insurers and/or their chosen defense counsel to determine if any wrongful conduct caused claims or judgments to exceed primary policy limits and invade excess policy limits.

Theories of Inter-Insurer Liability

Formerly, courts struggled with relationships between primary and excess insurers in order to establish guidelines for controlling the conduct of primary insurers. Early lawsuits brought by excess insurers against primary insurers dealt with the reality that there are no contractual relationships between primary and excess insurers. Lacking contractual relationships, excess insurers had no basis to recover, even though primary insurers' wrongful conduct caused them harm. Courts fashioned theories of liability to allow excess insurers to recover from primary insurers who wrongfully refuse to settle underlying tort lawsuits to the detriment of insureds (and/or to the excess insurers). The two principal theories are "direct action" and "equitable subrogation," but a majority of courts recognize only the latter.[38]

THE NATURE OF SUBROGATION

Subrogation is the substitution of one person in place of another as to a lawful claim, demand, or right, so that he who is substituted succeeds to the rights of the other in relation to a

debt or claim, and its rights, remedies, or securities.[39] The legal fiction of equitable subrogation comes into play when excess insurers pay losses. Excess insurers then stand in the shoes of their insureds, acquiring any causes of action their insureds may have against primary insurers who caused damage to those insureds.

The elements of equitable subrogation claims against primary insurers are: (a) insureds suffer losses covered by primary policies; (b) excess insurers indemnify insureds; (c) insureds could assert causes of action against their primary insurers but for the fact that insureds are not injured (because excess insurers paid the insureds' losses); (d) excess insurers suffer damages from wrongful acts or omissions of primary insurers; (e) justice demands that courts shift losses from excess insurers to primary insurers; (f) damages of excess insurers are in stated sums, usually amounts they paid to satisfy excess judgments (assuming payments were reasonable and not voluntary); and (g) insureds committed no wrongful acts.[40] Once all these elements exist, the equitable subrogation doctrine entitles excess insurers (subrogees) to assert insureds' rights (subrogors) against primary insurers.[41]

HOW OTHER COURTS FIND REMEDIES

Because excess insurers only stand in the shoes of their insureds, "the primary concern to excess carriers with proceeding against the primary carrier on the basis of subrogation or assignment of claim is that by doing so, the primary carrier can assert against the excess carrier all defenses which the primary carrier has against the insured."[42] For example, if insureds fail to cooperate with their primary insurers, primary insurers can defeat subrogation claims by asserting their insured's breach of contract as a defense. To avoid this perceived inequity, some jurisdictions, not including Texas, apply a "direct duty" theory of liability in which primary insurers owe duties of care directly to excess insurers.[43]

DIRECT DUTY THEORY

An early case recognizing the harsh effects of equitable subrogation was *Hartford Accident & Indem. Co. v Michigan Mutual Ins. Co.*,[44] in which the excess insurer (Hartford) asserted bad faith by the primary insurer (Michigan Mutual). Michigan Mutual insured D.A.L. Construction, whose employee was injured. Michigan Mutual also insured D.A.L.'s parent company, DeFoe Corporation. The injured employee sued only DeFoe. Hartford demanded Michigan Mutual to implead D.A.L. as a third party defendant, but Michigan Mutual refused.[45]

The lawsuit settled for greater than Michigan Mutual's policy limit, thereby exposing Hartford. Hartford claimed that if Michigan Mutual had impleaded D.A.L. as a third party defendant, liability would have attached to D.A.L. and Hartford's policy would not have been reached. To complicate matters, D.A.L. was named as an additional insured under both Michigan Mutual's policy and Hartford's policy. Michigan Mutual argued that Hartford could not subrogate against its own insured, D.A.L.

The court resolved matters in Hartford's favor by finding that Michigan Mutual owed Hartford a fiduciary duty because Michigan Mutual controlled the defense. As a fiduciary, Michigan Mutual was held to an exacting standard of utmost care and good faith. Hartford's right of action against Michigan Mutual was based on that independent and direct duty.

The court in *American Centennial Insurance Co. v. American Home Assurance Co.*,[46] also invoked a direct duty theory. In that case, American Home insured Continental Air Transport Company, Inc./Parmelee Transportation Company under a primary policy with a $1 Million limit, and American Centennial provided excess coverage. A tort plaintiff was injured in Continental's air transport bus and demanded $300,000. American Home responded with a $100,000 offer which the tort plaintiff rejected. Shortly before trial, the plaintiff demanded $1.5 Million. American Home countered with $300,000. A jury returned a verdict against Continental for $7.7 Million.

American Centennial sued American Home alleging a fiduciary duty was owed to the excess insurer and that American Home breached that duty by failing to settle. American Home filed a motion to dismiss for failure to state a cause of action, contending that primary insurers owe no such direct duties to excess insurers.

When the federal district court imposed a direct duty on the primary insurer, the court cited an earlier case under Illinois law[47] which held that:

> [c]ourts across the country are increasingly amenable to recognizing that a primary carrier owes a direct duty to an excess carrier, . . . Illinois law will impose a duty of care when: (1) the alleged tortfeasor could reasonably have foreseen that his conduct would injure the plaintiff, and (2) policy considerations justify placing the risks and the burden of care on the alleged tortfeasor. [citations omitted] As discussed below, both of these considerations indicate that, if faced with the precise issue raised in the cases at bar, the Illinois Supreme Court would impose a duty of care on American Home.[48]

The court then applied the law of the earlier case to the present facts before it, stating:

> A primary liability carrier who knows of the existence of excess liability carriers knows that a judgment against the insured in excess of the primary policy limit will harm the excess carriers. Furthermore, it is very reasonably foreseeable to a primary carrier that its unreasonable refusal to settle a claim against the insured within its policy limit could result in a judgment in excess of its policy limit. Thus, it is reasonably foreseeable that a primary carrier's unreasonable refusal to settle a claim against the insured may injure excess carriers of whose existence the primary carrier is aware during the settlement negotiations.[49]

The court noted several reasons for imposing a direct duty of care on a primary insurer in favor of an excess insurer, including:

> encourag[ing] . . . settlements when an offer exists at or near the policy limits, discouraging gambling with the excess carrier's money, hoping to keep excess liability insurance premiums low, reducing the necessity for the excess carrier to participate in the defense of the action to protect its rights, and reflecting the duties of the primary carrier to perform the duty which it has delegated to itself, that is, providing primary coverage.

The court left little doubt that primary insurers in Illinois must settle… if prudent insurers would do so.

The court left little doubt that primary insurers in Illinois must settle if circumstances are such that ordinary reasonable and prudent insurers would do so.

The direct duty theory has two advantages. First, direct duty allows excess insurers to recover even though insureds engage in culpable conduct that would destroy the excess carrier's bad faith claim under equitable subrogation.[50] Second, direct duty permits courts to "apportion liability between primary and excess insurers based on principles of comparative negligence."[51] The direct duty theory obligates primary insurers to consider the financial interests of excess insurers, and any wrongful conduct of insureds will not completely bar excess insurers' claims.[52]

TRIANGULAR RECIPROCITY

Because equitable subrogation limits excess insurers to those rights insureds may have against primary insurers, at least one jurisdiction imposes a duty of due care under principles known as "triangular reciprocity," which appears to offer the same results as the direct duty theory.[53] This theory was formulated because equitable subrogation fails to provide evenhanded justice where insureds violate the rights of primary insurers.[54] This theory, which does not appear in Texas law, rests on the reciprocal duties of reasonable care owed by insureds, primary insurers and excess insurers, one to another, sharing losses according to the measure of each party's comparative fault. Contrasted with the all-or-nothing results from equitable subrogation, triangular reciprocity apportions losses according to whether the wrongful conduct of the primary insurer or the insured, over which the excess insurer had no control, contributed to the invasion of excess carrier limits. Thus, triangular reciprocity is intended to prevent unjust denials of recoveries to excess insurers when acts of either primary insurers or insureds contribute to any bad-faith failures to settle claims.[55]

NO CAUSE OF ACTION

Courts in approximately sixteen jurisdictions, including a federal court in Texas, have found that excess insurers may not recover from primary insurers for any failures to accept reasonable policy limit settlement offers.[56] A few examples show the reasoning behind this minority position.

In *Federal Insurance. Co. v. Travelers Casualty. & Surety Co.*[57] a construction worker was killed and his family sued Pearce Construction Company for wrongful death. Travelers insured Pearce under a $1 Million primary policy, and Federal insured Pearce under a $10 Million excess policy. When tort plaintiffs' offered to settle for $350,000, Travelers refused. At trial, the jury found Pearce liable and awarded tort plaintiffs $4.6 Million. Travelers paid its policy limit and Federal paid $3.6 Million. Federal and Pearce sued Travelers, alleging: (1) refusal to settle resulting in extracontractual damages; (2) negligent and/or wanton failure to settle; and (3) assumption of duties wrongfully performed.[58] The federal district court granted summary judgment for Travelers, noting that the Alabama Supreme Court never "'expressly adopted the doctrine of equitable subrogation between a primary and excess insurer'" and never held that "'a primary insurance carrier owes a duty of good faith to an excess insurance carrier of its

insured.'" The Eleventh Circuit sent certified questions to the Alabama Supreme Court.

The Alabama Supreme Court ruled that primary insurers owe no duties of good faith to excess insurers with respect to settlements of lawsuits, focusing on the fact that primary insurers reserve rights to control defenses and settlements of potentially covered claims. Helplessness of insureds in such circumstances caused the Alabama Supreme Court to impose duties of good faith and fair dealing on primary insurers who reserve those exclusive rights, but those duties flow only to insureds. The court found that primary/excess insurer relationships lack sufficient public policy considerations to justify the imposition of an additional duty of good faith and fair dealing on primary insurers.

Federal argued that even if Alabama law recognizes no direct duty of good faith and fair dealing with respect to settlements, Alabama law does recognize the doctrine of equitable subrogation which Federal may use as Pearce's subrogee on a claim for bad faith failure to settle. The Alabama Supreme Court also rejected this argument because:

> when equitable subrogation is sought to assert a bad-faith-failure-to-settle claim in a primary-insurer/excess-insurer scenario, like the one involved here, a unique analysis must be undertaken. It is well-settled that an insurer that, through subrogation, "stands in the shoes of its insured and may assert only claims that would be validly asserted by the insured." [Citation omitted] . . . "It is also well-settled that a bad-faith-failure-to-settle claim does not exist where the insured is subject to no personal loss from a final judgment."[59]

Insureds have no bad faith claims against insurers where insureds face no "final judgment ordering the payment of money that [the insured] personally--and not his insurer--would have to pay;" equitable subrogation would therefore never apply to an excess insurer "whose insured is subject to no such final judgment. Simply put, equitable subrogation cannot exist to provide a conduit to assert what are conclusively nonexistent rights."[60]

Rocky Mountain Fire & Casualty Co. v. Dairyland Insurance Co.[61] involved a single vehicle auto accident in which an injured passenger sued the driver who was insured by Dairyland. Rocky Mountain also insured that driver as a permissive user of an automobile owned by another person. By operation of both insurers' "other insurance" clauses, Dairyland's policy, with a $10,000 limit of liability, became primary and Rocky Mountain's policy was excess. When the tort plaintiff offered to settle for $12,000, Rocky Mountain agreed to pay $2,000 toward settlement but Dairyland refused to pay its policy limit. The case went to trial and the jury found the driver liable and awarded the tort plaintiff $21,500.

Rocky Mountain, as subrogee of the insured's rights, sued Dairyland, claiming Dairyland owed a duty to consider settlements in good faith, and that Dairyland breached that duty. The federal court rejected Rocky Mountain's claim, based on the holdings of the following case out of the Arizona Supreme Court.

Courts in the various jurisdictions impose liability on primary insurers for failing to settle under a variety of standards.

In *Universal Underwriters Inurance Co. v. Dairyland Mutual Insurance Co.*,[62] Jones drove a car for his employer, but the car was owned by Meyer. Jones struck Nugent, causing injury. Dairyland insured Meyer's vehicle, and Universal insured Jones' employer. Dairyland, with a $10,000 limit of liability, refused to defend Jones. After Universal assumed Jones' defense and settled Nugent's lawsuit for $30,000, Universal sued Dairyland to recover the settlement amount, attorney fees and costs. The trial court rendered judgment for Dairyland and the court of appeals affirmed.

The Arizona Supreme Court reversed the trial court's decision, holding that although primary insurers owe duties of good faith and fair dealing to their insureds in defending and paying claims or judgments, no contractual relationship exists between primary insurers (Dairyland) and excess insurers (Universal) that would allow excess insurers to maintain bad faith actions against primary insurers for their refusal to defend and settle claims against their insureds. The existing Arizona law also precluded excess insurers from bringing direct actions against primary insurers.

TEXAS LAW

Courts in the various jurisdictions impose liability on primary insurers for failing to settle under a variety of standards.[63] Texas courts apply the negligence standard established in 1929 by the Supreme Court of Texas as the *Stowers doctrine*,[64] clarified by the same court's 1994 holding in Garcia.[65] The resulting standards are these: (1) underlying tort lawsuits against insureds must fall within coverage, (2) tort plaintiffs must

specifically offer to settle for policy limits, (3) insurers need not make settlement nor solicit settlement offers, and (4) any tort plaintiffs' settlement offers must be those that prudent insurers would ordinarily accept, given the potential in each case for exposing insureds to excess judgments.

Excess insurers may succeed with equitable subrogation claims brought against primary insurers for their refusal to accept reasonable offers to settle within policy limits, but only if the excess insurers prove that any tort plaintiffs' settlement offers satisfy the Garcia factors, and all other conditions are met.[66]

In *Westchester Fire Insurance Co. v. American Contractors Insurance Co. Risk Retention Group*,[67] American Contractors insured Phillips 66 with primary limits of $250,000. Westchester provided a third level starting at $2 Million up to $4 Million. A subcontractor's employee sued Phillips when he suffered a progressive, permanent, and incurable injury. American Contractors hired an attorney to defend Phillips who sent the insurer an unfavorable assessment of Phillips' chances for success, but American Contractors nevertheless concluded that Phillips would prevail at trial. Settlement negotiations were unsuccessful and the underlying tort lawsuit went to trial where the jury found Phillips liable in the amount of $5 Million, plus approximately $2.5 Million in prejudgment interest. The insurers later settled for $4.3 Million of which Westchester paid $1.3 Million. Westchester then sued American Contractors for equitable subrogation, arguing that American Contractors mishandled settlement negotiations, never intending to negotiate in good faith. Plaintiffs' only offer to settle was for $1.8 Million which, although probably reasonable, was far in excess of American Contractors' $150,000 policy limit. Therefore, no *Stowers* duty was triggered. Although equitable subrogation can shift to primary insurers the exposure risks faced by excess insurers, this risk-shifting only occurs when tort plaintiffs make reasonable offers to settle within policy limits of the primary insurers.[68] The trial court granted summary judgment for American Contractors.[69]

In *Birmingham Fire Insurance Co. of Pa. v. American National Fire Insurance Co.*,[70] Avala of Texas owned the Plymouth Park Shopping Center operated by Intershop Real Estate. Birmingham provided primary insurance to Avala and Intershop, and American provided excess insurance. When unknown assailants killed a patron in Plymouth's parking lot, the deceased's family sued Avala and Intershop. Although lawyers considered the case "very dangerous" with potential for a multimillion dollar verdict against Avala and Intershop, Birmingham offered only $250,000 to settle against the tort plaintiffs' demands ranging from $3.5 Million to $5.0 Million. At trial, a jury found damages in excess of $10 Million. Birmingham tendered its policy limit to American which then settled with the deceased's family for $7.9 Million. When American sued Birmingham under *Stowers*, a jury found Birmingham negligently failed to settle the case. On appeal, Birmingham claimed "[t]he district court erred in submitting appellants' negligence to the jury and in entering judgment on the negligence action because, as a matter of law, appellants have no liability with respect to negotiation of settlement."[71] Birmingham argued that Stowers governs only the rejection of reasonable settlement offers within policy limits.[72] The court of appeals reversed in favor of Birmingham because insurers owe no duty to solicit settlement offers from tort plaintiffs under Garcia where the Supreme Court of Texas held that "an insurer cannot breach a duty by not tendering a settlement offer."[73]

In *Employers National Insurance Co. v. General Accident Insurance Co.*,[74] two window washers died when their scaffold fell. Several pedestrians below were also injured. Tort plaintiffs sued Jobs Building Services (the window washing contractor) and others in multiple lawsuits. General insured Jobs under a policy with a primary limit of $1 Million, and Employers provided excess insurance of $5 Million. General defended Jobs. When the tort plaintiffs offered to settle all claims against Jobs for $950,000 prior to trial, General offered $150,000. The tort plaintiffs thereafter increased their demands to $6 Million.

