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RULE OF CONSTRUCTION

Divided High Court Sides With Builder In Home-Defect Case

by MARY ALICE ROBBINS

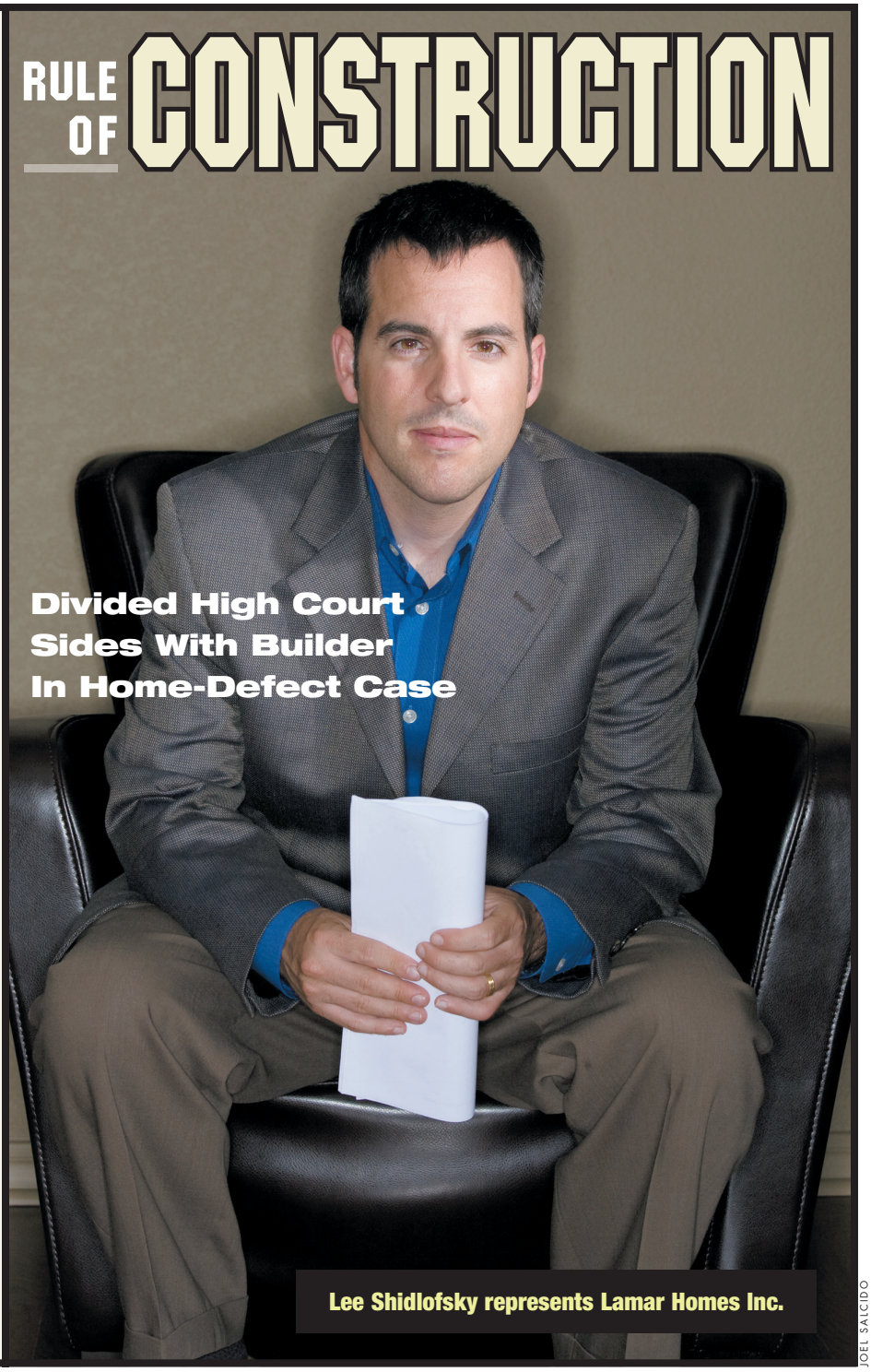
A divided Texas Supreme Court delivered a double whammy to the insurance industry on Aug. 31.

In a 6-3 decision, the court held that unintended construction defects may constitute an "occurrence" under a homebuilder's commercial general liability (CGL) policy and that "property damage" resulting from the occurrence may trigger the insurer's duty to defend its insured.

But the biggest surprise for insurers in the high court's decision in *Lamar Homes Inc. v. Mid-Continent Casualty Co.* is that the state's prompt-payment-of-claims statute applies to an insurer's breach of its duty to defend.