Employers' policy provided for General to control the defense unless General tendered its policy limit to Employers. Employers met with the tort plaintiffs' attorney without General's knowledge and agreed in principle to a settlement. Employers later informed General of the settlement talks and demanded that General tender its policy limit. Jobs, General (under protest), and Employers agreed to settle for $3 Million of which Employers paid $2 Million.

When Employers sued General, the court observed that, under Texas law, an excess insurer may have a cause of action against a primary insurer that fails to accept a reasonable settle offer within the primary insurer's policy limit when it becomes reasonably clear that the value of the tort claims exceed the primary policy limit. Equitable subrogation therefore permits an excess insurer to sue under *Stowers* if the insured could sue the primary insurer for a loss occasioned by the primary insurer's negligent failure to settle.[75]

General argued that it acted reasonably when it predicted that a jury would find Jobs no more than ten percent liable, basing its prediction on advice of defense counsel. The appellate court disagreed, opining that a jury would likely find Jobs liable for more than ten percent of the fault and that General wrongfully relied on defense counsel's evaluation. General also alleged that, when Employers negotiated with tort plain-

tiffs' attorney, Employers acted in bad faith by coercing a settlement. The court found that General acted unreasonably by not accepting a settlement offer within General's policy limit, causing Employers to become involved by necessity. According to the court:

> General's gamble with the money of both its insured and Employers would be considered risky by even the risk seekers. The size of the gamble is not just an after-the-fact assessment. General had sufficient facts to calculate the risks and in fact was being continually apprised by other parties about the extent of those risks. It is irrelevant whether it made its calculation using the upper limit of [defense counsel's] ten percent estimation of liability or [the tort plaintiffs' attorney's] eighty-five percent of a lower figure. A fully-informed, disinterested attorney would find that the likely upper limit of liability exceeded $1,000,000. General's failure to act was negligent, violating its duties to both Jobs and derivatively to Employers.[76]

The court also found General violated the standard of care which requires primary insurers to determine reasonable ranges of likely outcomes in underlying tort lawsuits and, if such ranges exceed primary policy limits, primary insurers must include excess insurers in the defense. General failed in these duties, causing $2,050,000 in damages which Employers could recover from General.

SUMMARY OF DUTIES OWED BY PRIMARY INSURERS

Courts generally find ways to provide equitable relief for excess insurers who are injured by the wrongful acts of lower-tier insurers, and/or counsel who ineptly handle defenses or settlement negotiations of underlying tort lawsuits. Only the means and methods for relief vary from jurisdiction to jurisdiction, with a handful refusing to grant excess insurers any relief. The clear majority view is that primary insurers must settle claims within their policy limits if opportunities arise to do so. A few jurisdictions require primary insurers to aggressively seek those opportunities. The reported cases show how excess insurers may recover for wrongful acts by insurers below them that cause damage to their common insureds.

DEMONSTRATIVE CASE ON HOW HIGHER-TIER EXCESS INSURERS' HAVE FEW RIGHTS IN SITUATIONS WHERE SELF INSUREDS CONTROL THE DEFENSE/SETTLEMENT

In *Liberty Mutual Insurance Company v. American Home Assurance Company*,[77] the issue was whether "lower-tiered" excess insurers can be liable in direct actions or in claims under principles of equitable subrogation for losses of "higher-tiered" excess insurers resulting from the failure of lower tiered insurers to settle lawsuits within lower tiered insurers' policy limits.[78] However, in this case, the "primary" insurer, American Home, was actually excess over the self-insured retention of its insured, Canadian National Railway Company ("CNR").[79]

CNR owned Chicago Central Railroad Company. CNR had two layers of liability insurance coverage above its $5 Million self-insured retention ("SIR").[80] American Home provided a first layer of insurance coverage of $20 Million, and the next and top coverage layer totaled $75 Million, provided by Liberty Mutual and other insurers.[81] Coverage looked like this:

INSURERS

	American Home	Liberty Mutual (and others)
Excess	$20 Million	
Underlying SIR	$5 Million	
Excess		$75 Million
Underlying SIR and American Home's coverage		$25 Million

A Chicago Central train struck a Ford Explorer. Three of the Explorer's occupants (the "Velarde" plaintiffs) were severely brain damaged. A lawsuit ensued and CNR took control of the defense. The Velarde plaintiffs, with claims valued at between $5 Million and $18 Million (and a settlement value estimated at $10 Million), demanded $30 Million, but were open to negotiation. (CNR's SIR plus American Home's coverage totaled $25 Million, as shown above.)

When CNR offered to tender its $5 Million SIR to American Home, American Home demanded that CNR settle all claims for CNR's $5 Million SIR. CNR responded by advising American Home that the Velarde plaintiffs already had rejected that offer.

At the Velarde plaintiffs' trial, defense counsel suggested to the jury that a verdict of $12 Million would be appropriate, but the jury returned a verdict of $54 Million. Liberty Mutual received first notice of the claim four days after the jury verdict and immediately sued American Home for equitable subrogation alleging: (1) breach of contract, (2) failure to notify Liberty Mutual of the claim with a potential for an excess verdict, and (3) failure to settle within American Home's excess layer of coverage.

Liberty Mutual moved for summary judgment claiming that American Home breached its duty to Liberty Mutual by failing to settle the Velarde plaintiff's claims for American Home's policy limit.[82] American Home responded that it owed no duty to Liberty Mutual because American Home had no control over the defense or settlement negotiations, arguing there was no evidence that Liberty Mutual's potential damages were proximately caused by any fault of American Home.[83]

Prevailing Illinois law, according to earlier cases of *Cramer v. Insurance Exchange Agency*[84] and *Haddick v. Valor Insurance*,[85] holds that duties to settle run only between parties to contractual relationships, and that insurers' duties to settle are compelled by the exclusive control insurers contractually reserve to themselves over defense and settlement matters.[86] The *Cramer* court discussed why duties run as they do:

> In the typical 'duty to settle' case, the third party has sued the policyholder for an amount in excess of the policy limits but has offered to settle the claim against the policyholder for an amount equal to or less than those policy limits.[87]
>
> In this circumstance, the insurer may have an incentive to decline the settlement offer and proceed to trial. The insurer may believe that it can win a verdict in its favor. In contrast, the policyholder may prefer to settle within the policy limits and avoid the risk of trial. The insurer may ignore the policyholder's interest and decline to settle.[88]

As for whether any common law duties or other equitable duties existed between American Home and Liberty Mutual, the Illinois federal district court concluded that the Illinois Supreme Court would not recognize any such duties between American Home and Liberty Mutual because there were no contractual relationships involved. Furthermore, American Home had no control over either defense or settlement. The court noted three reasons for refusing to recognize a direct duty between excess insurers:[89]

> 1. Excess insurers depend on primary insurers to properly defend underlying tort lawsuits. For this reason alone, placing duties on excess insurers to settle cases within their policy limits would be inequitable. Furthermore, excess insurers would not have the benefits of having conducted discovery or controlling defenses of those lawsuits. It would be more difficult for excess insurers to conduct settlement discussions because the insurers would have no dependable information. In such situations, excess insurers may not know enough about cases to determine whether certain settlement demands are reasonable.
>
> 2. Courts must consider the feasibility of enforcing rules that impose duties upon insurers that have only partial control over defenses or settlements. If courts began to impose duties on excess insurers that only partially controlled either defenses or settlements, courts would have to parse through a fact-intensive reconstruction of defenses of underlying claims in order to determine who was at "fault." In other words, courts would have to determine if excess insurers had enough control over settlements and defenses to take responsibility for failures to settle.
>
> 3. Insurers have greater power than insureds to bargain for their rights and duties. Although courts might find that there are reasons to protect insureds against insurers where insurers perhaps have unequal bargaining power, there are no similar policy arguments when parties to contracts are large insurance companies.

Liberty Mutual's goal was to step into the shoes of CNR so that Liberty Mutual could assert claims that CNR, as the insured, could have brought against American Home.[90] Although American Home participated in settlement negotiations, American Home argued that it had no control over the defense, and it should therefore owe no duty to settle to another excess insurer under the doctrine of equitable subrogation.[91] In this case, (a) the virtual primary insurer of CNR was CNR itself because of its $5 million SIR; (b) CNR's chosen attorney controlled the defense, conducting discovery, and preparing for and conducting the trial; (c) specific provisions of American Home's policy granted CNR the right to settle any claim for any amount including the limit of American Home's policy; (d) American Home had no contractual duty to defend claims against CNR; and (e) American Home did not hire the defending attorney, nor did it assume any active role in the case until eleven days before trial.[92] Because of American Home's inactive role, no duty existed under a direct duty theory, nor was there justification for relief to be granted under principles of equitable subrogation.

Liberty Mutual's rights ***may*** have been different had the Velarde plaintiffs demanded settlement within the policy limits of American Home, but perhaps not, due to the fact that American Home had no control of the defense or settlement activities.

But what if tort plaintiffs demanded more than the combined amounts of the SIR and American Home's policy limit?

CNR, as insured, would likely have had an obligation to advise Liberty Mutual of the claim, but would American Home also have had a duty to advise Liberty Mutual if CNR failed to give such notice? If so, to whom would American Home have owed that duty? To CNR and/or to Liberty Mutual? If Liberty Mutual refused to pay the excess over $25 Million because of a lack of notice of a potential claim, would CNR have had a claim against American Home for the uncovered excess judgment?

CONCLUSION

The authors have found no statistics on the increased use of self-insurance in contemporary commerce, but they observe a substantial increase.[93] Although most jurisdictions find means to compensate higher tier insurers for misconduct of commercial primary insurers, there is no body of reported law that assigns the same responsibility to self-insureds who control their own defenses and settlement of claims.

The absence of that body of law by itself convinces us that Texas law would not likely find that self-insureds owe any duties to excess insurers under an equitable subrogation theory, and Texas does not follow any direct duty theory. (Also, the *Garcia* factors do not apply because there is no primary insurer.)[94] However, sufficient other rationale appears in Texas law to support our prediction:

1. The only reported Texas case on the subject (1992) shows that the California case of *Commercial Union Assurance Companies v. Safeway Stores, Inc.* is persuasive. The Dallas Court of Appeals found that a self-insured owes no common law duty to make or accept settlement offers in order to protect the financial interests of excess insurers.[95]

2. That same Dallas case shows that where a self-insured has a contractual right to control claims (including settlements), the "primary" insurer cannot force the self-insured to settle, and that insurer owes no duties to other insurers with layers of coverage above.[96]

3. A corporation chartered under the Texas Business Corporation Act is expressly forbidden to engage in the insurance business, therefore the self-insured will not likely be found to be a primary insurer.[97]

4. "Self-insurance" has a distinct meaning recognized by Texas courts: "The practice of setting aside a fund to meet losses instead of insuring against such through insurance,"[98] further suggesting that self-insureds are not insurers under the law.

5. Self-insurance has been found not to constitute "other valid and collectible insurance" in Texas,[99] providing further proof that self-insureds do not have the same characteristics as insurers.

1. Fred A. Simpson is a partner in the Houston Litigation Section of Jackson Walker L.L.P., and Randall L. Smith is a solo insurance practitioner in Houston, Texas.

2. *See* Anthony M. Lanzone, Stephen G. Ringel, *Duties of a Primary Insurer to an Excess Insurer*, 61 NEB. L. REV. 259 (1982).

3. *See Employers Mut. Cas. Co. v. Key Pharm., Inc.*, 871 F.Supp. 657, 665 (S.D.N.Y. 1994).

4. *Id.*

5. *Id.* at 666.

6. 156 Cal.Rptr. 360 (1979), overruled, Commercial Union Assurance Cos. v. Safeway Stores, Inc., 610 P.2d 1038, 1043 (Cal.1980).

7. 610 P.2d 1038, (1980). *See Key Pharm.*, 871 F.Supp. at 665.

8. *Safeway Stores*, 610 P.2d at 1041- 42.

9. *In Int'l Ins. Co. v. Dresser Indus., Inc.*, 841 S.W.2d 437, 444-46 (Tex. App. — Dallas 1992, writ denied), the Dallas Court of Appeals followed the California Supreme Court's reasoning/result in *Safeway*. Self-insureds owe no common law duties to their excess insurers to settle lawsuits at points below the thresholds of excess policies.

10. *See Revco D.S., Inc. v. Gov't Employees Ins. Co.*, 791 F.Supp. 1254, 1264 (N.D. Ohio 1991); *Archer - Daniels - Midland Co. v. Phoenix Assurance Co.*, 975 F.Supp. 1129, 1134 (S.D. Ill. 1997); *Am. Special Risk Ins. Co. v. A-Best Prods., Inc.*, 975 F.Supp. 1019, 1022 (N.D. Ohio 1997). *See also* Michael M. Marick, *Excess Insurance: An Overview of General Principles and Current Issues*, 24 TORT & INS. L. J. 715, 716 (Summer 1989).

11. *See Nat'l Union Fire Ins. Co. v. CNA Ins. Cos.*, 28 F.3d 29, 31 n.1 (5th Cir. 1994); *Fed. Ins. Co. v. Srivastava*, 2 F.3d 98, 101 (5th Cir. 1993); *Harville v. Twin City Fire Ins. Co.*, 885 F.2d 276, 278 (5th Cir. 1989); *Westchester Fire Ins. v. Heddington Ins., Ltd.*, 883 F.Supp. 158, 163 n.10 (S.D. Tex. 1995), *aff'd*, 84 F.3d 432 (5th Cir. 1996).

12. *See Gencorp, Inc. v. Am. Int'l Underwriters*, 178 F.3d 804, 809 n.3 (6th Cir. 1999). Unless otherwise specified, the authors use the term "excess insurance" as a generic description for both types of insurance. The terms "umbrella liability insurance" and "excess liability insurance," refer specifically to each of the two separate and distinct forms of excess insurance.

13. Michael M. Marick, *Excess Insurance: An Overview of General Principles and Current Issues*, 24 Tort & Ins. L. J. 715, 719 (Summer 1989).

14. *See Commercial Union Ins. Co. v. Walbrook Ins. Co., Ltd.*, 7 F.3d 1047, 1053 (1st Cir. 1993); *Am. Special Risk Ins. Co. v. A-Best Prods., Inc.*, 975 F.Supp. 1019, 1022 (N.D. Ohio 1997).

15. 2 JACK P. GIBSON, MAUREEN C. MCLENDON, W. JEFFREY WOODWARD, COMMERCIAL LIABILITY INSURANCE XII. B.1. - B.2. (1986). The declarations page of a multilayered insurance program might provide as follows: $5,000,000 p/o $10,000,000 xs $50,000,000 xs $1,000,000 SIR. This means that the excess insurer provides $5,000,000 of excess coverage as a part of a $10,000,000 layer of coverage. This $10,000,000 layer of excess coverage sits over a $50,000,000 layer of coverage. This $50,000,000 layer of excess coverage is excess of the SIR, or self-insured retention, of $1,000,000. Eileen M. Dacey, *Issues in Excess Coverage*, INSURANCE COVERAGE LITIGATION 1993: CRITICAL ISSUES AND STRATEGIES 247-248 (Practicing Law Institute, PLI Order No. H4-51 73, Sept. 30, 1993) (Westlaw cite 477 PLI/Lit 243).

16. *Commercial Union Ins. Co. v. Walbrook Ins. Co., Ltd.*, 7 F.3d 1047, 1053 (1st Cir. 1993) (quoting F.C.&S. Bulletins, Companies and Coverages: Specialty Lines, U-1, December 1980).

17. *See* DONALD S. MALECKI, MALECKI ON INSURANCE 2 (April 1993).

18. *See* Mitchell F. Dolin, *Excess Defense Coverage and Long-Tail Liabilities*, 32 Tort & Ins. L. J. 875, 877 (Spring 1997); *See* also *Garmany v. Mission Ins. Co.*, 785 F.2d 941, 948 (11th Cir. 1986); *Fed. Ins. Co. v. Stroh Brewing Co.*, 127 F.3d 563, 567 (7th Cir. 1997); *Commercial Union Ins. Co. v. Walbrook Ins. Co.*, 7 F.3d 1047, 1053 (1st Cir. 1993); *Am. Special Risk Ins. Co. v. A-Best Prods., Inc.*, 975 F.Supp. 1019, 1022 (N.D. Ohio 1997).

19. *See* DONALD S. MALECKI, MALECKI ON INSURANCE 2 (April 1993). In most cases, coverage under an umbrella liability policy will not attach until some specified retained amount, as defined in the policy, has been met. The retained amount usually coincides with the limits of underlying insurance, or with a self-insured retention ("SIR") when no underlying coverage applies. The SIR is so named because the insured is to assume that amount before insurance becomes payable. The amount of the SIR is not insurable under any other policy and therefore encourages the insured to exercise a degree of care that may not otherwise exist in the absence of such a retained amount. 2 JACK P. GIBSON, MAUREEN C. MCLENDON, W. JEFFREY WOODWARD, COMMERCIAL LIABILITY INSURANCE XI.B.12-13. *See also Interco Inc., v. Mission Ins. Co.*, 808 F.2d 682 (8th Cir. 1987) (finding umbrella policy was excess over self-insured retention).

20. *See* Scott M. Seaman and Charlene Kittredge, *Excess Liability Insurance: Law and Litigation*, 32 TORT & INS. L. J. 653, 667-68 (1997).

21. 883 F.Supp. 158 (S.D. Tex. 1995), *aff'd*, 84 F.3d 432 (5th Cir. 1996).

22. *Id*. at 160.

23. *Id*.

24. *Id*.

25. *Id*.

26. *Id*. at 161.

27. *Id* (citing *Carrabba v. Employers Cas. Co.*, 742 S.W.2d 709, 714 (Tex. App. -- Houston [14th Dist.] 1987, no writ)).

28. *Id*. at 164.

29. *Id*. at 164.

30. *See Guar. Nat'l Ins. Co. v. Am. Motorists Ins. Co.*, 758 F.Supp. 1394 (D. Mont. 1991), *aff'd*, 981 F.2d 1108, 1109 (9th Cir. 1992); *Tex. Employers Ins. Ass'n v. Underwriting Members of Lloyds*, 836 F.Supp. 398, 399 (S.D. Tex. 1993).

31. *See Guar. Nat'l*, 981 F.2d at 1109.

32. *See* DONALD S. MALECKI, MALECKI ON INSURANCE 2 (April 1993).

33. *See* DONALD S. MALECKI, MALECKI ON INSURANCE 2 (April 1993).

34. *See* Eileen M. Darcey, *Issues in Excess Coverage*, INSURANCE COVERAGE LITIGATION 1993: CRITICAL ISSUES AND STRATEGIES 248 (Practicing Law Institute, PLI Order No. H4-5173, Sept. 30, 1993) (Westlaw cite: 477 PLI/Lit 243).

35. *Laster v. Am. Nat'l Fire Ins. Co.*, 775 F.Supp. 985 (N.D. Tex. 1991), *aff'd*, 966 F.2d 676 (5th Cir. 1992).

36. *See* DONALD S. MALECKI, MALECKI ON INSURANCE 2 (April 1993).

37. For excellent histories of follow-form excess policies, *see* Mitchell F. Dolin, *Excess Defense Coverage and Long-Tail Liabilities*, 32 TORT & INS. L. J. 875 (Spring 1997), and Randolph M. Fields, *The Underwriting of Unlimited Risk: The London Market Umbrella Liability Policy - 1950 - 1970*, 5 COVERAGE 36 (July/August 1995).

38. *Peter v. Travelers Ins. Co.*, 375 F.Supp. 1347, 1350 (C.D. Cal. 1974).

39. Most jurisdictions recognize two types of subrogation: (1) conventional or "contractual" and (2) "legal," which is controlled by principals of equity. *See Vogel v. Glickman*, 117 F.Supp.2d 572, 577 (W.D. Tex. 2000), *aff'd*, 276 F.3d 729, 735 (5th Cir. 2002).

40. Michael M. Gallagher & Edward C. German, *Resolution of Settlement Conflicts Among Insureds, Primary Insurers, and Excess Insurers: Analysis of the Current State of the Law and Suggested Guidelines for the Future*, 61 NEB. L. REV. 284, 335-42 (1982).

41. Courts in the following cases have applied equitable subrogation: **Alaska**: *R.W. Beck & Assoc. v. City and Borough of Sitka*, 27 F.3d 1475 (9th Cir. 1994); **Arizona**: *Hartford Accident & Indem. Co. v. Aetna Cas. & Sur. Co.*, 792 P.2d 749, 752-57 (Ariz. 1990); **California**: *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Cal. 1980); **Colorado**: *Eklund v. Safeco Ins. Co.*, 579 P.2d 1185 (Colo. 1978); **Florida**: *Ranger Ins. Co. v. Travelers Indem. Co.*, 389 So.2d 272 (Fla.App. 1980); **Georgia**: *Home Ins. Co. v. N. River Ins. Co.*, 385 S.E.2d 736, 740 (Ga. 1989); **Illinois**: *Westchester Fire Ins. Co. v. Gen. Star Indem. Co.*, 183 F.3d 578, 583 (7th Cir. 1999); **Indiana**: *Phico Ins. Co. v. Aetna Cas. & Sur. Co. of America*, 93 F. Supp.2d 982, 989 (S.D. Ind. 2000); *Certain Underwriters of Lloyd's v. Gen. Accident Ins. Co. of America*, 699 F.Supp. 732, 738 (S.D. Ind. 1988), *aff'd*, 909 F.2d 228, 233 (7th Cir. 1990); **Kansas**: *Pac. Employers Ins. Co. v. P.B. Hoidale Co.*, 796 F.Supp. 1428, 1432 (D. Kan. 1992); **Louisiana**: *St. Paul Ins. Co. v. AFIA Worldwide Ins. Co.*, 937 F.2d 274, 278 (5th Cir. 1991); **Maryland**: *Fireman's Fund Ins. Co. v. Cont'l Ins. Co.*, 519 A.2d 202 (Md. 1987); **Massachusetts**: *RLI Ins. Co. v. Gen. Star Indem. Co.*, 997 F.Supp. 140 (D. Mass. 1998); **Michigan**: *Commercial Union Ins. Co. v. Med. Protective Co.*, 393 N.W.2d 479 (Mich. 1986); **Minnesota**: *Cont'l Cas. Co. v. Reserve Ins. Co.*, 238 N.W.2d 862, 864 (Minn. 1976); **New Hampshire**: *Allstate Ins. Co. v. Reserve Ins. Co.*, 373

A.2d 339 (N. H. 1976); **New Jersey**: *Estate of Penn v. Amalgamated Gen. Agencies*, 372 A.2d 1124, 1127 (N. J. 1977); **New York**: *Hartford Accident & Indem. Co. v. Mich. Mut. Ins. Co*., 463 N.E.2d 608, (N.Y. 1984); **Ohio**: *Centennial Ins. Co. v. Liberty Mut. Ins. Co*., 404 N.E.2d 759, 762 (1980); **Oklahoma**: *Am. Fid. & Cas. Co. v. All Am. Bus Lines*, 190 F.2d 234 (10th Cir. 1951); *St. Paul Mercury Indem. Co. v. Martin*, 190 F.2d 455, 457-58 (10th Cir. 1951); **Oregon**: *Portland Gen. Elec. Co. v. Pac. Indem. Co*., 579 F.2d 514 (9th Cir. 1978); **Pennsylvania**: *Puritan Ins. Co. v. Canadian Universal Ins. Co*., 775 F.2d 76, 80 (3d Cir. 1986); **South Carolina**: *Royal Ins. Co. of America v. Reliance Ins. Co*., 140 F.Supp.2d 609, 617-18 (D. S.C. 2001); **South Dakota**: *N. River Ins. Co. v. St. Paul Fire & Marine Ins. Co*., 600 F.2d 721 (8th Cir. 1979); **Tennessee**: *Am. Fire & Cas. Co. v. Roberts*, 186 F.2d 921 (6th Cir. 1951); **Texas**: *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. CNA Ins. Companies*, 28 F.3d 29, 31 n.2 (5th Cir. 1994); *Westchester Fire Ins. v. Heddington Ins. Ltd.*, 883 F.Supp. 158, 162 (S.D. Tex. 1995), *aff'd*, 84 F.3d 432 (5th Cir. 1996); *Employers Nat'l Ins. Co. v. Gen. Accident Ins. Co*., 857 F.Supp. 549, 552 (S.D. Tex. 1994); *Keck, Mahin & Cate v. Nat'l Union Fire Ins. Co.* 20 S.W.3d 692 (Tex. 2000); *Am. Centennial Ins. Co. v. Canal Ins. Co*., 843 S.W.2d 480, 482-83 (Tex. 1992); **Washington**: *First State Ins. Co. v. Kemper Nat'l Ins. Co*., 971 P.2d 953, 957-958, (Wash. 1999); **West Virginia**: *Vencill v. Cont'l Cas. Co*., 433 F.Supp. 1371 (S.D. W. Va. 1977); **Wisconsin**: *Evanston Ins. Co. v. Stonewall Surplus Lines Ins. Co*., 111 F.3d 852 (11th Cir. 1997); **Wyoming**: *Hocker v. N.H. Ins. Co*., 922 F.2d 1476 (10th Cir. 1991).

42. Paul B. Butler, Jr. & Robert B. Potter, Jr., *The Primary Carrier Cought in the Middle with Bad Faith Exposure to its Insureds, Excess Carriers and Reinsurers*, 24 TORT & INS. L. J. 118, 123-24 (1988).

43. Cases supporting the direct duty theory include: **Colorado**: *Hawkeye-Sec. Ins. Co. v. Indem. Ins. Co*. 260 F.2d 361, (10th Cir. 1958); **Florida**: *Colonia Ins. Co. v. Assuranceforeningen Skuld*, 588 So.2d 1009, 1010-11 (Fla.App. 1991); **Illinois**: *Ranger Ins. Co. v. Home Indem. Co*., 714 F.Supp. 956, 960-62 (N.D. Ill. 1989) (applying Illinois law); *Am. Centennial Ins. Co. v. Am. Home Assur. Co*., 729 F.Supp. 1228, 1232 (N.D. Ill. 1990); **Kansas**: *Attorneys Liab. Prot. Soc'y v. Reliance Ins. Co*., 117 F.Supp.2d 1114, 1124 (D.Kan. 2000); *Twin City Fire Ins. Co. v. Country Mut. Ins. Co*., 23 F.3d 1175 (7th Cir. 1994); **Louisiana**: *Nat'l Union Fire Ins. Co. v. Liberty Mut. Ins. Co*., 696 F.Supp. 1099, 1101 (E.D. La. 1988); **Michigan**: *Commercial Union Ins. Co. v. Med. Protective Co*., 356 N.W.2d 648 (Mich. App. 1984), *aff'd in part*, 393 N.W.2d 479 (1986); **New Jersey**: *Estate of Penn v. Amalgamated Gen. Agencies*, 372 A.2d 1124, 1127 (N.J. 1977); **New York**: *Hartford Accident & Indem. Co. v. Mich. Mut. Ins. Co.*, 93 A.D.2d 337, (N.Y. 1983); *Russo v. Rochford*, 472 N.Y.S.2d 954 (N.Y. 1984); **Oklahoma**: *St. Paul Mercury Indem. Co. v. Martin*, 190 F.2d 455 (10th Cir. 1951); **Pennsylvania**: *Puritan Ins. Co. v. Canadian Universal Ins. Co.*, 775 F.2d 76, 80-81 (3d Cir. 1985); *United States Fire Ins. Co. v. Am. Nat'l Fire Ins. Co*., 53 Pa. D. & C.4th 474, 486-92 (Pa. Com. Pl. 2000); **Washington**: *Truck Ins. Exch. v. Century Indem. Co*., 887 P.2d 455, 460; **Wyoming**: *Hocker v. N.H. Ins. Co*., 922 F.2d 1476, 1486-89 (10th Cir. 1991).

44. 93 A.D.2d 337, (N.Y.S. 1983), *aff'd*, 61, 463 N.E.2d 608 (1984).

45. Michigan Mutual arguably refused because Michigan Mutual also provided Worker's Compensation/Employers' Liability coverage for D.A.L. and would be liable for any judgment under its Employers' Liability coverage.

46. 729 F.Supp. 1228 (N.D. Ill. 1990).

47. *Ranger Ins. Co. v. Home Indem. Co*., 714 F.Supp. 956 (N.D. Ill. 1989).

48. *American Centennial*, 729 F.Supp. at 1232.

49. *Id*.

50. *See* John F. Jenks, *Picking Up the Pieces: The Excess Insurer's Bad Faith Cause of Action Against the Primary Insurer*, 54 MONT. L. REV. 385, 402 (1993).

51. John F. Jenks, 54 MONT. L. REV. at 402.

52. Cases criticizing or rejecting the direct duty theory include the following: **Alabama**: *Fed. Ins. Co. v. Travelers Cas. & Sur. Co*., 843 So.2d 140 (Ala. 2002); **Arizona**: *Twin City Fire Ins. Co. v. Superior Court*, 792 P.2d 758 (Ariz. 1990); **Indiana**: *Phico Ins. Co. v. Aetna Cas. & Sur. Co. of America*., 93 F.Supp.2d 982, 989 (S.D. Ind. 2000); **Louisiana**: *Pac. Employers Ins. Co. v. United Gen. Ins. Co*., 664 F.Supp. 1022 (W.D. La. 1987); **New Hampshire**: *Allstate Ins. Co. v. Reserve Ins. Co.*, 373 A.2d 339 (N.H. 1976); **North Carolina**: *U.S. Fire Ins. Co. v. Nationwide Mut. Ins. Co*., 735 F.Supp. 1320 (E.D. N.C. 1990); **Texas**: *Am. Centennial Ins. Co. v. Canal Ins. Co*., 843 S.W.2d 480 (Tex. 1992); **Wisconsin**: *Teigen v. Jelco of Wis., Inc*., 367 N.W.2d 806 (Wis. 1985).

53. Cases applying the direct duty-triangular reciprocity theories of liability include the following: **California**: *Transit Cas. Co. v. Spink Corp*., 156 Cal.Rptr. 360 (1979); **Florida**: *Colonia Ins. Co. v. Assuranceforeningen Skuld*, 588 So.2d 1009, 1010-11 (Fla. App. 1991); **Illinois**: *Schal Bovis, Inc. v. Cas. Ins. Co*., 732 N.E.2d 562, (Ill. 1999); **New Jersey**: *W. World Ins. Co. v. Allstate Ins. Co*., 376 A.2d 177, 180 (N.J. 1977); **New York**: *Hartford Accident & Indem. Co. v. Mich. Mut. Ins. Co*., 93 A.D.2d 337, 342, (1983), *aff'd*, 463 N.E.2d 608, (1984); **Wyoming**: *Hocker v. N.H. Ins. Co*., 922 F.2d 1476, 1487 (10th Cir. 1991).