The prompt-payment statute — formerly Texas Insurance Code Article 21.55, which the Legislature recodified in 2003 as §§542.051-542.061 — adds an interest penalty to the amount that an insurance carrier must pay when it fails to provide a defense and an insured incurred costs in defending itself. If the insurance carrier fails to meet deadlines set by the statute for paying a claim or providing a defense for its insured, the carrier must pay interest at the rate of 18 percent a year in damages — in addition to the insured's legal costs.

Robert J. Cunningham, an insurance appellate attorney who represents policyholders but who is not involved in *Lamar Homes,* says the Supreme Court's decision on the duty to defend under the prompt-payment statute is surprising, because state and federal courts in Texas have gone separate ways on the issue.



Lee Shidlofsky represents Lamar Homes Inc.

JOEL SALCIDO

"The general feeling was the [Supreme] Court would be more likely to come down in favor of insurers," says Cunningham, a partner in Cook & Roach in Houston.

"Given what the court had done in the past . . . I would say that most people believed the court would reject the Article 21.55 argument," says Lee Shidlofsky, Lamar Homes' attorney and a partner in Austin's Visser Shidlofsky.

But Shidlofsky says the majority is "absolutely right" that the prompt-payment statute does apply to Lamar Homes' claim.

Lamar Homes' brief to the Supreme Court provides the following background: Vincent and Janice DiMare discovered problems in their home, which was built by Lamar Homes. In 2003, the DiMares filed *DiMare v. Lamar Homes Inc., et al.* in the 53rd District Court in Austin alleging that the defendants failed to design and construct the foundation in a good workmanlike fashion. After Mid-Continent, Lamar Homes' insurer, denied that it had a duty to defend or indemnify Lamar Homes under a 2001-2003 CGL policy, the homebuilder filed *Lamar Homes Inc. v. Mid-Continent Casualty Co*. in a state district court in Travis County seeking a declaration of its rights under the CGL policy and recovery under the prompt-pay statute.

Mid-Continent removed the suit to federal court. U.S. District Judge Lee Yeakel of Austin granted Mid-Continent's motion for summary judgment in 2004.

According to the Supreme Court's majority opinion, written by Justice David Medina, Yeakel concluded that Mid-Continent had no duty to defend Lamar Homes for construction errors that harmed only Lamar Homes' own product. Yeakel reasoned that the purpose of a CGL policy is "to protect the insured from property damage (or bodily) injury caused by the insured's product, but not for the replacement or repair of that product."

As noted in the Supreme Court's majority opinion, Lamar Homes appealed to the 5th U.S. Circuit Court of Appeals, which determined there was disagreement among Texas' courts of appeals about the application of a CGL policy under such circumstances. In 2005, the 5th Circuit submitted three certified questions to the Supreme Court: Under Texas law, does an alleged construction defect that causes damage to or loss of the use of a home constitute an "accident" or "occurrence" under a CGL policy and do such allegations constitute "property damage" that triggers the duty to defend or indemnify under the policy? If the Supreme Court answered both questions in the affirmative, the 5th Circuit asked whether the prompt-payment statute applies to a CGL insurer's breach of the duty to defend. On Aug. 31, the Supreme Court answered "yes" to all three questions.

E. Thomas Bishop, who filed an amicus brief on behalf of the Property Casualty Insurers Association of America in *Lamar Homes,* characterizes the Supreme Court's decision as a setback for the insurance industry.

"Not only did they hold that there was a duty to defend, they then went on and said, 'Oh, and by the way, you're going to be penalized under the penalty statute if you do not defend and choose wrong,' " says Bishop, a shareholder in Bishop & Hummert in Dallas.

"Practically speaking, I think it's going to require the insurance industry to defend a lot more construction defect cases," Bishop says of the high court's decision in *Lamar Homes.*

James Cornell, who represents policyholders in insurance cases but who is not involved in *Lamar Homes,* describes the decision as one of the most important insurance decisions in the past 10 years. "This is a major win for policyholders and consumers in Texas," says Cornell, a partner in Houston's Cornell & Pardue.

Cornell says the majority focused on the policy language "and let it take them to the logical conclusion."

Cunningham says, "What's striking about it is how much the majority opinion sticks to the policy wording and does not try to impose any overreaching meaning."

An Occurrence

Medina wrote in the majority opinion that the CGL policy provides that the insurance carrier must pay damages resulting from "bodily injury" or "property damage" to which the insurance applies and must defend the insured against any suit seeking those damages. The policy further provides that the insurance applies only if the bodily injury or property damage is caused by an "occurrence."