54. *Transit Cas. Co. v. Spink Corp*., 156 Cal.Rptr. 360 (1979).

55. *See id*. However, the California Supreme Court refused to apply the theory of triangular reciprocity in a self-insured situation, holding that a self insured owed no duty to give an excess insurer's financial interests equal consideration to its own. *Commercial Union Assurance Companies v. Safeway Stores, Inc*., 610 P.2d 1038, 1040, (Cal. 1980).

56. **Alabama**: *Fed. Ins. Co. v. Travelers Cas. & Sur. Co*., 843 So.2d 140 (Ala. 2002); **Arizona**: *Universal Underwriters Ins. Co. v. Dairyland Mut. Ins. Co*., 102 Ariz. 518, 433 P.2d 966 (1967); **California**: *Commercial Union Assurance Companies v. Safeway Stores, Inc*., 26 Cal.3d 912, 197, 610 P.2d 1038, 1041, 164 Cal.Rptr. 709, 712 (1980); **Colorado**: *Hawkeye-Security Ins. Co. v. Indem. Ins. Co. of N. America*, 260 F.2d 361 (10th Cir. 1958); **Florida**: *Gen. Accident Fire & Life Assurance Corp. v. American Cas. Co*., 390 So.2d 761, 765 (Fla. App. 1980); **Idaho**: *Stonewell Surplus Lines Ins. Co. v. Farmers Ins. Co*., 971 P.2d 1142 (Idaho 1998); **Michigan**: *Commercial Union Ins. Co. v. Med. Protective Co*., 393 N.W.2d 479 (1986); **Minnesota**: *Cont'l Cas. Co. v. Reserve Ins. Co.*, 238 N.W.2d 862, 864 (1976); **New Jersey**: *Estate of Penn v. Amalgamated Gen. Agencies*, 372 A.2d 1124, 1127 (N.J. 1977); **New York**: *Hartford Accident & Indem. Co. v. Mich. Mut. Ins. Co*., 463 N.E.2d 608, (1984); **North Carolina**: *U.S. Fire Ins. Co. v. Nat'l Mut. Ins. Co*., 735 F.Supp. 1320 (E.D. N.C. 1990); **Ohio**: *Centennial Ins. Co. v. Liberty Mut. Ins. Co*., 404 N.E.2d 759, 762 (Ohio 1980); **Oklahoma**: *United States Fid. & Guar. Co. v. Tri-State Ins. Co*., 285 F.2d 579, 591 (10th Cir. 1960); **Oregon**: *Maine Bonding & Cas. Co. v. Centennial Ins. Co*., 693 P.2d 1296 (Or. 1985); **Pennsylvania**: *United States Fire Ins. Co. v. Royal Ins. Co*., 759 F.2d 306 (3d Cir. 1985); **Texas**: *Union Indem. Ins. Co. v. Certain Underwriters at Lloyds*, 614 F.Supp. 1015 (S.D. Tex. 1985); **West Virginia**: *Vencill v. Cont'l Cas. Co*., 433 F.Supp. 1371, 1376 (S.D. W.Va. 1977); **Wisconsin**: *Teigen v. Jelco, Inc*., 367 N.W.2d 806 (Wis. 1985). *See* Stephen S. Ashley, *The Peculiar Fate of Excess Carriers in the Law of Bad Faith*, 3 BAD FAITH LAW REPORT 197 (1987).

57. 843 So.2d 140 (Ala. 2002).

58. *Fed. Ins*., 843 So.2d at 142.

59. *Id*. at 144.

60. *Id*. at 145-146.

61. 452 F.2d 603 (9th Cir. 1971) (per curiam).

62. 433 P.2d 966 (Ariz. 1967).

63. *See* Michael D. Gallagher & Edward C. German, *Resolution of Settlement Conflicts Among Insureds, Primary Insurers and Excess Insurers: Analysis of the Current State of the Law and Suggested Guidelines for the Future*, 61 NEB. L. REV. 284, 333-34 (1982).

64. *G. A. Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved).

65. *Am. Physicians Ins. Exch.. v. Garcia*, 876 S.W.2d 842, 848-49 (Tex. 1994).

66. *See Westchester Fire Ins. Co. v. Am. Contractors Ins. Co. Risk Retention Group*, 1 S.W.3d 872, 874 (Tex.App. — Houston [1st Dist.] 1999, no pet.); *Birmingham Fire Ins. Co. v. Am. Nat'l Fire Ins. Co.*, 947 S.W.2d 592 (Tex. App. — Texarkana 1997, writ denied).

67. 1 S.W.3d 872 (Tex. App.—Houston [1st Dist.] 1999, no pet.).

68. *See American Centennial Ins. Co. v. Canal Ins. Co.* 843 S.W.2d 480, 481 (Tex. 1992).

69. *Westchester Fire*, 1 S.W.3d at 873.

70. 947 S.W.2d 592 (Tex. App. -- Texarkana 1997, writ denied).

71. *Id*. at 597.

72. The court cited *American Physicians Insurance Exchange v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994).

73. *Garcia*, 876 S.W.2d at 850 n. 17.

74. 857 F.Supp. 549 (S.D. Tex. 1994).

75. *Id*. at 551.

76. *Id*. at 554.

77. 348 F.Supp.2d 940 (N.D. Ill. 2004).

78. *Id*. at 952.

79. Conspicuously missing from the analysis in this reported case is any attack against the self-insured, CNR, which actually controlled the defense and settlement of the claim at issue.

80. *Id*. at 942.

81. *Id*. at 943.

82. *Id*. at 951.

83. *Id*. at 951.

84. 675 N.E.2d 897 (Ill. 1996).

85. 763 N.E.2d 299 (Ill. 2001).

86. *Liberty Mut*., 348 F.Supp.2d at 958-59.

87. *Cramer*, 675 N.E.2d at 903.

88. *Id*.

89. *Liberty Mut*., 348 F.Supp.2d at 959-60.

90. *Id*. at 960.

91. *Id*. at 961.

92. *Id*. at 962.

93. "The high cost of ground-up protection has spurred many insureds to self-insure their primary liability and purchase excess coverage for loss amounts that would impair them financially." Dennis G. LaGory, et al, *"Recent Developments In Excess, Surplus Lines, and Reinsurance Law."* 38 TORT TRIAL & INS. PRAC. L. J. 335, 364 (Winter 2003).

94. The *Garcia* factors are as follows: (1) underlying tort lawsuits against insureds must fall within coverage of a primary insurer, (2) tort plaintiffs must specifically offer to settle for the primary insurer's policy limits, (3) primary insurers need not make nor solicit settlement offers, and (4) any settlement offers must be those that prudent primary insurers would ordinarily accept, given the potentials for exposing insureds to excess judgments.

95. *Int'l Ins. Co. v. Dresser Indus., Inc*., 841 S.W.2d 437, 446 (Tex.App. — Dallas 1992, writ denied).

96. *See Id.*

97. *See Home Indemnity Co. v. Humble Oil & Refining Co.*, 314 S.W.2d 861 (Tex.Civ.App.—Dallas 1958, writ ref'd n.r.e.) (per curiam). TEX. BUS. CORP. ACT. art. 2.01.B.(4)(d).

98. *Maxus Exploration Co., v. Moran Bros, Inc*., 773 S.W.2d 358, 360 (Tex.App.—Dallas 1989), *aff'd*, 817 S.W.2d 50 (Tex. 1991).

99. *Allstate Ins. Co. v. Zellars*, 462 S.W.2d 550, 552 (Tex. 1970).

BY CHRISTOPHER "KIPPER" BURKE

Coverage for Construction Defects under a Commercial Liability Policy – Clarifying the Confusion

I. INTRODUCTION

Insurance coverage questions regarding claims for defective construction have received significant treatment from the courts in Texas over the past five years. The decisions generally concern whether the allegations in the pleading or facts proven at trial are sufficient to trigger the insuring agreement in a commercial general liability policy. The vast majority of the opinions concern whether the allegations are sufficient to state an "occurrence" sufficient to trigger an insurer's duty under the policy. Several cases have also considered whether allegations of defective construction are sufficient to state "property damage." What has resulted is a confusing mess of law that is neither predictable nor stable.

The Texas Supreme Court is currently considering two separate cases that deal with these issues. In *Lamar Homes v. Mid-Continent Casualty Company*,[2] the court has accepted three questions certified by the United States Court of Appeals for the Fifth Judicial Circuit.[3] The first two questions are:

> 1. 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?
>
> 2. 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?[4]

The third question deals with the applicability of Article 21.55 of the Texas Insurance Code to claims for defense.[5] The briefing schedule has been issued, and the case is set for oral argument on February 14, 2006.[6]

In the second case, *Employers Mutual Insurance Company v. Gehan Homes*, the insurers filed petitions for review on whether a construction defect was sufficient to state an "occurrence" under a commercial general liability policy.[7] At the time of writing, the Texas Supreme Court had received full briefing in *Gehan Homes* but has not acted on the petition for review.[8] Because the questions it will answer in *Lamar Homes* are potentially dispositive of the issues in *Gehan Homes*, it is likely the court will take no action on the petition for review until after it has decided *Lamar Homes*.

This article will analyze the "occurrence" and "property damage" questions as they relate to claims for defective construction. For purposes of this article, it is important to distinguish between claims involving damage only to what the contractor built on that project and claims where the contractor's work damaged something other than what was provided. For the discussion contained here, construction defects will involve only the first of these two scenarios – damage caused by the contractor's work solely to what the contractor provided pursuant to that sales or building contract.[9]

II. THE POLICY PROVISIONS

The commercial general liability policy contains several sections including (1) the insuring agreement, (2) the exclusions, (3) the definitions, (4) the conditions, and (5) endorsements. For a complete understanding of the issues related to coverage issues related to construction defect claims, the insuring agreement, certain exclusions, and certain definitions need to be analyzed.

The insuring agreement at issue in a standard commercial general liability policy states the following:

Mr. Burke[1] is a founding shareholder in the San Antonio firm of Miller & Burke, P.C. He devotes significant attention to insurance coverage issues, including coverage claims related to defective construction.

1. Insuring Agreement.

a. We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages.

……

b. This insurance applies to "bodily injury" and property damage" only if:

(1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory"; and

(2) The "bodily injury" or "property damage" occurs during the policy period.

The policy contains numerous exclusions that are potentially applicable in a construction defects cases. However, only a few of the exclusions are germane to the issues in this paper. Many of the other exclusions will come into play in a construction defect case. However, for purposes of the discussion regarding whether any construction defect claims constitute an "occurrence" or "property damage" only the following exclusions are necessary for a full understanding of the issues.

2. Exclusions.

This insurance does not apply to:

a. Expected or Intended Injury

"Bodily injury" or "property damage" expected or intended from the standpoint of the insured.

……

b. 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.

The following definitions are relevant to the discussion as well:

SECTION V — DEFINITIONS

"Occurrence" means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.

……

a. "Products-completed operations hazard" includes all "bodily injury" and "property damage" occurring away from premises you own or rent and arising out of "your product" or "your work" except:

(1) Products that are still in your physical possession; or

(2) Work that has not yet been completed or abandoned.

b. "Your work" will be deemed completed at the earliest of the following times:

(1) When all of the work called for in your contract has been completed.

(2) When all of the work to be done at the site has been completed if your contract calls for work at more than one site.

(3) When that part of the work done at a job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.

Work that may need service, maintenance, correction, repair or replacement, but which is otherwise complete, will be treated as completed.

……

"Property damage" means:

a. Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or

b. Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

……

"Your work" means:

a. Work or operations performed by you or on your behalf; and

b. Materials, parts or equipment furnished in connection with such work or operations.

"Your work" includes:

a. Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of "your work," and

b. The providing of or failure to provide warnings or instructions.

III. THE STANDARDS OF REVIEW

A. Duty to Defend

In determining whether an insurer has a duty to defend, the court looks solely to the face of the pleadings and the policy provisions. *National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997); *Argonaut Southwest Ins. Co. v. Maupin*, 500 S.W.2d 633 (Tex. 1973) (stating that under the "complaint allegation" rule developed in Texas jurisprudence, the duty to defend is determined by the allegations of the petition when considered in light of the policy provisions without reference to the truth or falsity of the allegations). The insurer is under a legal duty if, and only if, the petition alleges facts construing a cause of action within the coverage of the policy. *Trinity Universal Ins. Co. v. Cowan*, 845 S.W.2d 819, 821 (Tex. 1997); *Snug Harbor Ltd. v. Zurich Ins. Co.*, 968 F.2d 538 (5th Cir. 1992). The duty is determined without regard to whether the facts alleged against the insured are true or false and without regard to what the insured and insurer know the true facts to be. *Heyden Newport Chem. Corp. v. Southern General Ins. Co.*, 387 S.W.2d 22, 26 (Tex. 1965). In a case of doubt as to whether the allegations of the complaint state a cause of action within the coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt will be resolved in the insured's favor. *Id.* An important limitation on this rule is that the insurer is not required to read factual allegations into the pleadings that could have been made, but were not. *Cowan*, 945 S.W.2d at 821.

In determining whether an insurer has a duty to defend, the court looks solely to the face of the pleadings and the policy provisions.

B. Duty to Indemnify

In Texas, the duty to defend and the duty to indemnify are distinct and separate duties. *Farmers Texas County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 82 (Tex.1997). The standards by which those two duties are examined are markedly different. *Pilgrim Enters., Inc. v. Maryland Cas. Co.*, 24 S.W.3d 488, 493 (Tex. App. – Houston [1st Dist.] 2000, no pet.); American Alliance Ins. Co. v. Frito-Lay, Inc., 788 S.W.2d 152, 153-54 (Tex. App. – Dallas 1990, writ dism'd) (contrasting duties to indemnify and defend under liability policy). While the duty to defend indulges all inferences in favor of the insured, the duty to indemnify requires that the *insured prove* that the damages fall within the scope of coverage. *See Hartrick v. Great American Lloyds Ins. Co.*, 62 S.W.3d 270, 275-76 (Tex. App. – Houston [1st Dist.] 2000, no pet.) (finding that unlike the duty to defend, which arises when a petition seeking damages alleges facts that potentially support claims covered by a liability policy, the duty to indemnify arises from proven, adjudicated facts). *See also Cowan*, 945 S.W.2d at 821 ("The duty to indemnify is triggered by the actual facts establishing liability in the underlying suit."). No duty to indemnify arises unless the underlying litigation establishes liability for damages covered by the insuring agreement of the policy. *See Employers Cas. Co. v. Block*, 744 S.W.2d 940, 944 (Tex. 1988) (disapproved on other grounds by *State Farm Fire & Casualty Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996)); *Heyden Newport Chem. Corp. v. Southern General Ins. Co.*, 387 S.W.2d 22, 25 (Tex.1965) (noting that, while "[n]o legal determination of ultimate liability is required before the insurer becomes obligated to defend the suit [,]" the insurer pays because the insured "has been adjudicated to be legally responsible").

IV. "OCCURRENCE" IN THE TEXAS SUPREME COURT

Under the terms of the policy, an insurer only agrees to pay for damages caused by an "occurrence." An "occurrence" is defined by the policy to mean "an accident including continuous or repeated exposure to substantially the same general harmful conditions." The Texas Supreme Court has analyzed similar definitions on several occasions.

The Texas Supreme Court has held that, where an insured's acts "are voluntary and intentional and the injury is the natural result of the act," the injury was not caused by an "occurrence" within the meaning of the policy even though the particular injury may have been unexpected, unforeseen, and unintended. *Argonaut Southwest Ins. Co. v. Maupin*, 500 S.W.2d 633, 635 (Tex. 1973). Under that definition, the Court must first determine whether specific acts alleged to have caused the plaintiff's injuries in the underlying suit were "voluntary and intentional." If so, the Court must next determine whether the injuries alleged were a "natural result" of the

acts. *See Wessinger v. Fire Ins. Exch.*, 949 S.W.2d 834, 838 (Tex. App. Dallas 1997, no writ) (describing analysis of whether injuries were caused by "accident" under *Maupin* as "two-step" process). *See also Folsom Investments, Inc. v. American Motorists Ins. Co.* 26 S.W.2d 556, 559 (Tex. App. – Dallas 2000, no pet.).

In *Cowan*, the Texas Supreme Court reaffirmed *Maupin* with refinement of the definition of "accident." *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 828 (Tex. 1997). The court in *Cowan* explained that the "natural result" of an act is an injury of a type that could be "reasonably anticipated from the use of the means, or an effect" that the insured could be "charged with ... producing." *Cowan*, 945 S.W.2d at 827-828 (quoting *Republic Nat'l Life Ins. Co. v. Heyward*, 536 S.W.2d 549, 555-56 (Tex. 1976). In other words:

> When a result is not the natural and probable consequence of an act or course of action, it is produced by accidental means. The natural result of an act is the result that ordinarily follows, may be reasonably anticipated, and ought to be expected. This standard is objective. A person is held to intend the natural and probable results of his acts even if he did not subjectively intend or anticipate those consequences.

Wessinger, 949 S.W.2d at 837-38.

The Texas Supreme Court has not examined anything even remotely analogous to a construction defect case. In fact, the Texas Supreme Court has not addressed whether a routine breach of contract, without anything more, would be sufficient to trigger an "occurrence" under a standard liability policy.[10] Thus, while the above standard is the only one the court has announced, that does not mean that in pure breach of contract cases, such as a claim solely for defective construction, the court would not adopt a different standard. The Texas Supreme Court has been more than willing to treat the two areas differently for liability and damages, so there is no reason to believe it will not treat them differently for coverage. The easiest way the court could address the contract scenario is to confirm a party to a contract who fails to perform properly under that contract presumptively foresees the damages that flow from that breach of contract as a matter of law. *See Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 816 (Tex. 1997); *Wade & Sons, Inc. v. American Standard, Inc.*, 127 S.W.3d 814, 823 (Tex. App. – San Antonio 2003, pet. denied). The court should state that factual allegations that the insured's failured to comply with its contractual obligations in a construction defect matter are insufficient to state an occurrence as a matter of law. However, even utilizing the court's stated standard results in there being no occurrence for construction defect claims.

V. THE OCCURRENCE CASES IN THE LOWER TEXAS APPELLATE COURTS AND FEDERAL DISTRICT COURTS.

The lower appellate courts and the federal district courts have had a difficult time in determining whether allegations of defective construction are sufficient to trigger an occurrence.[11] Any attempt to harmonize the opinions is futile.[12] An examination of the cases holding both ways shows that the correct interpretation of the policy is that there is no "occurrence" when the damage is solely to the subject matter of the contract between the builder and the homeowner.

A. THE CORRECT RESULTS – CASES FINDING NO "OCCURRENCE" FOR CONSTRUCTION DEFECT CLAIMS

Numerous Texas courts have properly concluded that the carrier had either no duty to defend or no duty to indemnify the insured from claims for faulty workmanship. *See Jim Johnson Homes, Inc. v. Mid-Continent Casualty Company*, 244 F.Supp.2d 706 (N.D. Tex. 2003); *Devoe v. Great American Ins.*, 50 S.W.3d 567 (Tex. App. – Austin 2001, no pet.); *Lamar Homes, Inc. v. Mid-Continent Casualty Company*, 335 F.Supp.2d 754 (W.D. Tex. 2004); *Michigan Mutual Ins. Co. v. Alliance Construction, Inc.*, 2005 WL 2297505 (W.D. Tex. Sept. 21, 2005); *Mid-Arc v. Mid-Continent Casualty Company*, 2004 WL 1125588 (W.D. Tex. Feb. 24, 2004); *Vesta Fire Insurance Corporation v. Nutmeg Insurance Company*, A-00-CA-468-SS (W.D. Tex. Sept. 29, 2003); *Tealwood Construction, Inc. v. Scottsdale Ins. Co.*, 2003 WL 22790856 at *5-*6 (N.D. Tex., Nov 19, 2003); *Malone v. Scottsdale Ins. Co.*, 147 F.Supp.2d 623 (S.D. Tex. 2001); *Acceptance Ins. Co. v. Newport Classic Homes, Inc.*, 2001 WL 1478792 (N.D. Tex. Nov. 19, 2001). *See also Thom v. State Farm Lloyds*, 10 F.Supp. 693, 702 n.9 (S.D. Tex. 1997) (expressing reservations as to whether allegations of negligent construction would be an "occurrence" under several policies).

In *Jim Johnson Homes, Inc.*, the homebuilder brought an action against its commercial liability insurance carrier asserting that the carrier had an obligation to defend the builder in arbitration proceedings brought by the homeowner for whom the builder Homes had agreed to build a home. *Jim Johnson Homes, Inc.*, 244 F.Supp.2d. at 709. The homeowners complained of improper construction, construction deficiencies, and design deficiencies. *Id.* at 711. In holding that the insurance carrier had no duty to provide coverage to the homebuilder, the court reasoned that the substandard construction did not constitute an accident and noted that "[n]one of the language of the insurance policy suggests that the policy was intended to serve as a performance bond as well as a typical liability insurance contract." *Id.* at 715. Furthermore, the

court stated that the claims made by the homeowners are not claims of accidental damage to property, with the consequence that no "occurrence" has taken place. *Id*. at 715-16. In finding that there had been no "occurrence" as defined by the policy, the court stated:

> Alternative, conclusory allegations of negligence such as the Jeters made in their demand cannot serve to overcome the specific facts, as set forth in the demand, when, as here, those facts quite clearly demonstrate that the real complaint is that plaintiff [homebuilder] did not live up to his contractual obligations to build their house properly. Artful pleading suggesting that plaintiff's [homebuilder's] acts were negligent or reckless cannot overcome the basic facts underlying [the] claims. The allegation that plaintiff [homebuilder] was negligent is simply an embellishment on, and a re-characterization of, the basic breach of contract and fraud claims the Jeters assert in their demand.

Id. at 716-17 (citations omitted). In concluding its analysis that no "occurrence" had been alleged, the court declared,

> The focus here, as it should be in all cases of this kind, is not on the characterization given by the homeowners of their claim against their builder, but is on whether the evidence would support findings invoking the insurance coverage.

Id. at 717.

In *Devoe*, the Devoes contracted with Tri-Mark Development Corporation to construct a custom home. *Devoe*, 50 S.W.3d at 568. The Devoes complained of improper and deficient workmanship. *Id*. The insurer declined to defend, citing in part that no occurrence had been alleged. *Id*. The Devoes took a default judgment, and then sued Great American as third-party beneficiaries under the insurance contract. *Id*. The *Devoe* court declined to adopt the theory that "shoddy workmanship" could be considered an occurrence. The court stated:

> [The Devoes] do not allege any event or series of events that could be construed as an accident. The Devoes' home was constructed over a period of time as a voluntary and intentional act by the insured, and the alleged deficient and substandard construction did not constitute an accident or an occurrence under the plain-meaning rule even if the resulting, poorly constructed home was unexpected unforeseen, or unintended by the insured.

Id. at 572 (citing *Argonaut Southwest Ins. Co. v. Maupin*, 500 S.W.2d 633, 633 (Tex. 1973)). Accordingly, the court upheld the trial court's summary judgment in favor of Great American.

In *Lamar Homes*, the court confronted allegations of a failure to design and/or construct the foundation in a good and workmanlike manner. *Lamar Homes*, 335 F.Supp.2d at 758. The homeowners further alleged that the foundation deflected excessively resulting in cracks in the sheetrock and stone veneer. *Id*. The homeowners alleged that these failures were caused by Lamar Homes' negligence. *Id*. Judge Yeakel concluded that the homeowners had not alleged an occurrence under the terms of the policy.

Each of these courts properly concluded that because the factual allegations in each case were that the insured failed to adequately construct the home, those facts failed to allege an occurrence. The *Jim Johnson Homes* court reasoned that the construction work had been conducted over a period of time, and the allegations of the homeowners merely contained complaints about things done voluntarily and intentionally by the homebuilder. Similarly, the Devoe court determined that based upon the fact that the insured presumptively foresaw the damages to the home as a result of their allegedly deficient performance; the insurance policy did not provide coverage for that loss. The *Lamar Homes* court noted that the Texas Supreme Court's specific pronouncements in *Jim Walter Homes v. Reed* rejected the notion that conclusory allegations of negligence would be sufficient to state an accident. The Texas appellate court in *Hartrick*, as well as the federal district courts in *Malone, Tealwood, Vesta Fire,* and *Newport Classic Homes* reached the same conclusion. *See, e.g., Malone*, 147 F.Supp.2d at 627-28 (relying on *Hartrick* to find insurer had no duty to defend allegations of negligent construction); *Newport Classic Homes*, 2001 WL 14789791 at *4 (finding allegations that insured failed to build home in a good and workmanlike manner and failure to build home in compliance with local building code did not state an occurrence within meaning of the policy). The cases that properly examined Texas law concluded that a commercial general liability policy does not cover construction defect claims because they fail to allege an occurrence.

The lower court cases including *Jim Johnson Homes, Devoe,* and *Lamar Homes* correctly apply the Texas Supreme Court's analysis to determine that there has been no occurrence. Those cases focus first on whether the insured intended to *act* as required by *Cowan*. The courts then consider the foreseen consequences of those actions, applying the Texas Supreme Court's specific directive that these types of damages are presumed to have been foreseen. These courts have properly determined that the petitions alleging damage only to what the contractor was hired to build fail to allege an occurrence under Texas law.

B. THE WRONG RESULT – CASES FINDING AN OCCURRENCE FOR CONSTRUCTION DEFECT CLAIMS

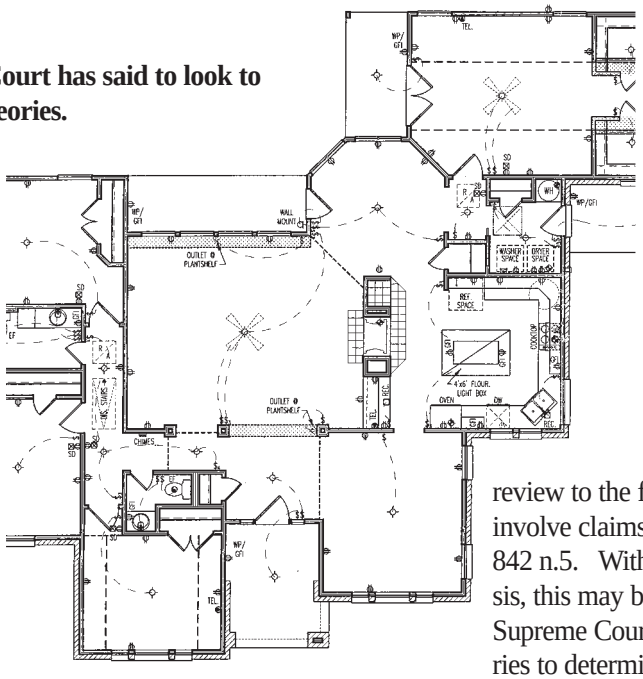
In the cases finding a duty to defend or indemnify for defective construction claims, the courts have adopted either a "negligence equals occurrence" position or have adopted the "the insured did not expect or intend the damage" theory. Neither of these two theories regarding the interpretation of occurrence are a correct application of the existing Texas Supreme Court precedent. In fact, both theories violate well-settled principles established by the Texas Supreme Court. In addition, many of the cases assert that if there is no "occurrence" then the subcontractor exception to exclusion l is rendered meaningless. Numerous examples support the insurance industry's interpretation of "occurrence" yet still trigger the subcontractor exception to exclusion l. As a result, the courts' conclusions that the subcontractor exception would be rendered meaningless is wrong.

1. Allegations of "negligence" are NOT sufficient to trigger coverage.

a. Texas Supreme Court has said to look to facts, not legal theories.

Insureds routinely argue that an allegation that it "negligently constructed" the residence or "negligently supervised" its subcontractors alleges an "occurrence." However, this approach is simply wrong.[13] In determining the duty to defend, it is the *facts* alleged which control. *National Union Fire Ins. Co. v. Merchant's Fast Motor Lines, Inc.*, 939 SW.2d 139, 141 (Tex. 1997); *Adamo v. State Farm Lloyds Co.*, 853 S.W.2d 673, 676 (Tex. App.—Houston [14th Dist.] 1993, writ denied). The legal theories of recovery pled by a plaintiff do not affect the duty to defend. *Adamo*, 853 S.W.2d 673. Stated another way, the label that the plaintiff puts on the cause of action is not controlling. *See National Union*, 939 SW.2d at 141. Numerous Texas cases have held that simply using of the term "negligence" or similar terms does not trigger a duty to defend where the facts alleged clearly do not involve accidental injury. *See, e.g., American Nat. General Ins. Co. v. Ryan*, 274 F.3d 319 (5th Cir. 2001) (allegations of negligence did not control and did not allege an occurrence); *Folsom Investments, Inc. v. American Motorists Ins. Co.*, 26 S.W.3d 556, 559-60 (Tex. App.—Dallas 2000, no pet.) (allegations of negligent hiring, training, supervision, and retention of the employee were insufficient to allege an occurrence). The rationale behind such a rule is simple – coverage decisions are based upon the substance of the pleadings, not on the form of the pleading. Despite this sound rationale, several courts have adopted the faulty premise that negligence equals occurrence.

Calli Homes, Main Street Homes, Gehan Homes encouraged reliance on the "negligence equals occurrence" argument in the construction defect area.[14] In *Calli Homes*, the court stated that an allegation of "negligently performed work" was sufficient to state an occurrence. *See Great American Ins. Co. v. Calli Homes, Inc.*, 236 F.Supp.2d 693, 699-702 (S.D. Tex. 2002). In *Main Street Homes*, the court discussed the allegations of negligence as if that legal theory alone was sufficient to state an occurrence under the commercial general liability policy. *See Main Street Homes*, 79 S.W.3d 687, 694 (Tex. App. – Austin 2002, no writ) (stating "the petition's allegations against Main Street include allegations of negligence").[15] In *Gehan Homes*, the Dallas Court of Appeals stated that it could not ignore the "negligence allegations" in the statement of claims. Gehan Homes, 146 S.W.3d at 842. The Gehan Homes court looked at the negligence allegations despite it's recognition that the Texas Supreme Court had specifically stated that the court should not look to the legal theories to make its determination. *Id.* Rather than accepting this mandate from the Texas Supreme Court, the Dallas Court of Appeals, in a footnote, asserts that most of the cases that limit review to the factual allegations "tend to involve claims of intentional conduct." *Id.* at 842 n.5. With respect to the occurrence analysis, this may be true. However, the Texas Supreme Court has *never* looked at legal theories to determine if there is a duty to defend. The Dallas court of appeals was doing something that the Texas Supreme Court has never done, and in fact has *specifically* directed the court not to do. *See National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 141 (Tex. 1997).[16]



Gehan Homes asserts that most cases that have declined to look at the legal theories were intentional tort cases. It then declines to follow those cases without providing any discussion of *why* it is believes those cases are distinguishable regarding the duty to defend. In fact, there is no reason to differentiate between intentional tort cases and construction defect cases

regarding whether court should look to legal theories rather than facts in determining the duty to defend. The Texas Supreme Court has determined that if the facts show solely intentional conduct, then the claim cannot be converted into an accident simply by alternately alleging negligence. *See Cowan*, 945 S.W.2d at 821, 828 (discussing facts showing intent despite pleading of negligence). The same can be said for a construction defect claim.