As Medina pointed out in the opinion, the policy defines an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions" and defines "property damage" as "physical injury to tangible property, including all resulting loss of use of that property." But the policy does not specifically define the term "accident," Medina wrote.

Mid-Continent noted in its brief to the Supreme Court that Lamar Homes paid about $12,000 for the CGL policy, which covered the homebuilder from July 2001 to July 2002, and provided $1 million in protection in the aggregate. The insurer contended that defective work cannot be an occurrence under the policy, because defective work is not accidental.

"I don't think it's intended to cover construction defects," Jennifer Hogan, Mid-Continent's attorney, says of the CGL policy.

When an insured pays only a modest premium and has millions of dollars in home sales, there is no intent to cover anything and everything that can go wrong with those homes, says Hogan, a partner in Houston's Hogan & Hogan.

Medina noted in the Supreme Court's majority opinion that the 5th Circuit concluded in 1999's *Federated Mutual Insurance v. Grapevine Excavation Inc.* that the terms "accident" and "occurrence" include damage that is unexpected or a conse-

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quence of an insured's negligent behavior, including "claims for damage caused by an insured's defective performance or faulty workmanship." In *Federated Mutual,* the 5th Circuit concluded that faulty workmanship that damages property of a third party is a covered occurrence, but faulty workmanship that damages the insured's work or product is not covered.

However, as Medina noted in the Supreme Court's opinion, the CGL policy does not define "occurrence" in terms of the ownership or character of the property that has been damaged by the act or event but asks instead whether the injury was intended or an accident.

According to the majority opinion, the DiMares asserted in the underlying suit that Lamar Homes' defective construction was a product of its negligence and therefore was an occurrence under the policy. "No one alleges that Lamar intended or expected its work or its subcontractors' work to damage the DiMares' home," Medina wrote.

The DiMares are not involved in the litigation between Lamar Homes and Mid-Continent at the Supreme Court. Shidlofsky says the DiMares' underlying suit, *DiMare v. Lamar Homes Inc., et al.*, settled.

The majority opinion also pointed out that the DiMares alleged in their underlying suit that Lamar Homes was negligent in designing their home's foundation and that the defective workmanship caused cracks in the structure's sheetrock and stone veneer, which are allegations of "physical injury" to "tangible property."

In *Lamar Homes*, the federal district court in Austin had found that damage to the homebuilder's own work cannot be property damage, because CGL insurance does not exist to repair or replace the insured's defective work. Yeakel found that such an interpretation would transform the CGL policy into a performance bond.

But Medina wrote for the Supreme Court majority, "The CGL policy covers what it covers. No rule of construction operates to eliminate coverage simply because similar protections may be available through another insurance product."

Medina also noted the subcontractor exception to the "your-work" exclusion of coverage for property damage to the insured's own work — an exception that has been included in the insurance industry's standard CGL policy since 1986.

Mid-Continent argued in its brief to the Supreme Court that damage to the insured's own work is not property damage but is a contractual economic loss. But Medina wrote that the CGL policy makes no distinction between tort and contract damages. "[A]ny preconceived notion that a CGL policy is only for tort liability must yield to the policy's actual language," he wrote.

"Plain English, Not Code"

Justice Scott Brister wrote in his dissenting opinion that the DiMares' negligence claims against Lamar Homes in the underlying suit were for allegedly breaching its promises and legal duties as a seller. The claims in *Lamar Homes* are for economic loss, not property damage, he wrote.

"The Court's conclusion to the contrary turns the construction industry on its head. Instead of builders standing behind their subcontractors' work and making necessary repairs, the Court shifts that duty to insurance companies," Brister wrote. Justices Nathan Hecht and Don Willett joined Brister in the dissent.

Medina disagreed, writing, "The dissent's infatuation with the economic-loss rule as a policy-construction tool leads to the conclusion that 'property damage' does not mean what the policy plainly says, but rather is code for tort damages. Texas law, however, requires that insurance policies be written in English, preferably plain English, not code."

In his dissent, Brister contended that the majority relies on the subcontractor exception to the your-work exclusion in the policy to find coverage. "This is a mistake for a simple reason: exclusions cannot create coverage. . . . By finding coverage based on an exception to an exclusion, the Court now has the policy's tail wagging the dog," Brister wrote.

But according to the majority opinion, the dissent ignored changes to the CGL policy over the years. "Contrary to the dissent's accusation, we have not said that the subcontractor

exception creates coverage; rather, it reinstates coverage that would otherwise be excluded under the your-work exclusion," Medina wrote for the majority.