The Texas Supreme Court has clearly defined the distinction between a breach of contract claim and a claim for negligence. In *Montgomery Ward & Company v. Scharrenbeck*, the Texas Supreme Court examined a situation where a defectively repaired water heater started a fire that damaged the remainder of the home. *Scharrenbeck*, 204 S.W.2d 508, 508-09 (Tex. 1947). The court determined there could be a recovery in negligence noting that a "contract may create the state of things which furnishes the occasion of a tort." *Id*. at 510. The court later reaffirmed and summarized *Scharrenbeck's* rationale. *See Southwestern Bell Tel. Co. v. DeLanney*, 809 S.W.2d 493, 494 (Tex. 1991). In *DeLanney*, the court distinguished between damage solely to the water heater (an economic loss for which there is no recovery in negligence) and damage to the remainder of the home because of the defective water heater (damages for which there could be a recovery in negligence). *DeLanney*, 809 S.W.2d at 494.

The facts showing a contract claim are clearly distinguishable from the facts showing a negligence claim…

The facts showing a contract claim are clearly distinguishable from the facts showing a negligence claim, just as the facts showing an intentional tort are clearly distinguishable from those showing a negligence claim. The *Gehan Homes* court failed to recognize that efforts to recast an intentional tort case as a negligence matter is indistinguishable from efforts to recast a breach of contract case as a negligence case. There is simply no justification for treating them differently in determining the coverage available for a construction defect claim. Accordingly, recasting a breach of contract claim as a negligence claim is insufficient to trigger an occurrence under a commercial general liability policy.

b. Facts showing breach of contract should not be converted to tort claims simply by mention of the word "negligence."

In breach of contract cases, the fact finder *never even considers* the standard of care the insured used in performing its contractual obligations.[17] Either the insured failed to do what it promised, or it did what it promised. Additionally, there is a good reason why there is no standard of care question. By entering into the contract, the contractor has *presumptively foreseen all of the damages that relate to the performance of the contract. See Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 816 (Tex. 1997); *Wade & Sons, Inc. v. American Standard, Inc.*, 127 S.W.3d 814, 823 (Tex. App. – San Antonio 2003, pet. denied). Damages to that which you contracted to provide are *as a matter of law* conclusively foreseen.[18] If the parties contemplated the risk by entering into an agreement, those risks cannot be re-characterized as tort damages. *See Jim Walter Homes v. Reed*, 711 S.W.2d 617, 618 (Tex. 1986). As the Texas Supreme Court determined in *Jim Walter Homes*, a plaintiff's recovery for a builder's failure to complete its contract is limited to contract, and not tort.[19] *See Id.*

Inserting the phrase "failed to use reasonable care" in place of the word " was negligent" shows why the negligence equals occurrence line of reasoning is wrong. Just because the contractor may have "failed to use reasonable care" in performing its obligations under the contract, that language does not magically transform the factual allegations into an accident. A general contractor, by entering into the contract, assumes the liability that those working to complete the project will do so according to the contract and its implied warranties. The contract requires the general contractor to hire competent individuals and adequately supervise those it hires to complete the contract. If not, the general contractor must pay the costs associated with correcting its failure. Failing to act reasonably in the performance of your contractual duties is not sufficient to make the damages unforeseen. Thus, there is no occurrence.

c. A claim of negligent supervision does not trigger coverage for a construction defect claim.

Some builders argue that allegations of "negligent supervision" are sufficient to trigger a duty to defend, citing *King v. Dallas Fire Insurance Company*.[20] A proper reading of *King* does not support such a conclusion. In *King*, the Texas Supreme Court set forth facts that the insured failed to (1) run a criminal background check, (2) determine whether the employee had a propensity for violence, and (3) provide training on how to peaceably respond to situations on the construction site. *Id*. at 187. An employee of the insured intentionally attacked and injured the plaintiff. *Id*. at 186. Noting that the ***separation of insureds*** provision in the commercial general liability policy

created separate insurance policies for the insured and the insured's employee, the court determined that the insured's standpoint controls in determining whether there has been an "occurrence" that triggers the duty to defend. *Id*. at 188.

By arguing that allegations of negligent supervision are sufficient to trigger a duty to defend, the building industry must believe that *King* looked solely at the legal theory, rejecting well-established Texas law without explicitly saying so. This is simply not true. Rather, the court focused on the *factual allegations* regarding the claims against the insured and what it allegedly failed to do. The court then determined that the injury to the third party was an accident based upon those facts. The court concluded that from the standpoint of the insured, because the facts showed the insured did not expect or intend his employee to commit an intentional tort, that these allegations were sufficient to allege an occurrence. *Id*. at 192-93.

King is also readily distinguishable from a construction defect case regarding claims of negligent supervision. Most importantly, the employee in *King* committed an intentional tort that was outside of the course and scope of his employment, whereas in construction defect claims, the subcontractors are acting wholly within their course and scope of their duties. The subcontractors are simply doing the job that they had been hired to do. Moreover, the builder hires the subcontractors to construct the home, and the builder oversees the construction at each step of creation.[21] Thus, this is not a case like *King*, where the intentional act of the employee was not attributable to the insured employer. Instead, the acts of the subcontractors in constructing a faulty home are wholly attributable to the contractor because subcontractors build the home, act within their course and scope of their duties, and are under the direct supervision and control of the contractor. Thus, King is simply not on point at least as it relates to the "negligent supervision equals occurrence" argument.

d. The building industry's approach wrongfully encourages pleading non-viable causes of action and it encourages insureds to leave non-viable causes of action in the lawsuit solely to require an insurance company to provide a defense.

If the negligence allegations are sufficient to trigger a duty to defend in a breach of contract case, it would encourage pleading of causes of action that are absolutely not viable under well-established Texas law solely to involve the insurance company in the defense of the claim. This is not a mythical problem.[22] Many attorneys plead negligence causes of action solely for the purpose of involving an insurance company in the defense of claims. But, the problems do not end at the pleading stage.

Insurers routinely assume the defense of construction defect claims under a reservation of rights. Many times during the course of discovery it is determined that the plaintiff is seeking damages solely to the home itself. Thus, the plaintiff has no cause of action for negligence. The insurer, recognizing that a meritorious defense to the negligence claim exists, asks defense counsel to file a motion for summary judgment on that claim. Without a reservation of rights letter, the insured would wholeheartedly agree to the motion. But, because of the negligence equals occurrence argument, defense counsel must explain to the insured that while the summary judgment motion is meritorious, it could have a negative impact on the insurer's duty to defend. If the motion is granted the insurer may very well withdraw from the defense. The insured, not wanting to lose the defense, instructs its counsel not to file the motion. Thus, because the insured fears losing his defense based upon the legal theory of negligence, a cause of action that should have been removed by summary judgment ends up going to the jury unnecessarily.[23] In fact, the building industry's interpretation of the policy encourages the plaintiff and the insured to work together to keep the insurer involved in providing the defense. For the courts to adopt the interpretation of the policy offered by the building industry, they encourage this type of gamesmanship.[24]

2. The standard requiring an insured to "expect or intend" to cause damage in order for their to be no "occurrence" violates the Texas Supreme Court's decision in *King v. Dallas Fire* and renders the "expected or intended" injury exclusion in the policy meaningless.

In addition to the problems associated with the negligence equals occurrence argument, another major error in many courts' analysis is in framing the issue as whether the insured "expected or intended" to cause the damage.[25] This position runs afoul of the Texas Supreme Court's opinion in *King v. Dallas Fire*, a case those same courts rely upon heavily. The *King* court rested its decision in large part on the fact that the insurer could not offer *any interpretation of the policy* that gave meaning to the expected or intended injury exclusion. *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 192 (Tex. 2002). The court found the insurer's position unreasonable because it had offered no interpretation that would give meaning to this exclusion in the policy. *Id*.

The courts that have framed the issue as whether the insured expected or intended to injure the plaintiff have created the exact same problem that the insurer had in King. Only this time, it is the insureds that cannot offer any interpretation of the policy that affords the expected or intended injury exclusion meaning.[26] If an occurrence is only stated when the

insured did not "expect or intend" the injury, then there is no conceivable instance in which the exclusion would ever apply. No claims could survive the definition of occurrence and still trigger the expected or intended injury exclusion, which renders the exclusion meaningless in direct violation of the Texas Supreme Court. *See King*, 85 S.W.3d at 189, 192-93. Thus, the Texas Supreme Court has already ruled that the interpretation offered by the insureds is unreasonable as a matter of law because it fails to give effect to each term in the insurance contract. Because courts are charged with giving effect to all provisions in the policy, the courts that have adopted the standard that there is an occurrence unless the insured "expected or intended" the injury have rendered this exclusion in the policy meaningless. *Id.*

This building industry's characterization of what constitutes an occurrence seriously misinterprets the Texas Supreme Court's pronouncements regarding that issue. The Texas Supreme Court requires the parties to look at both the intent of the actor and the reasonably foreseeable result of that act. The builders have argued that if there is no allegation of intentionally defective construction, that this satisfies the definition of occurrence.[27] However, this analysis ignores the court's instructions. The first prong does not ask whether the insured intended to perform in any particular manner, rather it asks whether the insured intended to perform at all. Only after the determination is made that the insured intentionally ***acted***, do you then examine the result of the conduct.

The policy only provides coverage for damages awarded "because of… property damage."

Take the firing of a gun for example. Assume that the gun was fired intentionally. If the firing of the gun were in a field that another hunter happened to be crossing camouflaged but was injured by the shot, then there is little doubt that this would qualify as an "accident" because the intentional act (firing the gun) caused an unexpected injury (the hunter being injured). But, if the field was filled with children playing and one was hurt, the injury would be anticipated because the law will presume that a person firing a gun into a crowded field anticipates that someone will be hurt. The standard is an objective one.[28] In the same way, the builder intended to act (to build the home) and foresees as a matter of law the damage for a failure to build the home correctly. In contrast, if the insured did not intend to act in the first place, (i.e. the gun went off when it was being cleaned), then there is an accident. Thus, the court's that have framed the issue in construction defect cases as whether the insured expected or intended the damage are simply wrong.

The building industry has also asserted a standard that is unworkable because it requires the court to litigate liability facts in order to determine whether there is a duty to defend. The *Gehan Homes* court states that the second prong of the Texas Supreme Court's test is whether "an action is intentionally taken but is performed negligently and the effect is not what would have been intended or expected had the deliberate action been performed non-negligently." *Gehan Homes*, 146 S.W.3d at 841. In addition to being horribly confusing, this characterization of the second prong is fatally flawed.[29] Asking whether the damage would have been the natural result had the insured acted in a non-negligent manner requires the court to determine whether the insured acted negligently in the first place. Thus, at the duty to defend stage, the court would need to litigate the liability question in order to determine coverage. The only way to determine if the insured was negligent is to have a trial on all the facts. Moreover, if the liability case is submitted to the jury properly only as a breach of contract case, the jury would never make a determination of whether the insured acted negligently.

An example shows why this standard is wrong. Assume the insured builder instructs its subcontractor not to put flashing around a certain part of the home because the builder heard a reputable builder say it was unnecessary. During a heavy rain, the fact that the flashing was not used allows water to seep in. It does not rise to the level of an intentional tort because the insured did not intend to cause damage. But, if the second prong is whether the insured acted non-negligently, then someone (presumably a jury) would have to determine whether the failure to flash was "non-negligent." If the failure to flash was not negligent (meaning a reasonably prudent builder would not have used flashing), then the resulting property damage would be the natural or probable result of the insured's failure to flash. Accordingly, there would be no occurrence (and apparently no negligence liability in the underlying lawsuit). But, if the failure to flash was negligent, then there would be an occurrence because the resulting property damage would not have occurred had the builder put in the flashing.[30] Thus, according to the standard advocated by the building industry, the occurrence issue is wholly dependent upon a determination of the liability question in the underlying lawsuit.

In contrast, the insurer's position is objective as directed by the Texas Supreme Court and does not require litigating the liability question. These facts would not state an occurrence. The construction of the home is an intentional act as is the builder's

decision to leave out the flashing. And, the presumptively foreseen effect of failing to adequately flash is that there will be water intrusion into the home. Thus, under the correct standard as offered by the insurers, there would be no occurrence.

3. If there is no "occurrence" in construction defect cases, the subcontractor exception would be illusory.

Another erroneous position adopted by Texas courts is that if there is no "occurrence" or "property damage" for construction defect claims then the subcontractor exception would be illusory. *See Lennar Homes v. Great American Ins. Co.,* 2005 WL 1324833 at *11 (Tex. App. – Houston [14th Dist.] June 2, 2005, n.p.h.); *Archon Investments, Inc. v. Great American Lloyds Ins. Co.,* 2005 WL 2037177 at *6 (Tex. App. – Houston [1st Dist.] August 25, 2005, n.p.h).[31] In order to show that a provision is not illusory, a party need only show one example that is sufficient to trigger the exception. In this case, two simple examples show that the insurance industry's interpretation of the policy provides meaning to the subcontractor exception contained in the policy. In order to show that the subcontractor exception is triggered, there are five steps that must be completed.

1. An "occurrence" (damage caused by the contractor's work to something other than the contractor provided by the damaging causing project);
2. "Property damage" (physical injury to something other than what the insured was hired to do for the damaging causing project);
3. Triggers exclusion l ("property damage" to the insured's work);
4. The property damage falls within the "products completed operations hazard;" and
5. Triggers the exception to the exclusion (subcontractor is the one performing operations or the work damaged was that of subcontractors).

The first example involves a fairly common issue in neighborhoods where lots must be graded before homes are built. The builder constructs two custom homes on separate lots pursuant to separate contracts to build. During preparation of the lot for Home A, the builder's subcontractor grades the land on one side to divert surface water away from the foundation of Home A. Both homes are completed and delivered to their purchasers. Several months later, during an especially heavy rain, the grading on lot A causes surface water to travel into lot B, causing significant structural damage to home B. The owners of home B sue the builder alleging that the diversion of water caused damage to their homes.

Taking each step individually shows that this scenario satisfies each step in the analysis that triggers the subcontractor exception. First, the contractor's work on home A caused damage to something other than its contract to build home A – it caused damage to home B. Home B was not the same project as project A where the improper grading was performed. The damage to the structure qualifies as property damage because the contractor's work on home A caused physical injury to home B. Home B qualifies as the insured's work, so it triggers the exclusion. Home B also falls within the definition of the "products completed operations hazard" (it has been completed and put to its intended use). Finally, the subcontractor exception is triggered because the work that caused the damage was performed by a subcontractor. Thus, every step necessary to the exception is satisfied.

The second example that triggers the subcontractor exception involves a contractor building home B near a garage its subcontractors built while constructing home A. The garage is completely on lot A and is being used by the homeowner who bought home A. During the course of constructing home B, an employee of the builder – not an employee of the subcontractor – damages the garage. This would qualify as an occurrence – damage caused by the contractor's work to something other than what the contractor was providing pursuant to the contract to build home B. It qualifies as "property damage" because there was physical injury to something other than what the contractor was building. It falls within the exclusion because the garage qualifies as the insured's work under the policy. The garage had been completed and put to its intended use so it falls within the "products completed operations hazard." It would trigger the exception because the damaged work was that of a subcontractor.

These two simple examples conclusively establish that the insurance industry's interpretation of the policy offers meaning to the subcontractor exception.[32] The courts that have made the statement that the insurer's interpretation of the policy fails to give meaning to the subcontractor exception are demonstrably wrong. The coverage may not be as broad as the insureds would like, but this interpretation of the policy gives meaning to the subcontractor exception – a fact that the building industry can no longer ignore. In fact, it is the building industry's interpretation that is unreasonable because has the practical effect of making the general contractor's CGL carrier the de facto insurance carrier for every subcontractor for any property damage that occurs to the project itself after it is completed.[33] This approach seriously undermines the insurers ability to determine with whom they will contract. This is further proof that the interpretation is unreasonable.

V. CONSTRUCTION DEFECT CLAIMS DO NOT STATE PROPERTY DAMAGE AS DEFINED BY THE POLICY

The policy only provides coverage for damages awarded "because of . . . property damage." The policy defines property damage to include the "physical injury to tangible property" and the "loss of use of tangible property that is not physically injured." Courts generally have interpreted property damage to require (1) actual damage to tangible property or (2) loss of use of property with tangible monetary value. *See Snug Harbor, LTD. V. Zurich Ins.*, 968 F.2d 538 (5th Cir. 1992). But, any damages awarded for a construction defect claim are not awarded because of "property damage. Rather, they are awarded because of economic loss under well-established Texas law.

Under Texas law, injury solely to the product of the insured's work constitutes economic loss. *Mid-Continent Aircraft Corp. v. Curry County Spraying Serv., Inc.*, 572 S.W.2d 308, 313 (Tex. 1978). An economic loss affects only a party's pocketbook, as opposed to personal injury or physical injury to other property. *See, e.g., Two Rivers co. v. Curtiss Breeding Serv.*, 624 F.2d 1242 (1245-46 (5th Cir. 1980). Economic loss includes the injury to the product itself. *Alcan Aluminum Corp. v. BASF Corp.*, 133 F.Supp.2d 482, 503 (N.D. Tex. 2001). When no physical injury results to persons or other property, injury to the defective product itself is an economic loss. *Mid-Continent Aircraft Corp. v. Curry County Spraying Serv., Inc.*, 572 S.W.2d 308, 313 (Tex. 1978); *Rocky Mountain Helicopters, Inc. v. Bell Helicopter Co.*, 491 F.Supp. 611, 620 (N.D. Tex. 1979). As the Texas Supreme Court stated:

> Direct economic loss may be said to encompass damage based on insufficient product value; thus, direct economic loss may be "out of pocket" – difference in value between what is given and received – or the "loss of bargain" – the difference between the value of what is received and its value as represented. Direct economic loss also may be measured by costs of replacement and repair. Consequential economic loss includes all indirect loss, such as loss of profits resulting from inability to make use of the defective product.

Nobility Homes of Texas, Inc. v. Shivers, 557 S.W.2d 77, 78 n.1 (Tex. 1977) (quoting Note, Economic Loss in Products Liability Jurisprudence, 66 Colum. L.Rev. 917, 918 (1966)). Damage to the product itself is essentially a loss to the purchaser of the benefit of the bargain with the seller. *Mid-Continent Aircraft Corp. v. Curry County Spraying Serv.*, 572 S.W.2d 308, 312-13 (Tex. 1978).

A commercial general liability policy does not cover damages for purely economic loss. *See, e.g., Gibson & Assocs., Inc. v. Home Ins. Co.*, 966 F.Supp. 468, 474 (N.D. Tex. 1997); *AIU Ins. Co. v. Mallay Corp*. 938 F.Supp. 407, 411 (SD. Tex. 1996); *State Farm Lloyds v. Kessler*, 932 S.W.2d 732, 736 (Tex. App. – Fort Worth 1996, writ denied); *Terra Int'l, Inc. v. Commonwealth Lloyds Ins. Co.*, 829 S.W.2d 270, 272 (Tex. App. – Dallas 1992, writ denied); *Houston Petroleum Co. v. Highlands Ins. Co.*, 830 S.W.2d 153, 156 (Tex. App. – Houston [1st Dist.] 1991, writ denied). Likewise, other jurisdictions routinely hold that economic damages are not covered by liability policies. *See, e.g., Allstate Ins. Co. v. Chaney*, 804 F.Supp. 1219, 1222-23 (N.D. Cal. 1992); *Reliance Ins. Co. v. Povia-Ballentine Corp.*, 738 F.Supp. 523, 526-27 (S.D. Ga. 1990) (distinguishing between *damage to* condominium as not covered with damage caused by condominium that would be covered); *Rockwood Ins. Co. v. Federated Capital Corp.*, 694 F.Supp. 772, 775 (D. Nev. 1988) (finding no property damage despite allegation of "negligent construction"); *Gary L. Shaw Builders, Inc. v. State Automobile Mutual Ins. Co.*, 355 S.E.2d 130 (Ga. Ct. App. 1987); *Century Indemnity Co. v. Golden Hills Builders, Inc.*, 561 S.E.2d 355, 358 (S.C. 2002) (collecting cases and noting that economic loss to the property itself is not covered while damage to property other than the work itself would be covered). If the property is not completed, then there is no claim for property damage.[34]

This Fort Worth Court of Appeals has addressed the intersection of these two concepts in a case involving a defective foundation finding no property damage. In *Kessler*, the purchasers of a home sued the seller after discovering foundation problems the buyers alleged had not been disclosed. *State Farm Lloyds v. Kessler*, 932 S.W.2d 732, 734 (Tex. App. – Fort Worth 1996, writ denied). The buyers based their claims on the legal theories of breach of contract, breach of warranty, and DTPA violations. The new homeowner sought the costs to repair the property to the condition in which the sellers represented it, as well as loss of use damages. *Id.* at 737. The court stated, "economic damages are not property damage as defined by liability insurance policies." The *Kessler* court completed the analysis by noting that the sellers "did not get the property they bargained for."

The *Kessler* opinion applies with equal force to claims for defective construction. The contract to build contains representations regarding that the home the builder will provide will be free from defects. Like the buyers in *Kessler*, the homeowner in a construction defect case is seeking the costs to repair the structure to the condition in which the builder represented it would be built. Just like the buyers in *Kessler*, the homeowners in the construction defect scenario have not received what

they bargained for from the builders. Thus, *Kessler* supports the conclusion that construction defects do not state damages because of property damage as required by the policy, and several courts have correctly recognized this correct conclusion.[35]

In *JHP Development*, the court attempted to distinguish *Kessler* on the grounds that the defendant in *Kessler* did not cause any damage, rather they only misrepresented that no damage was present. But, in *JHP Development*, the insured had represented in the contract that it would provide condominiums free from defects, and it failed to do so. There is no reason to distinguish between *Kessler* and a construction defect case on those grounds both are grounded in the economic loss caused by the insureds' false representations, not by any conduct causing damages.[36] Because the Texas Supreme Court has specifically limited a plaintiff's recovery in a construction defect case to economic losses, the claimed damages are not transformed into property damage merely because the insured played some role in causing them.[37]

VI. THE INSURER'S APPROACH IS CONSISTENT WITH DECISIONS FROM THROUGHOUT THE UNITED STATES.

Texas courts strive for consistency with other jurisdictions, especially in respect to coverage under commercial general liability policies. *See National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 517, 522 (Tex. 1995). Thus, looking at the decisions from other jurisdictions on these issues where a consensus is being developed is very important. No less than 26 states[38] have adopted one or both of the insurance industry's interpretation of the policy in construction defect litigation.[39] In fact, under Mississippi law, the United States Court of Appeals for the Fifth Circuit has found that there is no coverage for a construction defect claim based on a two-step analysis similar to the applicable standard in Texas. *See ACS Construction Co. v. CGU*, 332 F.3d 885 (5th Cir. 2003). Thus, by finding no occurrence or property damage for a construction defect claim, Texas courts are following the majority of the courts nationwide that have examined this issue.

VII. CONCLUSION

When interpreted as not providing coverage for a construction defect claim, the policy is appropriately considered to be what it was intended to be – a liability policy covering tort damages incurred by third parties. The insurance industry's arguments follow the Texas Supreme Court's pronouncements on coverage issues, and supports the policies underlying the Texas Supreme Court's pronouncements on liability and damages issues. It gives meaning to all the provisions and exclusions in the policy and endorses substance over form.

Clear standards are necessary for both insurers and insureds to determine whether a duty to defend exists under a policy of insurance. The above analysis provides as bright a line rule as is possible in these types of cases. When the petition alleges damages solely to the subject matter of the contract between the homebuilder and the homeowner, then there is no coverage for the claimed damages. When, in contrast, the petition alleges damages to something other than what the parties contracted for, then there is coverage. For example, if the construction defects cause mold damage to grow on the personal property of the homeowner, then there would be coverage for the cost to repair or replace the damaged items. Another example is when the homeowner puts in some improvements (carpet, hardwood floors, etc.) after the sale of the home, if those items were damaged then coverage would be owed for those items. But, when there is damage solely to what the contractor provided, there is no coverage for that claim.

The insurer's interpretation of the policy provides coverage for those damages that are classically tort damages but not those damages that are classic breach of contract damages. The critical situation that most courts have failed to recognize is that the policy provides coverage for when the insured had performed pursuant to two separate contracts and one causes to the other. This coverage would be available if two different builders had completed the homes. And, the correct interpretation of the policy extends coverage to the situation where one builder completed both homes. The policy does not, however, cover the costs for the insured to complete a contract as promised. For construction defect claims involving only damage to that provided by the builder pursuant to that contract, there is simply no coverage.

1. Mr. Burke is a founding shareholder in the San Antonio firm of Miller & Burke, P.C. He devotes significant attention to insurance coverage issues, including coverage claims related to defective construction. He has represented numerous carriers relating to coverage for defective construction, including arguing the issues discussed in this paper before a Texas appellate court as well as the United States Court of Appeals for the Fifth Circuit. His practice also includes other commercial litigation, personal injury litigation, wrongful death litigation, as well as civil appeals. For more details, visit www.millerburke.com.

2. Cause No. 05-0832 in the Texas Supreme Court. The certified question is from Cause No. 04-51074 in the United States Court of Appeals for the Fifth Circuit. *See Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, ___ F.3d ___ , 2005 WL 2432029 (5th Cir. Oct. 3, 2005).

3. The Texas Supreme Court accepted the certified questions on November 4, 2005. *See* http://www.supreme.courts.state.tx.us/opinions/Event

Info.asp?EventID=450013.

4. *See* Certification Order, *Lamar Homes, Inc. v. Mid-Continent Casualty Co.*, 2005 WL 2432029 *12 (5th Cir. Oct. 3, 2005) (also available at http://www.ca5.uscourts.gov/opinions/pub/04/04-51074-CV0.wpd.pdf) (hereafter Certification Order).

5. Certification Order at *12. Question three is prefaced on an affirmative finding to the first two questions and asks "does Article 21.55 of the Texas Insurance Code apply to a CGL insurer's breach of the duty to defend?" While the appropriate analysis of article 21.55 is that it does not apply to claims for a breach of the duty to defend, that discussion is beyond the scope of this article.

6. See http://www.supreme.courts.state.tx.us/opinions/Case.asp?FilingID=26539.

7. *See* http://www.supreme.courts.state.tx.us/opinions/Case.asp?FilingID=25654. *Gehan Homes* also concerns whether certain claims for mental anguish are sufficient to state a "bodily injury" under the terms of the policy. If the claims for mental anguish are sufficient to state a "bodily injury" under the terms of the commercial general liability policies at issue in that case, then the court would not need to decide whether the allegations of faulty construction were sufficient to state an "occurrence."

8. *See* http://www.supreme.courts.state.tx.us/opinions/Case.asp?FilingID=25654 for the latest on the status of that case.

9. As will be demonstrated later, the framing of this issue in this way is critical to the proper understanding of the commercial general liability policy. While *most* claims involve the situation where the contractor's work pursuant to one contract causes damage its work pursuant to the *same* contract, for a complete understanding of how the policy works, that situation needs to be distinguished from situations where the contractor's work pursuant to one contract causes damage to the contractor's work completed under a separate contract. Failing to recognize this critical distinction has created law that is seriously flawed. For example, the Wisconsin Supreme Court has stated that the insurer's interpretation of the occurrence would render many of the exclusions in the policy meaningless. *See American Family Mut. Ins. Co. v. American Girl, Inc.* 673 N.W.2d 74, 78 (Wis. 2004). The Fourteenth District Court of has accepted this as persuasive. *See Lennar Homes, Inc. v. Great American Ins. Co.*, 2005 WL 1324833 (Tex. App. – Houston [14th Dist.] June 2, 2005, n.p.h.). But, if either court were to have considered the circumstance where the contractor's actions pursuant to one contract damaged the contractor's work pursuant to another contract, it would have to recognize that the insurer's definition did not render the business risk exclusions illusory.

10. It is true that the breach of contract/tort distinction is not specifically enumerated in the commercial general liability policy. If you accept that the contractual liability exclusion in the policy only applies to claims where the insured assumes the tort liability of a third party, there is no exclusion for breach of contract in the policy.

11. Certification Order at *5 -- *6 noting conflict among intermediate Texas courts of appeal as well as split among federal district courts in Texas.

12. For example, if a builder has not followed the plans and specifications, several courts would find that this is not sufficient to establish an "occurrence" under the CGL policy. But, if the petition were to allege generally substandard or deficient construction, those courts would find an "occurrence" has been alleged. The major problem with this analysis is that by not following proper "standard" or "sufficient" construction techniques, the builder is failing to comply with the plans and specifications of the construction industry. Or, if the plans and specifications are followed, but problems still arise, the plans and specifications are likely the problem. If the builder provides the plans and specifications, then the builder has failed to provide sufficient and proper plans and specifications for the job.

13. As one New York court has phrased it, a construction dispute is " not transformed into an accident…so as to be covered by comprehensive general liability policy by the simple expedient of alleging negligent performance or negligent construction." *George A. Fuller Co. v. U.S. Fidelity and Guar. Co.*, 200 A.D.2d 255 (N.Y. App. 1994).

14. This has become the method by which most courts determine that there is an occurrence for defective construction cases. *See, e.g., Home Owners Mgmt Enterps., Inc. v. Mid-Continent Casualty Co.*, 2005 WL 2452859 *5 - *6 (N.D. Tex. Oct. 3, 2005); *Luxury Living, Inc. v. Mid-Continent Casualty Co.*, 2003 WL 22116202 (S.D. Tex. Sept. 10, 2003). Interestingly, the builders strenuously argue that there is no breach of contract/tort distinction in the policy to avoid explaining why coverage should exist for a truly breach of contract claim. And yet, those same builders argue the fact that a tort (i.e., negligence) is alleged that that one word alone is sufficient to state an occurrence under the terms of the policy. The building industry cannot have it both ways.

15. The author of the *Main Street Homes* opinion was Judge Yeakel. He is also the author of the trial court opinion in *Lamar Homes*. *See Lamar Homes v. Mid-Continent Casualty Co.*, 335 F.Supp.2d 754 (W.D. Tex. 2004). When confronted with the appropriate arguments regarding coverage, Judge Yeakel issued an opinion that directly conflicts with his previous opinion in *Main Street Homes*. This seriously calls into question the continued validity of *Main Street Homes*.

16. Note that *National Union* had nothing to do with whether the insured intended injury. The question presented dealt with whether the plaintiff's claims stated the use of an auto. *National Union*, 939 S.W.2d at 141.

17. The pattern jury charge asks the following question "Did _____ fail to comply with the contract it had with _____?" COMM. ON PATTERN JURY CHARGES, STATE BAR OF TEX., TEXAS PATTERN JURY CHARGES-BUSINESS, CONSUMER, EMPLOYMENT PJC 101.2 (2000). *See also Mustang Pipeline Co., Inc. v. Driver Pipeline Co., Inc.*, 134 S.W.3d 195, 199 (Tex. 2004).