The Supreme Court majority agreed with the 5th Circuit's decision in *Federated Mutual* that "claims for damage caused by an insured's defective performance or faulty workmanship" may constitute an "occurrence" when "property damage" results from the "unexpected, unforeseen or undesigned happening or consequence" of the insured's negligent behavior. As such, the damage stemming from the construction defects alleged by the DiMares in the underlying suit triggers the insurance carrier's duty to defend its insured.

Cunningham says the core of the majority's approach in *Lamar Homes* is what the policy says and what it doesn't say. The issue, Cunningham says, is whether the way the Supreme Court decided *Lamar Homes* has potential implications for other insurance cases pending before the court, including *Fairfield Insurance Co. v. Stephens-Martin Paving*, which raises the question of whether public policy should preclude the insurability of punitive damages.

First-Party Claim?

While the biggest surprise to insurance lawyers who read the *Lamar Homes* opinions was the Supreme Court's decision on the applicability of the prompt-payment statute to an insurer's claim of breach of the duty to defend, the majority opinion deals with that issue the least. The dissenting opinion does not address the issue at all.

John C. Tollefson, who filed an amicus curiae brief in *Lamar Homes* on behalf of Nautilus Insurance Co., says the court gave "short shrift" to the issue of whether the prompt-payment statute applies to the homebuilder's claim.

"That's a major decision," says Tollefson, a partner in Tollefson Bradley Ball & Mitchell in Dallas.

Tollefson says the Supreme Court majority found that the claim in *Lamar Homes* is a first-party claim. "I disagree," he says.

Medina pointed out in the majority opinion that the prompt-payment statute does not define a first-party claim and that Texas cases are divided as to the statute's meaning.

According to the opinion, one line of cases, which generally follow the reasoning of Dallas' 5th Court of Appeals in *TIG Insurance Co. v. Dallas Basketball Ltd.* (2004), holds that an insured's claim for defense costs under a liability policy is not a first-party claim.

As noted in the high court's majority opinion, a conflicting line of cases holds that the insured's claim for defense costs is a first-party claim and that the prompt-payment statute applies when an insurer wrongfully refuses to pay for the defense of its insured. That line of cases reasons that an insured's claim for defense costs under the prompt-payment statute is a first-party claim, because the claim concerns a direct loss to the insured.

"We think that this reasoning is correct because it more accurately reflects the Legislature's purpose for enacting the prompt-payment statute," Medina wrote for the majority.

Hogan says the court's decision that the prompt-payment statute applies to claims such as the one Lamar Homes made is surprising, because the courts of appeals in Texas have ruled the other way. The issue did not come up in oral arguments, she says.

"There was not one question on Article 21.55," Hogan says.

However, federal district courts have held that the prompt-payment statute applies to such claims. For example, in 2005's *Rx.Com Inc. v. Hartford Fire Insurance Co.*, U.S. District Judge Lee Rosenthal of Houston denied an insurer's motion to dismiss a claim under the prompt-payment statute. Hartford had argued that Article 21.55 pertained only to first-party claims, not to an insured's demand for a defense against a third-party suit. Stating that an insured's right to a defense is a first-party right, Rosenthal found that Article 21.55 applied to the duty to defend.

According to Medina's majority opinion, some insurers have argued that a first-party claim is synonymous with a claim under a first-party insurance policy — such as a life, accident or health policy — that typically is payable to the insured or a named beneficiary. But Medina noted that the term "first party" in the prompt-payment statute modifies "claim" and does not limit the nature of the policy or insurer. While the statute exempts certain types of insurance, liability insurance or third-party insurance is not one of those exempted, Medina wrote.

Tollefson says the question now is whether the prompt-payment statute is constitutional. He says a statute that imposes a penalty — such as an 18 percent interest rate — is unconstitutional if it's so vague that a normal person cannot interpret it.

"If you're going to penalize somebody, you have to spell it out," Tollefson says.

Unless Mid-Continent files a motion for rehearing — and Hogan says no decision has been made regarding taking such action — the case goes back to the 5th Circuit for a decision.

But Shidlofsky says the Supreme Court majority essentially has decided the case. Notes Shidlofsky: "In effect, they have not left the 5th Circuit really any discretion. The 5th Circuit is going to have to reverse the district court's opinion."

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The Texas Supreme Court's opinion in *Lamar Homes Inc. v. Mid-Continent Casualty Co.* is online at www.texaslawyer.com. Look for the link within the online version of this article.