18. There is a critical distinction between what is presumptively foreseen and what is reasonably foreseeable. In his article, Lee Shidlofsky asserts that the test articulated by the insurers is predicated on determining whether damages are reasonably foreseeable. *See* Lee H. Shidlofsky, *Demystifying CGL Coverage for Residential Construction Claims*, Vol. 1, No. 5, Journal of Tex. Ins. Law 37, 43 (February 2004) (hereinafter *Demystifying CGL Coverage*). Mr. Shidlofsky asserts that "the very act that triggers liability would also preclude coverage." This is simply not true. Whether damages are reasonably foreseeable is a fact issue to be resolved by the fact finder. However, there is no issue as to whether any damages are reasonably foreseeable in a construction defect case. By entering in the contract, the builder has agreed that a failure to complete the contract as promised will result in liability. Thus, any damages for a failure to complete the contract are foreseen as a matter of law. That is why there is no tort recovery for a breach of contract case.

19. It is also interesting to note, that when attempting to insulate themselves from punitive damages, the building industry argued that they could not be liable in negligence. Now, when confronted with coverage issues, the building industry is taking the position that tort claims – specifically negligence claims – are sufficient to trigger a duty to defend. The building industry seeks to have it both ways – one way for coverage and the other way to avoid liability for punitive damages.

20. 85 S.W.3d 185 (Tex. 2002).

21. The building industry's position creates outrageous results. Consider a builder who signs a contract, hires subcontractors, then ***never*** goes to the project again. Certainly, if there is a problem during construction the builder will have breached its contract. Likewise, if there were a viable claim for negligent supervision of its subcontractors, the builder likely would have violated that duty as well. But, if a builder consciously decides not to supervise the subcontractors' work at all, under the building industry's interpretation it would be sufficient to state an occurrence. This is true despite the fact that its duties as a general contractor are in large part to supervise the work of subcontractors to ensure proper performance.

22. The author is even aware of certain ***homeowners insurance carriers***, who have subrogation claims against builders for construction defects who take this approach. Despite the fact that the carriers have paid only damages to repair the home, they sue the builder for breach of contract, breach of warranty, and negligence. The negligence allegation is almost always very sparse, but the subrogation attorneys argue that the allegation is necessary to trigger at least a defense. Moreover, there are others pleadings that have evolved over time to allege damage to personal property, despite the fact that the claim file and other discovery conclusively establishes that the only damages are for damages to the home itself. These are classic breach of contract damages, and not negligence damages.

23. This creates further problems post-judgment. Many times, defense counsel, not wanting to lose the defense on appeal, will not move for a directed verdict at the close of evidence. If the jury finds the builder not only breached its contract, but also was negligent, many times the judgment will be entered based upon those findings but will not specify which theory any of the damages are awarded under. On appeal, the defense counsel may try to argue the economic loss rule precludes any recovery in negligence as a matter of law. But, if they have failed to raise the issue at the trial court (for fear of losing the defense), it is now waived. In essence, a non-viable cause of action could end up being the basis for the judgment solely because of this gamesmanship.

24. At its worst, there is actually an affirmative agreement by the insured with the plaintiff not to move for summary judgment on the negligence claims in order to force the insurer to continue defending. But, there is little, if anything, that the insurer can do to prevent this conduct. By rejecting this approach, the courts actually prevent this from occurring.

25. For example, the *Gehan Homes* court framed the issue as "whether the resulting damage was unexpected or unintended." *Gehan Homes*, 146 S.W.3d at 843. Likewise, the *Lennar Homes* court framed the issue as whether the damage was "unexpected or unintended from [the insured]'s standpoint." *Lennar Homes v. Great American Ins. Co.*, 2005 WL 1324833 at *12 (Tex. App. – Houston [14th Dist.] June 2, 2005, n.p.h.). The First District Court of Appeals used the same standard. *See Archon Investments, Inc. v. Great American Lloyds Ins. Co.*, 2005 WL 2037177 at *5 (Tex. App. – Houston [1st Dist.] August 25, 2005, n.p.h) (finding occurrence because insured "could not have intended that the negligent work of its subcontractors" caused damage).

26. The insurers offers a reasonable interpretation of the policy that provides meaning to the expected or intended injury exclusion. As an example, the insured contracted to build a home on lot A. But, because of faulty information it received from a third party, it erroneously clears lot B, knocking down a garage that was located there. The owner of lot B sues the builder claiming that the builder was negligent in destroying the garage. The damage to the garage would qualify as an occurrence and property damage under the insurer's interpretation of the policy, but the damages would be excluded because the insured expected or intended to knock down the garage on lot B.

27. *Demystifying CGL Coverage* at 44. *See also Archon Invest., Inc. v. Great American Lloyds Ins. Co.*, ___ S.W.3d ___, 2005 WL 2037177 *7 (Tex. App. – Houston [1st Dist.] Aug. 25, 2005, n.p.h.) (finding pleadings stated both intentional and unintentional acts and therefore the insurer had a duty to defend); *Mid-Continent Casualty Co. v. JHP Development, Inc.*, 2005 WL 1123759 (W.D. Tex. April 21, 2005) (finding absence of allegations that insured "intentionally caused the damage" was sufficient to state an occurrence.

28. *See Cowan*, 819 S.W.2d 827-28 (noting insureds' subjective intent not relevant to the question of occurrence). This also makes Mr. Shidlofsky's claim that the expected or intended injury exclusion is triggered only when the insured subjectively intended to cause damage wrong. *See Demystifying CGL Coverage* at 46. If the insured subjectively expected or intended to cause damage, then the insured would also have objectively expected or intended to cause injury as well.

29. Mr. Shidlofsky also bases his entire occurrence argument upon this flawed standard. *See Demystifying CGL Coverage* at 43-44.

30. To interpret this standard otherwise would require even worse results. The standard would devolve into whether the insured completed its contract properly. The builders would really like for the court to find that a failure to perform perfectly pursuant to the contract, and not really non-negligently. Had the builder performed perfectly, there would never be any damages. Therefore, ***every*** time there is a construction defect claim that is not an intentional tort there would be an occurrence because the damages would not be the natural or probable result had the insured acted perfectly. This clearly violates the Texas Supreme Court's two step process in determining whether an occurrence has been alleged.

31. This faulty argument was adopted by several courts of appeals outside Texas. *See Kalchthaler v. Keller Constr. Co.*, 591 N.W.2d 169, 174 (Wis. Ct. App. 1999); *O'Shaughnessy v. Smuckler Corp.*, 543 N.W.2d 99, 102-03 (Minn. Ct. App. 1996), *abrogated on other grounds* by *Gordon v. Microsoft Corp.*, 645 N.W.2d 393 (Minn. 2002). The argument was recently adopted by the Wisconsin Supreme Court. *American Family Ins. Co. v. American Girl, Inc.*, 673 N.W.2d 65, 74 (Wis. 2004). However, because the court failed to recognize the situation when a contractor's work pursuant to one contract damages the work pursuant to another contract, it failed to recognize that the insurer's position did not render the subcontractor exception in the policy meaningless. Moreover, this same problem rebuts the *Lennar Homes* court's argument regarding the reasoning underlying the addition of the Broad Form Property Damage Endorsement to the policy. *See Lennar Homes*, 2005 WL 1324833 at *11. Because all of the insured's work was excluded under the predecessor CGL policy, the revisions to the policy broadened coverage, not to act as a virtual performance bond for the insured's work, but to provide the coverage that an insured would have had if there

had been two separate companies that had entered into the contracts. The revisions were designed to broaden coverage to provide classic tort liability, and not to make the CGL policy respond to claims of faulty construction.

32. There are numerous other examples that can be imagined that satisfy the insurance industry's occurrence argument yet still trigger the subcontractor exception. The key factor is whether the damaged project was completed under a separate contract than the one that caused the damages. Once this distinction is recognized, there are numerous other examples that illustrate the insurer's interpretation does not render the subcontractor exception as illusory.

33. In the general contractor situation, the building industry's interpretation essentially inserts an additional insured endorsement adding all subcontractors as insureds for all damages to the property after it is completed. This interpretation would alleviate the need for subcontractors to obtain insurance for their work, and would eliminates the need for additional insured endorsements where the contractor pays an additional premium to have subcontractors named as additional insureds.

34. To be considered "property damage" under the commercial general liability policy, the property alleged to be damaged has to have been undamaged or uninjured at some point in time. *See Travelers Indemn. Co. v. Miller Building Corp.*, 2003 WL 21357206 (E.D.N.C. 2003); *William C. Vick Constr. Co. v. Pennsylvania Nat'l Mutual Casualty Ins. Co.*, 52 F.Supp.2d 569, 582 (E.D. N.C. 1999), *aff'd*, 213 F.3d 634 (4th Cir. 2000).

35. *See Great American Lloyd's Ins. Co. v. Mittlestadt*, 109 S.W.2d 784 (Tex. App. – Fort Worth 2003, no pet.); *Jim Johnson Homes*, 244 F.Supp.2d at 708. *But see Lennar Homes*, 2005 WL 1324833 at *13 - *16 (finding coverage for cost to replace property damaged by water, but not to repair the defect that allowed the water to intrude); *Gehan Homes*, 146 S.W.3d at 844; *JHP Development v. Mid-Continent Casualty Co.*, 2005 WL 1123759 *5 (W.D. Tex. April 21, 2005); *Home Owners Mgmt. Enterps., Inv. v. Mid-Continent Casualty Co.*, 2005 WL 2452859 *7 (N.D. Tex. Oct. 3, 2005).

36. Because the builders have coverage only for the work of their subcontractors under their own interpretation of the policy, this makes the argument that *Kessler* is distinguishable even weaker. The insured must necessarily argue that it's subcontractor caused the damage to trigger the subcontractor exception to exclusion l, but for purposes of triggering the definition of property damage, the insured must assert that it caused the damages to make the case distinguishable from Kessler. This is yet another inconsistent position the insured must take in order to trigger coverage under the policy for construction defect claims.

37. While still wrong, at least some court recognize a distinction between damages that are caused by a construction defect. *See Lennar Homes*, 2005 WL 1324833 at *16 (distinguishing between costs to replace defect and costs to repair damaged caused by defect). In other cases, the courts simply award all damages, even those for the faulty work itself. *See Home Owners Mgmt. Enterps., Inc. v. Mid-Continent Casualty Co.*, 2005 WL 2452859 *7 (N.D. Tex. Oct. 3, 2005).

38. *U.S. Fidelity & Guar. Co. v. Warwick Development Co. Inc.*, 446 S.O.2d 1021 (Ala. 1984); *United States Fidelity & Guar. Corp. v. Advance Roofing & Supply Co.*, 788 P.2d 1227, 1233 (Ariz.1989); *St. Paul Fire & Marine Ins. Co. v. Coss*, 145 Cal.Rptr. 836, 839 (Cal Ct. App.1978); *Union Ins. Co. v. Hottenstein*, 83 P.3d 1196, 1202 (Col. App.2003); *Brosnahan Builders Inc. v. Harleysville Mut. Ins. Co.*, 137 F.Supp 2d 517, 526 (D. Del 2001) (applying Delaware law); *Home Owners Warranty Corp. v. Hanover Insurance Co.*, 683 So.2d 527, 529 (Fla.App.3rd DCA 1996); *Custom Planning & Development v. American Nat. Fire Ins. Co.*, 606 S.E.2d 39, (Ga. App. 2004); *Indiana Insurance Company v. Hydra*, 615 N.E.2d 70, 73-74 (Ill. App. Ct. 1993); *Amerisure, Inc. v. Wurster Const. Co., Inc.*, 818 N.E.2d 998, 1005 (Ind. App. 2004); *Pursell Construction, Inc. v. Hawkeye-Security Ins. Co.*, 596 N.W.2d 67, 71 (Iowa 1999); *Standard Fire Insurance Company v. Chester-O'Donley & Assoc.*, 972 S.W.2d 1, 9 (Tenn. Ct. App. 1998) (applying Kentucky law); *U. S. Fire Ins. Co. v. Milton Co.*, 35 F.Supp 2d 83, 86 (D.D.C. 1198) (applying Maryland law); *Hawkeye-Security Insurance v. Vector Construction Co.*, 460 N.W.2d 329, 331 (Mich. Ct. App. 1990); *American States Insurance Company v. Mathis*, 974 S.W.2d 647, 649-650 (Mo. Ct. App. 1998); *Auto-Owners Insurance Company v. Home Pride Companies*, 684 N.W.2d 571, 578-580 (Neb. 2004); *McAllister v. Peerless Ins. Co.*, 474 A.2d 1033, 1036-1037 (N.H. 1984); *J.Z.G. Resources Inc. v. King*, 987 F.2d 98 (2nd Cir. 1993) (interpreting NY law); *Wm. C. Vick Const. Co. v. Penn. Nat. Mut. Cas. Ins. Co.*, 52 F.Supp2d 569 (E.D. N.C. 1999); *Heile v. Herrman*, 736 N. E. 2d 566, 568 (Ohio Ct. App. 1999); *Solcar Equipment Leasing Corp. v. Penn. Manuf. Assoc. Ins. Co.*, 606 A.2d 522, 527-528 (Pa. Super. Ct. 1992); *L-J Inc, v. Bituminous Fire and Marine Ins. Co.*, ___ S.E.2d ___ (S.C. 2004) (unpublished opinion); *Vernon Williams & Son Construction v. The Cont'l Ins. Co.*, 591 S.W. 2d 760, 762-764 (Tenn. 1979); *H.E. Davis & Sons, Inc. v. North Pacific Ins. Co.*, 248 F.Supp.2d 1079 (D. Utah 2002); *Erie Insurance Property and Casualty Co. v. Pioneer Home Improvement, Inc.*, 526 S.E.2d 28 (W. Va. 1999); *Burlington Ins. Co. v. Oceanic Design & Construction Inc.*, 383 F.3d 940 (9th Cir. 2004) (interpreting Hawaii law); *ACS Construction Co. v. CGU*, 332 F.3d 885 (5th Cir. 2003) (construing Mississippi law).

39. There are several articles that discuss a more nationwide approach to the occurrence arguments regarding defective construction claims. *See* Linda B. Foster, *Point/Counterpoint: No Coverage Under The CGL Policy For Standard Construction Defect Claims*, 22 Construction Lawyer 18 (Spring 2002); Clifford J. Shapiro, *Point/Counterpoint: No Coverage Under The CGL Policy For Standard Construction Defect Claims*, 22 Construction Lawyer 13 (Spring 2002).

Comments FROM THE EDITOR

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

2006 is shaping up to be a landmark year for Texas Insurance Law. As this is going to print, the Texas Supreme Court has before it almost a dozen very significant cases that will impact insurance claims and insurance lawsuits for many years to come. More than sixty lawsuits have already been filed arising out of Hurricane Rita and such suits are expected to steadily increase over the next few months. As we each navigate our respective clients through the maze of Texas Insurance Law in 2006, the substantative law should become clearer in some respects yet more complicated in others as new issues arise. It is a good time to be an insurance lawyer in Texas.

The Chair of our Section, Veronica Czuchna, continues to do a great job in leading the Counsel and the entire Section. Tremendous work goes on behind the scenes which no one can appreciate unless they have done it (or seen it done) on a weekly basis. The role of Section Chair is not simply a figurehead but someone who must work very hard to keep the Section moving forward, responding to changing issues, and attuned to our member needs. Veronica is succeeding in every area.

Special thanks to **Kim Steele** and **Gwen Pilgrim** of **Sedgwick, Detert, Moran & Arnold** in Dallas who volunteered to assist in editing the articles in this issue of the *JTIL*. This issue would not be in your hands without their willingness to help with the thankless job of editing the *Journal* before it goes to print. Kim and Gwen, thank you for your valuable assistance.

Finally, we always need good articles that will both inform and educate our members. If you are interested in writing an article, or if you have materials you could very easily turn into an article, please let me know. We still have some space available in our other 2006 issues of the *JTIL*.

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

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